AUDITING

QUESTIONS & ANSWERS

DHRUBA DUTTACHOWDHURY

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[Questions & Answers]

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Dhruba Duttachowdhury

Author of 'Cost Audit & Management Audit' and
'Principles of Audit & Internal Auditing'

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NCBA

REGD OFFICE
8/1 Chintamoni Das Lane, Kolkata 700 009, India
email: ncbapvtltd@eth.net

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NCBA (UK) Ltd, 149 Park Avenue North, Northampton, NN3 2HY, UK
email: ncbauk@yahoo.com

EXPORT
NCBA Exports Pvt. Ltd, 212 Shahpur Jat, New Delhi 110 049
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208B Peacock Lane, Shahpur Jat
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Shop No. 15, Bharati Towers, Ground Floor
Forest Park, **Bhubaneswar** 751 001
email: ncbabub@ncbapvtltd.com

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Dedicated to the Loving
Memory of my sister

Usha Kana Roy

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Preface to the Third Edition

In recent years there had been extensive changes in Company Law and also in the domain of Accounting and Auditing Standards. The Government also instituted regulatory measures like compulsory Audit Committee formation and so on.

In view of the above, the author has completely re-written the topics and added new items in the reading materials, and inserted some Appendices — while retaining the core concepts.

DHRUBA DUTTACHOWDHURY

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Preface to the First Edition

There are a number of standard texts on Auditing. These are mostly general type for academic and professional studies.

Thus, the present title is drafted in a question-answer style and addressed to these studies.

This title aims to remove a student's anxiety, overcome his handicaps and shortcomings, and instill in him an air of confidence. It is purely a student oriented tutor-text. Appropriate answers within the time-constraint are a *sine qua non* for success. The book has attempted to take care of this.

The features of this book are that it :

1. Includes a good number of **short answer questions** for better comprehension

2. Explains all necessary **theoretical and practical parts** of the subject in detail.

3. Gives **plenty of references and illustrations** necessary to understand the principles clearly.

4. Incorporates additional topics, such as Govt. audit, audit of Public Undertakings, and audit in EDP environment, etc.

The author is indebted to all standard works on the varied aspects of the subject, and in particular, to the thoughts and commentaries of the leading practitioners published.

The author expresses his deep sense of gratitude to all his colleagues and other educationists (the names are not given as it would be a long list with a chance of omission through inadvertence) who inspired him all through the preparatory stages of the manuscript. The author also thanks those students who pressed for such a book and asked about the progress from time to time.

The author takes full responsibility for all errors of logic and reasoning and of omission and commission, and invites constructive suggestions and criticisms from the readers for further improvement in the future edition.

He also remains grateful to his wife Smt. Tripti Duttachowdhury for her services at all odd hours, and to his son Dibyendu Duttachowdhury for his assistance.

Finally, the author extends his appreciation to Sri Jogendra Nath Sen for guidance, Sri Amitabha Sen for shouldering the responsibility of publication and Sri Arunabha Sen for his sincere endeavour in bringing out the book within the shortest possible time span.

DHRUBA DUTTACHOWDHURY

CONTENTS

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CHAPTER 1

AUDITING — ITS NATURE, SCOPE AND BASIC CONCEPTS

Learning Objectives : *After reading and carefully studying this chapter, the student should* :
- Understand the concepts, fundamental postulates and major components of audit.
- Know what the audit process is all about and of the structural elements of audit findings.
- Appreciate how audit objectives vary with the variations in the audit function.

Q. 1.1 : Define and explain the term : Audit or Auditing.

Ans. : *Definitions :*

The term ‘audit’ or ‘auditing’ has been defined in different ways by different authors. International Auditing Guideline of the International Federation of Accountants, New York, defines the term as follows :“An Audit is the independent examination of financial information of any entity whether profit oriented or not and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon”

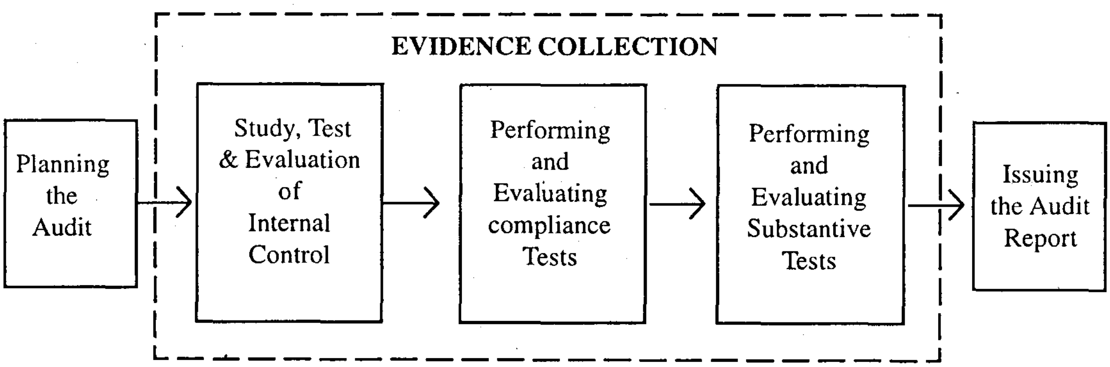
Auditing is the process of checking, vouching and verification. It is the art by means of which an auditor seeks to establish the accuracy or otherwise of the financial records and of the balance sheet or other statement of figures. It is a function based on which an auditor makes a report to express an opinion as to : (i) Whether the accounts furnish the information as required by a statute; and (ii) Whether they give a ‘true and fair view’ of the state of affairs of a business and of the profit for the period under audit.

The above refers to the statutory audits only and does not envision the modern concept of auditing. Keeping in view the wider concept of the term, the definition below (extracted from — ‘A statement of Basic Auditing Concepts’ by American Accounting Association, 1973) appears to be very much relevant and appropriate :

“A systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between these assertions and established criteria and communicating the results to the interested users.”

Q. 1.2 : Prepare a flowchart of the major components of an Audit.

Ans. : *Major components of an Audit : Flow Chart*



The above flowchart represents the major components of an audit in a highly condensed form. The preparation of audit working papers necessary to document the evidential matter collected during the audit is also an important component of the total auditing process.

Q. 1.3 : Enumerate the essential features of Statutory Audit.

[C.U. B.Com. (Hons.), 1993]

Ans. : *Essential Features of Statutory Audit.*

1. Making a critical examination, by a review process, of the systems of book-keeping, accounting and internal controls;

2. Doing such tests and making such enquiries as the auditors consider necessary to form an opinion as to the credibility and reliability of the records as a basis for the preparation of accounts and related financial information and / or statements;

3. Verifying by a method of comparison, the Profit and Loss Account and the Balance Sheet with the underlying records in order to ascertain and ensure that they are in accordance therewith and with the generally accepted accounting principles;

4. Carrying out a critical review and analysis of the Profit and Loss Account and the Balance Sheet in order that a report may be made to the members stating "whether, in the opinion of the auditors, the accounts are, and the items are described in such a way that they show not only a true but also a fair view and give in the prescribed manner the information required by the Act".

Q. 1.4 : Mention in brief the basic functional approaches of auditing.

Ans. : *Functional approaches of auditing* :

The functional approaches of auditing are basically

1. To make a critical review of the systems and procedures in an organisation;

2. To make such tests and enquiries into the results as well as the operation of such systems and procedures, as the auditor may consider necessary to form an opinion;

3. To express that opinion in the accepted phraseology that has been developed; and

4. To ensure that the opinion covers all aspects which are required to be stated by the law or accepted by professional standards.

Q. 1.5 : Distinguish between Accounting and Auditing.

Or,

'Auditing begins where accountancy ends'. Comment, distinguishing between auditing and accountancy.

Or,

"The relationship of auditing to accounting is close, yet their natures are very different; they are business associates not parent and child." — Discuss. [C.U. B.Com. (Hons.), 1991]

Ans. : Accounting involves measurement and communication of business events and conditions as they affect and represent a given enterprise or other entity.

Auditing must consider business events and conditions too, but it does not have the task of measuring or communicating these. Its task is to review the measurements and communications of accounting for propriety.

The function of auditing is essentially dependent on accounting. Auditing is the end-result obtained through checking and verification of accounting data-and information. So, an element of pragmatism is strongly present in auditing which should be viewed 'as the checking of the work of one set of skilled financial accountants by another'. The accounts, after audit and attestation, attain the qualities of truthfulness and fairness, and of reliability and credibility.

The process of preparation of the cost and financial statements is typically referred to as the accounting function. In contrast, an audit is a process of performing certain mechanical. analytical, and judgmental procedures on the accounting data that are summarised in the cost and/ or financial statements.

Q. 1.6 : Is auditing a profession? Discuss.

Ans. : The attributes that characterise a profession are broadly : (1) organisation, (2) socially desirable, (3) education, training and licence, (4) established code of ethics, (5) public recognition, and (6) an opinion expressed on the basis of expert judgement. Each of these characteristics fits well to the auditing as a profession as discussed below :

(1) Organisation : With respect to the practice of public accounting and statutory auditing, the most influential organisations in India are the Institute of Chartered Accountants of India and the Institute of Cost and Works Accountants of India. Again, the activities of these Institutes cover various functional areas of practice, such as auditing, taxation, cost and management accounting services.

(2) Socially desirable : The services rendered by any profession should be of benefit to the society. For auditing, this role is described as "attestation of financial statements", "attestation of cost statements" (by cost auditors). This attest function benefits society and all the interested groups, viz. investors, employees, creditors, fellow businessmen, analysts, community and the government.The need for and social benefit of the attest role fully describe the implications of the characteristic of 'socially desirable' as it relates to auditing as a profession and its contribution to society.

(3) Education, training and licence : The prescriptions of minimum academic qualification for registration as a student, scheme of articleship or apprenticeship, holding of qualifying examinations, continuing education programmes for members, the gradation of membership into Associates and Fellows, certificate of practice as an evidence of basic competence of professional quality in the discipline of accounting and auditing, etc. are essential requirements.

(4) Established code of ethics : The public expects a high standard of behaviour from people in any respected profession. The formal code acts as a guideline to the practising auditors. It provides a message to the public that the practising auditors are willing and are expected to act with integrity and independence.

(5) Public recognition The Institures, viz. ICAI and ICWAI in India have made substantial progress in enhancing this. The Chartered Accountants and Cost Accountants are recognised as professionals.

(6) Opinion expressed on the basis of expert judgement : The desired result of any professional activity is the expression of an opinion based upon expert judgement.The auditor's opinion upon the financial statements (by a statutory financial Auditor, usually Chartered Accountant) and the cost statements (by a statutory Cost Auditor, usually Cost Accountant) of a client are generally prescribed for reporting in which an unqualified opinion is expressed. Other types of opinions — qualified, adverse, and disclaimers — dictate modifications in 'wording' appropriate for the individual reporting situation.

Q. 1.7 : (a) Enumerate briefly the objectives of auditing.

(b) Discuss how audit objectives vary with the variations in the type of emphasis in the conduct of audit functioning.

Ans. : (A) *Objective of Auditing*

The fundamental objectives of auditing are contained in the definition of 'Auditing' (extracted from : 'A statement of basic auditing concepts' by American Accounting Association), which runs as follows :

"A systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between these assertions and established criteria and communicating the results to the interested users".

To state precisely, the objectives of auditing are to ensure that :

1. All transactions that have been recorded have actually occurred;

2. All transactions that occurred have actually been recorded;

3. All assets of an organisation are actually owned by it;

4. All liabilities of an organisation are actually owed;

5. All amounts that have been recorded in the books and accounts of an organisation are reasonably accurate ;

6. Business and economic circumstances in which an organisation operates are fairly reflected in the cost and financial statements ;

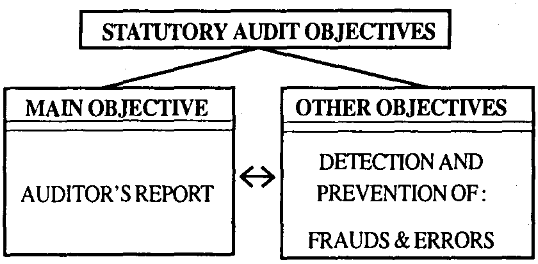
7. Amounts that have been reported in the cost and financial statements are classified correctly ;

8. Amounts are recorded in the accounting period to which they actually relate ; and

9. All information that is relevant has been properly included.

With a view to achieving the aforesaid audit objectives, the procedures adopted by the auditor should be adequate so that the evidential matters obtained during the examination are sufficient for the auditor to arrive at the conclusions concerning the validity of individual assertions embodied in the components of cost and financial statements.

The objectives of statutory auditing can be classified into two categories as under :



(b) *Audit objectives vis-a-vis Audit Function* :

Auditing today like any other evolving function is seen as a control of all controls and its focus has shifted to a varying extent to the more general non-financial areas including the areas of accounting control. In this sense, the objectives of auditing are multi-faced and guided by the function-wise demarcation based on the outlook of the management.

In this respect, it is interesting to note that the mode, manner, scope, and extent of audit examination on a statutory basis may vary from organisation to organisation depending on their affiliation to various laws and enactments (for examples, companies registered under the Companies Act, Banking Companies under the Banking Regulations Act; Charitable trusts governed by different Religious and Endowment Acts, Insurance Companies under Insurance Act, Co-operative Societies under different State Co-operative Societies Act, Corporate Public Bodies under the different Acts of Parliament, Firms under the Partnership Act, etc.) but the objectives of auditing to present a true and fair view of the state of affairs and of the profit or loss for the financial period of an organisation remain the same.

Q. 1.8 : "Auditor is not an Accountant" – Explain.

Or,

'An auditor is not an adviser. His duty is to ascertain and state the true financial position of the company' — Comment. [C.U. B.Com (Hons.), 1991]

Ans. : The principal functions of an accountant are : (i) the compilation of accountrs in a manner that will reflect the state of affairs of the business and; (ii) the interpretation and analytical review of accounts as a service to other functions of the management. On the other hand, an auditor is concerned with the verification of these accounting data to find out their accuracy and reliability, and remains responsible to submit a report of his findings to the persons who appointed him. Thus, the roles played by each of them are distinct and separate. But it is to be noted that the function of an auditor is essentially dependent on the accountant. In short, an auditor performs certain mechanical, analytical, and judgmental procedures on the accounting data that are summarised in the cost and/or financial statements by an accountant.

Q. 1.9 : Auditing does not mean 'ticking' or 'checking totals' — Comment.

Ans. : The given expression underlines that auditing does not confine itself merely to the task of verifying the arithmetical accuracy of the statements of accounts by the routine procedures of 'ticking' or 'checking totals'. It is something more than this. It should inquire into the substantial accuracy and ascertain that the accounting and financial statements have been properly drawn up so as to depict the attributes of truth and fairness, objectivity, disclosure and consistency. It is 'a systematic examination of the books and records of a business or other organisation in order to ascertain or verify and to report upon the facts regarding its financial operation and the results thereof'. It should be undertaken 'to increase the reliability of information where reliability may be defined as congruence between the message transmitted and the reality being described'.

Q. 1.10 : 'Accountancy is a necessity, auditing is a luxury' — Comment, giving reasons for your opinion.

Ans. : The ascertainment of profit or loss of an entity for a given period is necessary for the formulation of managerial decisions. Accountancy is, thus, a necessary function to be undertaken in any enterprise.

Auditing, for a small entity, may be a luxury. But it is a necessity for a large and complex organisation for the following reasons :

(1) Accounting data need to be verified as to their reliability and accuracy ;

(2) Public funds invested in the private sector of economy need to be thoroughly examined as to their proper utilisation ;

(3) Various social groups who are interested in the affairs of a business entity need to be assured that the entity functions are discharged efficiently and to the best advantage of social well-being.

(4) Absentee shareholders created out of widely dispersed ownership of management need to be provided with sufficient assurance that the figures in the Profit and Loss Account and Balance Sheet are fair representations of the financial conditions of a business.

Q. 1.11 : State the principal benefits that can be expected from audit of business accounts. **[C.U. B.Com (Hons.), 1992]**

Ans. : The principal benefits of audit are :

(1) It protects the interests of the workers, owners, investors, creditors and the government for tax purposes.

(2) It provides the information regarding the actual financial conditions and earning capacity of the business to the owners, partners or shareholders.

(3) It affords a basis for (a) settlement of insurance claims against loss or damage, (b) admission or retirement of partners and determination of the claims of deceased partners, (c) settlement of trade union disputes, (d) comparison of current-year financial information with those of previous years, (e) securing additional capital or borrowings, (f) submission of various statutory returns to the government and other public authorities, and (g) determining action in bankruptcy and insolvency cases.

Q. 1.12 : "The concept of an audit is not free from any limitation"— Comment.

Ans. : The concept of an audit suffers from the following limitations :

(1) The auditor of a company is appointed by the shareholders as per the Companies Act. But in reality, he is appointed by the directors and remains responsible to the latter.

(2) The auditor's report, in most cases, depends on the genuineness of the explanations and information given by the client or its responsible officials. Incorrect or inaccurate information affects the report.

(3) The auditor does not guarantee the discovery of all fraud. He cannot approach his work with suspicion or with a foregone conclusion that there is something wrong. He has to believe the tried servants of the company in whom confidence is placed by the company.

(4) The auditor needs to seek opinion of the experts in the areas not falling within his expertise and has to rely upon the certificates issued by engineers or geologists or architects.

Short Answer Questions :

Q. 1 : List the primary concepts of auditing.

A. 1 : There are five primary concepts of auditing. These are :

(1) Evidence ;

(2) Due audit care ;

(3) Fair presentation as to —

(a) Accounting propriety (*i.e.*, accounting methods and financial statements presentation should be in accordance with the generally accepted accounting principles),

(b) Adequate disclosure and

(c) Audit obligation ;

(4) Independence and

(5) Ethical conduct.

Q. 2 : 'Audit is an instrument of financial control' — Comment.

Or,

'Auditing may be defined as Accounting Control' — Comment.

A. 2 : 'Audit' involves the process of checking, vouching, verification and confirmation of accounts. It appraises the propriety of expenditure incurred. It ensures the reporting of facts based on the accounts maintained. In this sense, it acts as a control device against fraud, irregularities, extravagence, etc. on the part of the firm's employees in the use of funds and assets.

Q. 3 : State the prime objective of an audit.

A. 3 : The prime objective of an audit is to enable an auditor to express an opinion on the financial statements (e.g. balance sheets, income statements, profit and loss statement, etc.).

Q. 4 : What does the auditor's opinion seek to achieve ?

A. 4 : The auditor's opinion helps establish the credibility of the financial statements.

Q. 5 : 'The user should not assume that the auditor's opinion is an assurance' — identify the circumstances.

A. 5 : The auditor's opinion is not an assurance as to : (a) the future viability of the entity; and (b) the efficiency or effectiveness with which management has conducted the affairs of the entity.

Q. 6 : How does the auditor determine the scope of an audit of financial statements ?

A. 6 : The auditor normally determines the scope of an audit of financial statements in accordance with the requirements of legislations, regulations or relevant professional bodies.

Q. 7 : How does the auditor assess the reliability and sufficiency of the information contained in the underlying accounting records ?

A.7 : The auditor assesses the reliability and sufficiency of the accounting information by : (a) making a study and evaluation of accounting systems and internal controls and testing those internal controls to determine the nature, extent and timing of other auditing procedures and (b) carrying out certain tests, enquiries and verification procedures of accounting transactions and account balances as appropriate in the particular circumstances.

Q. 8 : Indicate the most important factor that contributed to the audit requirement in a limited company.

A. 8 : The audit requirement in a limited company grew out of the divorce of the ownership of the usage of funds.

Q. 9 : Lst the four individual causes of distortion of facts in 'Fair-presentation' which an audit function seeks to eliminate or minimise at least.

A. 9 : (i) Personal bias, (ii) Self-interest, (iii) Carelessness and (iv) Dishonesty, on the part of an individual.

Q. 10 : What is the Latin word from which the word 'Audit' originates and what is the meaning of that Latin word ?

A. 10 : The word 'Audit' originates from the Latin word '*audire*' which means '*to hear*'.

Q. 11 : State two secondary (or subsidiary) objects of audit.

A. 11 : Two secondary objects of audit are : (i) detection of errors and fraud and (ii) prevention of errors and fraud.

CHAPTER 2

AUDITING IMPLICATION REGARDING FRAUD AND ERROR

Learning Objectives : *After reading and carefully studying this chapter, the student should* :

- Understand the meanings attached to the terms — fraud and error.
- Be familiar with the auditing practices when there is a possible evidence of fraud.
- Be aware of the auditor's responsibility in this regard.

Q. 2.1 : "Public impression of auditing is that it is something designed to seek out frauds and errors". — Comment.

Ans. : Until the beginning of the 20th century, the detection of errors and prevention of fraud were the major objectives of auditing. But the objectives of modern auditing are not simply to guarantee the accuracy of the accounts against fraud and error. The auditing function attempts to ensure, via the medium of current disclosure requirements and reporting standards, that the information contained in the accounts is relevant and objective to meet the needs of the shareholders. In view of the apparent misconceptions which exist in the public mind concerning the nature and objectives of audit, International Auditing Guideline on fraud and error states that "the responsibility for the prevention and detection of fraud and error rests with the management. The responsibility is fulfilled principally through the implementation and continued operation of an adequate system of internal control". But at the same time, the guideline observes that,

(i) the audit should seek reasonable assurance that fraud or error which is material to the financial information has not occurred;

(ii) if fraud or error has occurred, it is either properly accounted for or corrected;

(iii) the audit planning should have a reasonable expectation of detecting material mis-statements in the financial information resulting from fraud or error;

(iv) the audit examination being based on the concept of selective testing, some material mis-statement of the financial statements resulting from fraud or error, if either exists, will not be detected; and

(v) When fraud is coupled with certain acts on the part of certain members of the management and designed to conceal it, such as collusion, forgery, or failure to record transactions, these acts are intentional misrepresentations which are difficult and impossible to detect.

However, it is important to note that an independent audit should be performed with an attitude of professional skepticism recognising that conditions or events ...... could lead (the auditor) to question whether fraud or error exists.

Q. 2.2 : (a) Define and explain the terms : Fraud and Error.

(b) Give example as to conditions or events which may indicate the possible existence of fraud or error.

(c) Briefly describe the auditing practices when evidence indicates that fraud or error may exist.

Ans. : (a) *Definitions :* **Fraud** That encompasses an array of irregularities and illegal acts characterised by intentional deception. Examples are : Sale of fictitious assets, improper valuation of transactions, assets, liabilities or income.

Intentional misrepresentations of financial information by, one or more individuals among management, employees, or third parties.

Errors Unintentional mistakes in cost and / or financial statements, including —

1. Mathematical or clerical mistakes in underlying records and accounting data,
2. Mistakes in the application of accounting principles and
3. Oversight or misinterpretation of facts that existed at the time financial statements were prepared.

(b) *Conditions or events indicating the possible existence of fraud or error* :

The following examples may be cited :

1. Question with respect to the integrity or competence of management :
   - (i) An individual or a small group dominates.
   - (ii) Audit board or committee is absent.
   - (iii) The corporate structure is complex, thereby complexity in operations.
   - (iv) There is no attempt to rectify major weakness in internal control.
   - (v) The rate of executive turnover is high, especially of key accounting and financial personnel.
   - (vi) The auditors are frequently changed.
2. Unusual pressure within an entity :
   - (i) High incidence of business failures.
   - (ii) The shortage of working capital for a number of times.
   - (iii) Unusually high risk-taking for credit sales and frequent changes in business practice.
   - (iv) Increased dependence on one or few products or customers by an entity.
   - (v) The accounting personnel are being constantly pressurised to complete accounting statements in an unusually short time span.
3. Unusual transactions :
   - (i) Unusual transactions, especially near the year-end.
   - (ii) Transactions made with related parties.
   - (iii) Unusually large payments relating to professional services, for example, to consultants, agents, solicitors or others.
4. Others :
   - (i) Inadequate records, e.g., incomplete records, excessive adjustments to records and reports.
   - (ii) Inadequate documentation of transactions, such as absence of authorisation, non-availability of original invoice, alteration to documents, etc.
   - (iii) Conflicting audit evidences, audit confirmations with third parties not tallying with the accounts in many cases etc.
   - (iv) Evasive or unreasonable replies by management to audit enquiries.

(c) *Auditing Practices* :

1. In case the suspected fraud or error is believed to have a material effect on the financial information, the auditor should judge the following factors to decide the extent of procedures :
   - (i) the types of fraud or error that could occur;
   - (ii) the relative risk of their occurrance;
   - (iii) the likelihood that a particular type of fraud or error could have a material effect on the financial statement.

2. If the above procedures fail to support or dispel a suspicion of fraud or error, the auditor should consider issuing a report on the financial statement. About the form and content of his report, the auditor should pay due consideration to the relevant laws and regulations and obtain legal advice, if necessary.

3. Substantive tests — An instance of fraud or error should not be assumed, unless circumstances clearly indicate. If fraud or error should have been prevented or detected by the system of internal control, the auditor should reconsider his prior evaluation of that system.

4. Reliability reconsideration — The auditor should reconsider the reliability of any representations made by a management member to him, when he believes that a fraud or error involves a member of management.

5. Communication to management — The auditor should communicate his findings to management on a timely basis if : (i) he believes that a fraud may exist, or (ii) fraud or significient error is actually found to exist.

While making such communication, the auditor should :

(i) report the matter to a level in the organisation structure above those responsible persons who are believed to be implicated; or

(ii) seek legal advice in the determination of procedures to follow when he doubts those persons ultimately responsible for the overall activities of an entity.

Q. 2.3 : What are the different classes of errors and frauds that are usually found in auditing of accounts ? Discuss them. To what extent, an auditor may be held responsible for the non-detection of such errors and frauds ?

Ans. : (A) *Different classes of Errors :*

In auditing the accounts of a firm, the following classes of errors are usually found —

1. *Error of Omission* : It is a kind of clerical or technical error, where a transaction is omitted either wholly or partially while making entries in the books of account. It may arise either due to carelessness and oversightedness on the part of the accounts assistant or due to ulterior motive of the accounts personnel to misappropriate cash and goods. The latter types of errors are difficult to be located even by an auditor. The auditor in these cases should : (i) vouch the records of purchases, sales, etc.; (ii) examine relevant correspondence; and (iii) verify the stock physically.

2. *Error of Commission* : It is a kind of clerical or technical error, where a transaction has been recorded incorrectly, either wholly or partially. Inaccuracy in calculations, postings, castings, extensions and carry forwards results in such errors. This kind of error may be intentional or unintentional. Mistakes in totalling, casting, posting or balancing an account are not deliberately done and thus they have an effect on the trial balance. If there is a mistake in the Sales invoice, the same mistake will appear in the original books as well as in the ledgers. So, such error cannot be detected in the trial balance. The auditor, thus, should : scrutinise the invoices, vouch the books of original entry, and check the totals and extensions to detect errors, if any.

3. *Compensating Error*: This is a kind of clerical or technical error. This is also known as 'off-setting error'. In this case, one error is compensated by other error. These errors usually have the following peculiariites, such as —

(i) wrong debit entry being balanced by another wrong credit entry, or vice-versa;

(ii) over-casting of an account being balanced by the undercasting of another account to the same extent;

(iii) under or over-cast balances of debit and credit by the same amounts; etc.

So, these errors are difficult to be detected by a trial balance. These errors, depending on the types, may or may not affect the Profit and Loss Account. The auditor, in order to find out such errors, should undertake exhaustive scrutiny and check the totals, castings and postings.

4. *Error of Principle* : Such error may be intentional or unintentional. When transactions are recorded in the books of original entry in disregard to the generally accepted accounting principles, these errors arise. The following cases are examples of such errors :

(i) Incorrect allocation between revenue and capital expenditure.

(ii) Recording capital expenditure as revenue expenditure, or vice-versa.

(iii) Over-valuation or under-valuation of stocks.

(iv) Provision of depreciation in the accounts in complete disregard of the relevant rules.

(v) Non-consideration of outstanding assets and liabilities in the accounts.

(vi) Valuation of assets in a way contrary to the accounting principles.

These errors do not affect the trial balance and thus, are difficult to trace out by simple means of routine checking. The auditor should, therefore, be critical and vigilant. He should undertake a searching inquiry and independent methods of check for the detection these errors.

5. *Error of Duplications* : When an entry is made twice in the original books as well as in the ledgers, and error of duplication is said to have been committed. Such error does not affect the trial balance as both the debit and credit aspects are posted twice in the ledger. So, the auditor should vouch the entries with the voucher with a view to ascertaining whether any entries remain unvouched.

(B) *Different classes of Frauds* :

Fraud may be perpetrated in various ways. We may classify them into three main categories as follows :

1. *Embezzlement of cash* : This may take place in one or more of the following ways :

(a) Omission of cash receipts, e.g., cash sales not recorded, casual receipts of miscellaneous nature not entered, sale proceeds of fully-written off assets not recorded, etc.

(b) Recording of less amounts than that actually received.

(c) Inclusion of fictitious payments in the cash book, e.g., wages paid to 'ghost' or 'dummy' workmen, salaries paid to apprentices whose tenure of service expired, etc.

(d) Recording of more amounts than that actually expended, e.g., discounts or rebates not taken into account while making payments, etc.

Since the chances of fraud of this natute are more in big establishments, the independent auditor should examine the extent and effectiveness of the system of internal checks existing in the organisation.

2. *Misappropriation of goods* : This involves pilferage of stores and stocks. Articles of smaller sizes but of higher value are generally susceptible to theft and pilferage. The auditor should check the methods of : (a) accounts kept, (b) stock taking, (c) periodical stock verification, etc. He should also examine the effectiveness of the existing systems of internal controls and internal checks.

3. *Manipulation of accounts* : This is generally committed by the higher levels of management with the object of fulfilling their vested interests. The falsification of accounts also comes under this category. The following types of vested interests are commonly found :

(a) Showing more profits than the actual to get more commission, to pay higher dividends, to obtain higher bank loans and credit facilities and to give a rosy picture before the shareholders for the sale of more number of shares, etc.

(b) Showing less profits than the actual to deceive shareholders and creditors and bankers, to reduce income tax burden, and to give a wrong impression to the competitors about the success of the firm.

The falsification of accounts is done in one or more of the following ways :

(a) under or over-valuation of stocks,

(b) false entries of sales or returns or purchases,

(c) providing more or less depreciation, or non-provision of depreciation,

(d) booking capital expenditure to revenue account, or vice-versa, etc.

As these frauds are committed by the trusted officials of a firm, the auditor should undertake the work of vouching very seriously and his inquiries about these matters should be made tactfully.

(C) Auditor's Responsibility for non-detection of errors and frauds :

While conducting an audit, the auditor should bear in mind the possibility of the existence of fraud or other irregularities in the accounts under audit. The responsibility of the auditor for failure to detect fraud (which responsibility may differ as to clients and others) arises only when such failure is clearly due to his not exercising reasonable skill and care.

The duty of safeguarding the assets of a company is primarily that of the management. The auditor is entitled to rely upon the safeguards and internal controls instituted by the management, although he will, of course, take into account any deficiencies he may note therein while drafting his audit programme. If an audit is to be conducted with the object of discovering frauds, in the first place it would take a considerable time and it would not be possible to complete the audit within the time limit prescribed by law for the presentation of accounts to the shareholders.

If after the auditor has completed his audit a fraud is discovered pertaining to that period, it does not necessarily mean that the auditor has been negligent or that he has not performed his duties competently. The auditor does not guarantee that once he has signed the report on the accounts, no fraud exists. If he has conducted his audit by applying due care and skill in accordance with the professional standards expected of him and has exercised reasonable skill and care, the auditor would not be held responsible for not having discovered that fraud.

Q. 2.4 : "Fraud does not necessarily involve misappropriation of cash or goods." Discuss giving illustrations.

[C.U. B.Com (Hons.), 1991, 1994]

Ans. : See : Q.2.3 — Part 3 of (B).

Q. 2.5 : Give examples of errors which might exist in the books of account even after the agreement of the Trial Balance. State the steps to be taken by an auditor to detect them.

Ans. : Even after the agreement of the trial balance, the following types of errors (as illustrative examples) might exist in the books of account.

Errors of Omission :

(i) With the omission of a particular purchase transaction, there are corresponding omissions of 'debit'entry in the Purchase Account and 'credit' entry in the Supplier Account. That means, both the debit and cerdit aspects are equally omitted and the trial balance continues to agree.

Auditor's duty : He should check the debit balance of the Suppliers Account and scrutinise the party's ledger to see whether payment to the supplier has been made.

(ii) There is an omission of both the debit and credit entries in the ledger even when the transaction is recorded in the books of original entry. So, trial balance agrees.

Auditor's duty : He should compare the original books with the ledgers to verify whether any item was omitted for posting in the ledger.

Errors of Commission :

(i) With the wrong entry of a particular purchase transaction in the Purchases Day Book, there are corresponding wrong debit entry in the Purchases Account and wrong credit entry of the same amount in the Suppliers Account. Hence, trial balance continues to agree with the equal wrong amounts in both debit and credit sides.

Auditor's duty : He should vouch the purchases with the original invoices and advise rectifications wherever necessary.

(ii) With the recording of a particular purchase transaction wrongly in the Sales Day Book, the Suppliers Account is debited and Goods

Account credited. In fact, the entries should have been the other way round. This wrong accounting does not affect the trial balance.

Auditor's duty : He should compare the Purchases or Sales Day books with the original documents for each of the transactions.

Compensating Errors :

(i) The wrong total of purchases day book shows an excess by Rs. 400 (say). So, the debit to Purchase Account is more by Rs. 400. Similarly, for some of the ledger accounts, let us assume that the Commission Account (credit side) was wrongly totalled more by Rs. 200 and the Travelling Expenses Account (debit side) wrongly totalled short by Rs. 200. These three mistakes are different. The position appears as under :

	Excess Debit	Excess Credit
Purchases A/c	Rs. 400	—
Commission A/c	—	Rs. 200
Travelling Expenses A/c (Short debit)	—	Rs. 200
	Rs. 400	Rs. 400

As a result, the trial balance agrees.

Auditor's duty : He should check up the totals, postings and castings of ledger accounts.

Q. 2.6 ; When called upon to discover the errors responsible for the disagreement of a trial balance, how would you proceed with your work ?

Ans. : The auditor, when called upon to discover the errors responsible for the disagreement of a trial balance, should proceed along the following lines :

1. Check up the totals of the trial balance. The totals drawn up may be wrong.

2. Compare : (a) the names of the accounts heads in the ledger with those recorded in the trial balance and (b) the accounts' items appearing in the trial balance between the current and previous years to find out any omissions.

3. Check up the totals of Debtors and Creditors and compare them with those appearing in the trial balance.

4. Examine the balances of subsidiary books (e.g., purchases / Sales day books, Cash book, etc.) and of the ledger accounts and compare them with the trial balance.

5. In case of the accounts books maintained under Self-balancing system, check up the totals of various accounts as well as the grand total of these accounts and compare the account balances with the figures taken in trial balance.

6. See whether there is any account item the value of which might be equal to the half of the trial balance difference and then verify if any debit balance included in the credit side of the trial balance or viceversa.

7. Examine the Ledger accounts' opening balances with the last year's trial balance and see whether the difference is equal to the difference in the closing balance also.

If the error cannot be detected in spite of the above checks, the following steps should be undertaken :

1. Whether there has been misplacement of figures, e.g., 64 for 46, 18 for 81, or 32 for 23 and so on.

2. Whether the difference is for a round sum of figure which may be due to wrong totalling.

Short Answer Questions :

Q.1 : What are the different kinds of fraud (Give names only) ?

A.1 : See : Q. 2.3 (Fraud).

Q.2 : What is an error of principle ? Give an example.

A.2 : See : Q.2.3 (4). First part.

Q.3 : How fraud can be perpetrated through manipulation of accounts (Give three examples) ?

A.3 : See : Q. 2.3 — Part 3 of (B).

Q.4 : What types of errors are reflected in a trial balance ?

A.4 : Errors of omission and errors of commission are reflected in a trial balance.

Q.5 : What types of errors are not easily traceable through the trial balance ?

A.5 : Errors of Principle, Errors of Duplication and Compensating errors are not traceable easily through the trial balance.

Q.6 : What is the effect on the trial balance in case the amount of a purchase transaction is wrongly entered into purchase book ? Classify this error.

A.6 : There is no effect on the trial balance as the Purchase A/c is debited with a wrong amount and the Supplier's A/c is credited with same wrong amount.

This is an *error of commission.*

Q.7 : X's A/c was credited by Rs. 200 instead of Rs. 2000. Y's A/c was debited by Rs. 200 instead of Rs. 2000. Classify the error and indicate effects on the trial balance.

A.7 : The positions are : short credit of Rs. 1800 in X's A/c, short debit of Rs. 1800 in Y's A/c, and the amounts are same. So, these are compensation errors. Both sides of the trial balance are equally affected.

Q.8. : A's A/c is debited more by Rs. 60 and an amount of Rs. 60 as rent received is posted twice in Rent A/c. Classify the errors and determine their effect on the trial balance.

A.8 : The positions are : excess debit in A's A/c, excess credit in Rent A/c, and the amounts are equal. Thus, these are compensating errors. Both sides of the trial balance being equally affected, the trial balance will agree.

Q.9 : Embezzlement of cash is possible by :

(a) omitting to enter any cash receipts, or entering less amount than that actually received ; and

(b) making fictitious entries, or entering more amount than that actually paid in the cash.

Identify the records and documents that the auditor should check in order to discover such frauds.

A.9 : In order to discover these frauds, the auditor should check the following records and documents :

(a) Main Cash book, Rough book of Cash receipts, Cash memos, Counterfoils of receipt books, Agents' returns, etc.

(b) Wages and Salary Registers, Cash book, Payroll sheets, Cash vouchers, Invoices, etc.

Q.10 : What is 'window dressing' ? Explain with illustration.

[C.U. B.Com (Hons.), 1991]

A.10 : Window dressing is an artificial practice to present financial position better or favourably than what it is. Misrepresentation of financial transactions such as : goods-in-transit not recorded but shown as sales, revenue expenses recorded and shown as capital expenses, etc., are the examples of 'window dressing'.

Q.11 : What is the main difference between Fraud and Window-dressing?

A.11 : 'Fraud' involves the deliberate recording of fictitious transactions with the intention of cheating others. On the other hand, 'Window dressing' is of the nature of misrepresentation of financial transactions or statements better than what it is.

Q.12 : What do you mean by : (i) Fraud detection, (ii) Fraud deterrence, (iii) Fraud investigation and (iv) Fraud reporting ?

A.12 : Fraud Detection : Consists of identifying indicators of fraud sufficient to warrant recommending an investigation. These indicators may arise as a result of controls established by management, tests conducted by auditors and other sources both within and outside the organisation.

Fraud Deterrence : Consists of those actions taken to discourage the penetration of fraud and limit the exposure if fraud does occur.

Fraud Investigation : Consists of performing extended procedures necessary to determine whether fraud, as suggested by the indicators, has occurred. It includes gathering sufficient evidential matter about the specific details of a discovered fraud.

Fraud Reporting : Consists of the various oral or written, interim or final, communications to management regarding the status and results of fraud investigations.

Q.13 : Distinguish between 'errors' and 'irregularities' as used in audit parlance.

A.13 : Errors : Unintentional mistakes in financial statements, including —

1. Mathematical or clerical mistakes in underlying records and accounting data,
2. Mistakes in the application of accounting principles, and
3. Oversight or misinterpretation of facts that existed at the time financial statements were prepared.

Irregularities : Intentional distortions of financial statements, such as :

1. Deliberate misrepresentation by management (management fraud); and
2. Misappropriation of assets (defalcation) which may result from —
   (a) misrepresentation or omission of the effects of events or transactions,
   (b) manipulation, falsification or alteration of records or documents,
   (c) omission of significant information from records or documents.

CHAPTER 3

AUDITING TECHNIQUES & PRACTICES

Learning Objectives : *After reading and carefully studying this chapter, the student should :*

- Understand the concepts of auditing standards / techniques / procedures, and of 'materiality' in audit.
- Be acquainted with the different types of audit and their distinctive characteristics.

Q. 3.1 (a) Distinguish between : Auditing Principles and Auditing Techniques.
(b) Explain why auditing techniques are subject to change though auditing principles may remain constant.

[C.A. Inter, May '89-adapted]

Ans. : (a) *Distinction* :

By 'Auditing principles' we mean the basic principles — (i) that guide the auditor in his audit task, and (ii) that govern an audit function.

Auditing principles are based on certain standards and consist of ten formal standards or principles categorised under the following three groups :

1. General (Competence, independence and due care on the part of an auditor).

2. Field-work (Planning and supervision, internal control and evidential matter).

3. Reporting (Accounting principles, consistency, disclosure and reporting obligation).

Auditing techniques, on the other hand, refer to —

(i) the devices or methods available to the auditor for obtaining evidential matter sufficient to form conclusions on the validity of the assertions, and

(ii) the acts or procedures to be performed by the auditor — such as, reviewing, inspecting and confirming.

Auditing techniques may include audit programme, audit guides, audit work division and staff assignment, audit note book, audit sampling, analytical review procedures, audit software, etc.

Thus, we can state that :

(1) Auditing principles give guidance on the auditing techniques or procedures to be applied.

(2) Compliance with auditing principles is achieved through the application of auditing techniques or procedures appropriate to the particular circumstances.

(3) Auditing techniques are the means of applying the auditing principles in practice.

(b) *Auditing Techniques change but Principles do not* :

Auditing principles are comprehensive, generally accepted, and laid down by the professional bodies, like Institute of Chartered Accountants of India (for statutory financial audit), Institute of Cost and Works Accountants of India (for statutory Cost audit), Institute of Company Secretaries of India (for statutory secretarial audit), etc. An individual auditor cannot change these principles and is committed to follow them. Again, irrespective of the classifications of audit : statutory or non-statutory, continuous or interim or periodical, partial or total, external or internal, the auditing principles are common. These principles do not even change with the category to which an organisation belongs (e.g., sole trader, partnership, co-operative, limited company).

But the auditing techniques are subject to change due to the following, among others —

(i) Class to which an organisation belongs (e.g., sole trader, partnership, co-operative, company).

(ii) Nature of business entity (e.g., trading, industrial, commercial, constructions, etc.)

(iii) Size, scale and complexity of operations (i.e., small, medium, large).

(iv) Statutes that govern the business (e.g., Central or State laws, Acts relating to Banks, Insurance, Electricity, Co-operative Societies, etc.).

(v) Methods of accounting — their changes and improvements, such as mechanisation and computerisation of accounting systems and records.

(vi) Auditor's experience and skill and his own work methodology.

Q. 3.2 : "If techniques are improper, the audit will fall below recognised standards of performance".

1. **Define and explain the term : Auditing techniques.**
2. **Distinguish 'auditing techniques from 'auditing procedures'.**
3. **List and explain with suitable illustrations : (a) Basic techniques of auditing and (b) Principal procedures of auditing.**

Ans. : 1. *Auditing Techniques* : The devices or methods available to the auditor for obtaining competent evidential matter.

To an auditor, auditing techniques are the working tools used and applied for identification and examination of those evidences which have been traced by audit procedures.

2. *Distinction* : We can draw distinctions between auditing procedures and auditing techniques as follows :

(i) An all-inclusive list of audit procedures cannot be prepared as these are addressed to the varying audit objectives; but such list can be outlined for audit techniques.

(ii) 'Auditing procedures are ways of applying (auditing) techniques to particular phases of a particular audit'.

(iii) 'The procedures (of audit) adopted in different engagements result from the judicious application of the available techniques (of audit)'

(iv) Audit procedure, in fact, is concerned with the general assertions like : existence or occurrence, rights and obligations, completeness, valuation or allocation and presentation and disclosure that may be made regarding an account; whereas audit techniques are concerned with the examination of those evidences which have been traced as such by audit procedures.

3. (a) *Basic Techniques of Auditing* : There are ten basic auditing techniques (as listed by Prof. Mautz):

(1) Physical examination and count — All physical items actually on hand, in transit, or on consignment that are represented in the books of account can be actually examined by personal inspection to ensure that they actually exist at a given date.

(2) Confirmation — The existence and ownership of items held on consignment or in public warehouses are capable of being confirmed by having communication with the consignors or warehouse owners. Similarly authenticity, validity and accuracy of any transaction can be established through confirmations received from banks and other creditors and minutes of the board of directors.

(3) Examination of authoritative documents and comparison with records — The documents duly signed by persons in authority, such as sales invoices, inventory lists, etc. can be examined with approved price lists and purchase invoices for value extensions and compared with accounting records to obtain authenticity of transactions in respect of entries, postings and balancing. This is known as 'vouching'.

(4) Recomputation —Arithmetically worked out balances of accounts are verified both as to their arithmetical accuracy by recomputation and with respect to the relevant factor chosen. For example, inventory values may be checked by recomputation under any one of several assumptions as to the flow of cost factors (such as, FIFO, LIFO, Average).

(5) Retracing book-keeping procedures — The genuineness and consistency of various accounting entries or account balances can be subjected to the process of verification by tracing back to the source book-keeping records. For example, closing balances in the balance sheet are retraced into the ledger of the succeeding period.

(6) Scanning — This involves a critical examination of any transaction, event, record or evidence. A sales ledger, for example, is scanned when all its posting details are noted and then critically appraised to observe characteristic features.

(7) Inquiry — This is a technique of obtaining an answer to a pertinent question.

(8) Examination of subsidiary records — The reliability obtained through the examination of records like : vendor invoices, material issue requisitions, shipping records and so on, can support the inventory account.

(9) Co-relation with related information — This is similar to analytical review. The use of co-relation method assists the auditor to determine that a proper inventory cut-off has been made. Similarly an analytical review of the inventory balance in relation to sales, production, shipments and purchases for the current period and /or with prior periods provides good audit technique.

(10) Observation of pertinent activities and conditions — Normally at year end, inventory quantities are counted by the client. The accuracy and validity of these quantities can be obtained by the auditor by observation of this pertinent activities.

3. (b) *Principal Procedures of Auditing* : The following may be cited as the principal audit procedures :

(1) Reviewing, testing and evaluating the internal accounting controls relating to inventories, purchases, payroll, sales invoice preparation, stock valuation, depreciation accounting and analysis, routing of invoices, etc.

(2) Inspecting, counting and calculating the different assets relating to cash, stocks, investments, plant and equipment, furniture and determining that the inventory is calculated properly at the lower of cost or market price in accordance with generally accepted accounting principles consistently applied and obtaining confirmation in regard to the validity of debtors and creditors balances, etc.

(3) Obtaining the proof of accuracy — A copy of final inventory listing can be obtained and its clerical accuracy checked and tested; obtaining the earnings records of employees and checking the same for accuracy with the original copies of appointment-cum-increment letters.

(4) Reconciling, comparing and confirming — Sales invoices may be reconciled with the total charges to customers. The reconciliation between the cost accounts records and the books of financial accounts is an illustration. The Bank Reconciliation Statement provides a good measure of confirmation.

(5) Observation and inquiry about any excess, slow-moving, obsolete, or unsaleable inventory.

(6) Accounting of all pre-numbered inventory tags before and after the physical stock-taking.

(7) Verification as to the evidences relating to the ownership of assets and existence of assets and liabilities, as a part of auditing practices and procedures, is the principal duty of the auditor before he certifies that the assets and liabilities that appear in the balance sheet exhibit 'true and fair view' of the state of affairs of the business.

Q. 3.3 : What do you understand by the term : Audit Evidence?

Ans. : *Definition and concept* :

"Evidence, for auditing purposes, consists of nothing more than facts in some form which have an inherent objective proposition that tends to influence the auditor's mind". Thus, the term denotes that audit evidence should not be fictitious based on imagination. It should be a reflection of realities found during the course of an audit. It should be such that is complete, accurate and valid in all respects in relation to the data produced by the accounting system.

Q. 3.4 : Enumerate the various types of : 'Audit Evidence' and explain how the Auditor can make use of them.

Ans. : Although anything concerning the business operations of an organisation may influence the judgement of the auditor, *the main types of audit evidence* can be outlined under two categories :

1. Audit Evidence (analytical),
2. Audit Evidence (corroborative).

Outline charts are given below :

- Analytical Evidence (entity organisation)
  - Diagnostic Analysis overall relationship between transaction and knowledge of the business operation resulting in transactions.
  - Internal Control Evaluation The method or means of processing transactions.
- Corroborative Evidence (entity activity)
  - Test of transactions-documents support for transactions.
  - Test of balance testimonial or observation support for the end result or outcome of an aggregate of transactions.

Analytical evidence : Consists of general and special journals, general subsidiary ledgers, reconciliation statements, accounting data, allocation analysis sheets for the relevant period and any other records and analysis that substantiate the data appearing in the cost and financial statements, etc.

Corroborative evidence : Consists of vendor's invoices, confirmation, cancelled cheques or similar documents and any procedures performed primarily by the auditor. It provides the auditor with information to determine whether a transaction is authentic, duly processed and reported.

There are several specific types of audit evidence the auditor may adopt while conducting an audit. Each type varies as to its degree of relevance depending upon the accounting transaction or the account being investigated. Arons and Lobbecke give a list of **seven types of audit evidence :** Physical examination, Confirmation, Documentation, Observation, Inquiries of the client, Mechanical accounting, Analytical tests.

Prof. R. K. Mautz listed **nine types of audit evidence** which are as follows :

(1) Physical examination by the auditor of the thing represented in the accounts.

(2) Statement by independent third parties —

(a) Written and (b) Oral.

(3) Authoritative documents :

(a) Prepared outside the enterprise under examination,

(b) Prepared inside the enterprise under examination.

(4) Statement by officers and employees of the company under examination :

(a) Formal, (b) Informal.

(5) Calculation performed by the auditor.

(6) Satisfactory Internal control procedures.

(7) Subsequent actions by the company under examination and by others.

(8) Subsidiary or detailed records with no significant indications of irregularity.

(9) Interrelationship within the data examined.

Q. 3.5 : Discuss the various methods by means of which an auditor can obtain 'audit evidence'.

Ans. : The auditor obtains his 'audit evidence' in the course of his audit through the performance of compliance and substantive procedures by one or a combination of the following methods :

1. Inspection,
2. Observation,
3. Inquiry and Confirmation,
4. Computation and
5. Analytical Review.

The application of these procedures will, of course, depend partly upon the period of time during which such audit evidence is sought for and is available.

1. **Inspection :** It consists of examination of records, documents or tangible assets. It therefore involves examination of the statements by the third parties and of the authoritative documents prepared inside and outside the organisation, etc. and also physical verification of petty cash, cash certificates or tangible assets, e.g., plant and machinery, equipment, goods, etc. Inspection of records and documents, thus, provides evidences of varying degrees of reliability depending on their nature and source and the effectiveness of internal controls existing with respect to accounting systems. *Three major categories of documentary evidence,* indicated below, provide different degrees of reliability to the auditor.

(a) Documentary evidence created and held by the third parties.

(b) Documentary evidence created by the third parties and held by the organisation.

(c) Documentary evidence created and held by the organisation.

Inspection of tangible assets does not necessarily provide an evidence as to ownership and value.

2. **Observation :** It consists of looking at a system or procedure being performed by the client's personnel. For example, the auditor may observe the stock-taking of inventories by the client's personnel or the performance of internal control procedures that leave on 'audit trail or the actual disbursement of salaries and wages to client's personnel. etc.

3. **Inquiry and Confirmation :** It consists of obtaining appropriate information from the knowledgeable persons inside or outside the organisation. Inquiries may be of two types formal, addressed to the third parties and informal, generally oral, addressed to the insiders. Responses to such inquiries would provide the auditor corroborative evidence. Inquiries and confirmation received from the company's solicitor with respect to ownership of assets and properties can give reliable evidence. Similarly, the auditor may also obtain corroborative evidence as to book debts by requesting confirmation of receivables by direct communication with the debtors.

4. **Computation :** It consists of checking the arithmetical accuracy of source documents and accounts or doing independent calculation so as to constitute a verification of the client's calculations.

5. **Analytical Review :** It consists of studying the significant ratios and trends, and investigating unusual fluctuations and items.

Q. 3.6 : (a) Define and explain the concept of 'Materiality' in audit. (b) State the circumstances or indicators that have a bearing on the questions of 'Materiality'.

Ans. : (a) *Definition :* The concept of materiality is closely related to that of truth and fairness. It is essentially a matter of professional judgement. Materiality may be defined as a 'state of relative importance'. The state of 'relative importance' is understood in varying dimensions in relation to time, place, and circumstance. So, the perception about materiality varies from auditor to auditor. What is material in one environment may be quite immaterial to another environment. It is difficult to draw a boundary line to judge a particular item as being material or immaterial. Materiality depends on some allied factors that guide and evaluate the particular items of expenditure or incident or happening as being material or immaterial. Generally, an item is considered as material if there is a reason to believe that knowledge of it could reasonably be deemed to have influenced the decision or attitude of an informed investor i.e., if it alters the true and fair view. So, to have a demarcation between the two (i.e., materiality and immateriality), much depends on the 'absolute integrity, judgement and knowledge of the environment, on the part of person making the decision'.

(b) *Circumstances on 'materiality' :*

On the questions of 'materiality', the Institute of Chartered Accountants of India observes the following circumstances :

(i) When mistakes are discovered by the auditors in the accounting books and records, such as in the calculation of depreciation, estimation of liabilities, valuation of stock, etc.

(ii) when the question of disclosure of non-recurring or unusual items of income or expenditure in the accounts arises.

(iii) the manner and extent to which prior adjustment need to be shown in the accounts and

(iv) whether any item of income or expenditure or assets or liabilities is of such an amount that, apart from statutory requirements, it is necessary to disclose it separately.

The concept of materiality is extremely important to the auditor in that it assists him in determining whether the true and fair view has been distorted.

Q. 3.7 : Prepare a list of auditing techniques corresponding to the auditing objectives (to be identified) of : (A) Cash, (B) Receivables and Sales and (C) Inventories of an organisation.

Auditing Objectives	Auditing Techniques
(A) AUDIT OF CASH :	
1. Verification of cash balances.	1. Written confirmation and physical inspection.
2. Classification of cash items on the balance sheet.	2. Written confirmation, physical inspection, oral inquiry and scanning.
3. Accuracy as to procedures for recording cash transaction and cash handling.	3. Vouching, verification, comparison, oral inquiry, accounts analysis and scanning
4. Internal control procedures — evaluation of effectiveness.	4. Oral inquiry, followed by the techniques suggested against 3 above.
(B) AUDIT OF RECEIVABLES & SALES :	
1. Verification of receivable balances.	1. Written confirmation, vouching and comparison.
2. Determining net realisable on the balance sheet.	2. Scanning, written confirmation, comparison, oral inquiry, and vouching.
3. Classification of receivables on the balance sheet.	3. Written confirmation, comparison, oral inquiry and scanning.
4. Determining any pledged or discounted portions.	4. Written confirmation, vouching, scanning, oral inquiry and verification.
5. Determining existence of ownership and value.	5. Written confirmation, vouching, physical inspection, oral inquiry, and scanning.
6. Reasonableness of sales total.	6. Comparison.
7. Internal Control Procedures evaluation of effectiveness.	7. Receivables : oral inquiry; Sales : vouching, verification, oral inquiry, comparison, accounts analyses and scanning.
(C) AUDIT OF INVENTORIES :	
1. Inventory-taking procedures - evaluation.	1. Physical inspection and oral inquiry.
2. Determining existence, ownership, accuracy and propriety in the valuation of inventory balances.	2. Physical inspection, written confirmation, vouching, comparison, verification, and scanning.
3. Determining a proper cut-off with respect to receipts and issues.	3. Vouching, comparison and oral inquiry.
4. Inventory valuation, necessity considerations.	4. Physical inspection, vouching, oral inquiry, comparison and scanning.
5. Internal Controls evaluation.	5. Oral inquiry.

Q. 3.8 : (a) What is meant by 'Continuous Audit'? (b) To what type of business it is specially applicable? (c) State its advantages and disadvantages. (d) What steps would you suggest to overcome the disadvantages?

Ans. : (a) **Continuous Audit** : An audit where the audit staff is occupied continuously on the accounts the whole year round or where the auditor attends at intervals, fixed or otherwise, during the currency of the financial year and performs an interim audit.

(b) A continuous audit is specially applicable :

(i) Where the businesses are relatively large in size and the audit work involved is considerable.

(ii) Where the management of the concern decides that the audited accounts should be available immediately after the end of the financial year.

(iii) Where the system of internal checks is either non-existent or not satisfacrtory.

(iv) Where the management of the concern is keen to have accurate monthly or quarterly statements of accounts.

(c) **Advantages are as follows :**

1. *To Shareholders* :

(i) Interim accounts are possible to be prepared without delay. These can be used by the company directors to arrive at a decision on the interim divident, to which the shareholders are interested.

(ii) The annual audit of accounts is possible to be completed very quickly. The shareholders come to know of the financial affairs of the business through the audited accounts which are presented at the annual general meeting soon after the close of the financial year.

2. *To Auditors* :

(i) Close and continuous touch with the business affords an opportunity to the auditors to gain knowledge of technical details.

(ii) Regular visits of the auditor induce the client staff to keep all accounts up to date.

(iii) The auditors' surprise visits act as a moral check on the client staff.

(iv) As the work is evenly distributed over the year, planning and programming of audit with respect to audit staff and arrangement can be made better.

(v) The auditors' attendance at regular intervals (say, fortnightly or monthly) requires examination of relatively smaller number of transactions. Hence, they are in a position to detect and prevent errors and frauds.

(vi) Sufficient time available before the close to the financial year enables the auditors to check the accounts with greater attention and in greater details. This way, the conduct of audit becomes thorough and efficient.

3. *To Management* :

(i) Interim accounts are audited.

(ii) Decision in respect of interim dividend is facilitated.

(iii) Discovery of errors and frauds can be made easily and quickly and set right in time.

(iv) Efficiency of the accounts staff increases.

(v) Final audited accounts can be presented at the annual general meeting soon after the close of the financial year.

Disadvantages are as follows :

1. An expensive system to operate.

2. The auditors' frequent visits cause inconvenience to the client staff.

3. The client staff becomes dependent upon the audit staff for clarification.

4. The client staff may, either innocently or fraudulently, alter the audited figures without the knowledge of the auditors.

5. The auditors are likely to lose the thread of continuity of work due to a long interval between two visits.

(d) **Steps to overcome disadvantages :**

1. The audit programme, drawn up month-by-month and mutually agreed upon, should be made known to both the client staff and audit staff.

2. The client staff should be suitably instructed not to alter the audited figures without the auditors' permission.

3. An 'audit note book' for recording queries should be maintained and the queries should be sorted out during next visits.

4. The examination of Impersonal, General or private Ledger should be undertaken at the end of the financial year when the final trial balance is drawn up. This would obviate the possibilities of fraud being committed by the client staff by recording fictitious entries.

5. The auditors should use secret tick marks against the figures that have been altered and glance over the alterations during next visit.

Q. 3.9 : (a) What is 'Periodical Audit'? (b) State its advantages and disadvantages.

Ans. : (a) **Periodical Audit :** An audit that is carried.out through completion in one continuous session at the end of the accounting period. It is also termed as : Final audit, Complete audit, Detailed audit. In the case of periodical audit, the auditors carry out their examinations only once in a year, (generally immediately before and after the close of the financial year).

(b) *Advantages* :

1. It is suitable for small concerns as it is less expensive.

2. It eliminates the possibility of alteration of audited figures as the audit work is performed in one continuous session.

3. It does not cause inconvenience to the client staff and to the preparation of annual accounting schedules as the examination is conducted at one time.

4. It minimises the chances of collusion between the auditor and auditee management.

5. It makes both the management and client staff serious as the auditor can exercise his own discretion to the extent of detailed work.

Disadvantages :

1. It is not suitable for large concerns as it puts a strain on the client staff and audit staff.

2. It usually results in delay in finalising the audited accounts. Due to this, it is generally subject to criticism from the shareholders.

3. It does not ensure detailed examination and so, errors and frauds are likely to pass over unnoticed.

4. It makes the auditor dependent on the company management as the former has to rely on the certificates furnished by the management, due to time constraints, in regard to some key areas. This way, the auditor runs the risks of being negligent and carelessness in his duties.

Q. 3.10 : (a) What is 'Interim Audit'? (b) What is its purpose? (c) Enumerate its advantages and disadvantages?

Ans. : (a) *Interim Audit :* Interim audit is an audit conducted in between the two statutory annual audits with reference to a particular date within the same accounting period. This audit is undertaken by the auditor under the specific instructions of the client. It covers a part of the accounting period, e.g., quarter or half-year.

(b) *Purposes are* :

1. To find out the profits for an interim period after having the relevant data of turnover and expenses duly audited; and

2. To certify the interim profits on the basis of which the management decides to declare an interim dividend.

(c) *Advantages are* :

1. It provides the management authentic data relating to the receipts, expenses and profit, the essential ingredients to assess the financial position of a business.

2. It helps to detect and prevent errors and frauds occuring during the chosen period.

3. It facilitates early completion of the final audit to be conducted at the close of the financial year.

4. It acts as a moral check on the client staff as the accounts are examined and the assets and liabilities are verified.

Disadvantages are :

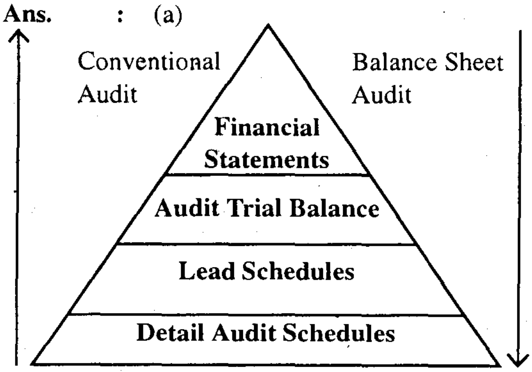
1. It involves an extra work for the auditor.

2. It requires the audit staff to keep notes for necessary follow-up measures at the time of final audit at year-end.

3. The final audit is likely to be affected if the audited figures are altered.

Q. 3.11 : (A) What do you understand by : Balance Sheet Audit? (B) How is it conducted? (C) What are its advantages?

Ans. : (a)



Financial Statements — are Balance Sheet, Profit and Loss Account or Income and Expenditure Statement.

Lead Schedules — are sub-accounts of assets, liabilities.

Detail Audit Schedules — are analysed accounts of various operating expenses and incomes.

In a balance sheet audit, the auditor considers the financial statements at the apex and identifies the individual items to a stage at which these can be effectively audited. He then refers to the 'audit trial balance' as a step downwards. Since the total accounts balances in the financial statements are difficult to be audited, the auditor refers to the 'lead schedules'. The significant sub-accounts schedules are thereafter subjected to audit tests via 'detailed audit schedules'. Thus, this audit commencing from the balance sheet works back to the books of original entry and their documentary evidence.

(b) *How conducted* : For the conduct of the balance sheet audit, the usual modes are to :

1. Examine the Directors' and Shareholders' Minute books for important resolutions that have a bearing to the items in the balance sheet.

2. Ascertain that the information in the balance sheet has been collated as per the generally accepted accounting principles.

3. See that the prior year information is also given in the balance sheet.

4. Compare the current year balance of all items in the balance sheet and profit and loss account with those of the prior year actuals and budgetary provisions, where applicable, in order to consider the significant variations and unusual fluctuations.

5. Prepare and / or examine the statement of Sources and Application of Funds with a view to understanding the changes in working capital and the increases / decreases of various elements of expenses which vitally affect the workings of the company.

(c) *Advantages* : The balance sheet audit offers the following advantages :

1. Detailed auditing procedures, such as vouching, casting, etc. are not necessary.

2. Accounting ratios as audit techniques can be usefuly employed for critical studies.

3. Cause-wise changes in assets and liabilities, gross and net profits can be studied.

4. Senior level auditors are afforded opportunities to budget their time for audit.

The constraint in the balance sheet audit is that it presupposes the existence of an efficient and effective system of internal check and internal accounting controls throughout the organisation.

Q. 3.13 : Write short notes on : (a) Occasional audit, (b) Partical audit, (c) Procedural audit, (d) Vouch and post audit, (e) Propriety audit, (f) Standard audit.

[C.U. B.Com (Hons.), 1992]

Ans. : (a) **Occasional Audit :** An audit conducted once a while as and when thought necessary.

Thus, this audit depends on the necessity felt by the client. The proprietory concerns, such as sole traders, partnership firms resort to this audit in the following circumstances, namely —

(i) Submission of tax returns.

(ii) Valuation of goodwill and assets owing to admission, retirement or death of partner.

(iii) Change of book-keeping method from single entry to double entry, etc.

The advantages associated with this audit are : (i) Traders and partners come to know of the actual state of affairs of their businesses; (ii) Partners become satisfied with the impartial views expressed by the auditor and (iii) The audit is less expensive.

(b) **Partial Audit :** It is not a full-scale audit. The work of an auditor is restricted to particular areas, such as cash, inventory, etc. depending on the requirements of the client. It is, thus, an audit for some special purposes determined by the proprietor. It is not applicable to the private and public limited companies and co-operative societies. The scope and extent of audit being limited by the client, the auditor must clearly state in his report that he has undertaken partial audit as per the terms of reference determined by the client.

This audit has certain advantages : (i) It acts as a moral check; (ii) It suits the client's specific objective; (iii) It helps locate errors and fraud and (iv) It makes possible critical analysis of the books relating to a particular assignment.

The main disadvantage of this aduit is that the complete picture of the business is not reflected.

(c) **Procedural Audit :** It is an audit which examines and appraises procedures, laid down by the management, in maintaining the books of account of an organisation. It is, thus, an audit of procedures and not any particular type of audit. Its scope and extent are broadly limited to :

1. Review of internal accounting control systems and procedures from the perspectives of objectivity, disclosure, adequacy and reliability.

2. Assessment of internal check systems as a measure of effectiveness in the maintenance and compilation of final accounts and balance sheet.

3. Recommendation of changes and improvements necessary in the procedures owing to the growing complexities of business in the light of business, economic and social laws.

This audit, in view of the Companies (Auditor's Report) Order, 2003 and various Cost Accounting Records Rules, has assumed its importance to the statutory Financial Auditors and Cost Auditors.

(d) **Vouch and Post Audit :** It is an expression having the same meaning attached to the term 'statutory audit'. Every statutory audit is a 'vouch and post' audit. This audit extends to the application of auditing techniques and procedures right from the verification and checking of all financial transactions (e.g., vouchers) to the examination of : records maintained, accounting rigidity, truthfulness of transactions and the presentation of financial statements, such as the profit and loss account and the balance sheet. It is important to note that this audit leads to propriety audit and compliance audit.

This audit achieves manifold objectives, such as prevention and / or detection of errors and fraud, protection against manipulation of accounts, precision in the presentation of final accounts as true and fair, etc.

(e) **Propriety Audit :** Audit concerning the decisions of the executives with an emphasis on public interest, financial discipline, basically to get audit satisfaction that such decisions are within the framework of sanction, authority, rule, procedure and law made by a competent authority and to advise the executives either in preventing or reducing losses and increasing productivity or improving performance by timely reporting.

This audit extends beyond the formality of expenditure to its wisdom, faithfulness and economy. It should not only ensure that an expenditure incurred is duly sanctioned by an appropriate authority but should also investigate the justifications and the necessity for it.

While conducting this audit, the auditor should ensure that the following 'canons of financial propriety' are strictly followed :

(i) The expenditure should not, *prima facie,* be more than the occasion demands.

(ii) Public money should not be utilised for the benefit of particular person or section of community unless (a) the amount is insignificant, (b) a claim for that amount could be enforced in a court of law, (c) the expenditure is in pursuance of a recognised policy or custom.

(iii) The allowances granted to meet an expenditure should be so regulated that these are not on the whole sources of profits to the recipients.

(iv) No authority should exercise its power of sanctioning expenditure to pass an order which will be directly or indirectly to his own advantage.

Besides the scrutiny of individual transactions with a view to detect cases of improper expenditure, an auditor, while performing the task of propriety audit, should examine how far the transactions sanctioned are adequate in discharging the financial responsibilities with regard to the various schemes undertaken.

To assess the adequacy or otherwise of the effect of financial responsibilities, propriety audit should examine on the following guidelines :-

(1) Whether the technical estimates or detailed programme and cost schedules are being framed and that the same are adhered to or not; whether there are adequate reasons for excess, delays, etc., or whether these are occasioned by inefficient handling, wastes, etc. or due to incorrect preparation of original estimates;

(2) Whether there have been any serious avoidable delays in the progress of the schemes resulting in increase in the total cost of the scheme;

(3) Whether there has been any wasteful expenditure including that resulting from lack of co-ordination;

(4) Whether there have been any losses of recurring nature;

(5) Whether the performance and cost compare with the results obtained in respect of similar schemes in other fields or in other public projects;

(6) How far the physical targets have been achieved within the estimated or sanctioned time;

(7) How far the ultimate objectives of the expenditure have been fulfilled.

Propriety audit has its following **limitations :**

(1) In decision making process : Since the auditor, examines and scrutinises every decision of the executive, the executive often does not take quick and bold decisions.

(2) In compliance with Regulations : The executives become inclined to function strictly according to rules and regulations. This does not ensure achievement of targets or objectives.

(3) Timeless : The audit and its report, if delayed, will not be of much use. It will be a futile report on an unprofitable contract after incurring losses.

Presently the forms of organisation which are having the benefits of propriety audit are :

(i) Government companies, such as the State and Central Government undertakings.

The Comptroller and Auditor General of India has a right to conduct efficiency-cum-economy oriented propriety audit, in addition to the statutory audit under his guidelines and instructions.

(ii) Public limited companies, a chartered accountant in practice has also some right to conduct such propriety audit in a limited sense according to the provisions contained in Section 227 of the Companies Act, 1956.

(iii) Companies where cost accounting record rules have been made applicable compulsorily and where the Central Government specifically issues orders for the conduct of Cost Audit under Section 233B of the Companies Act, 1956. A Cost Accountant in practice has a right to conduct such audit and submits his report covering the points which are propriety based.

(f) **Standard Audit :** It is neither a kind of audit nor a technique of auditing. It refers to the auditing standards to be followed by an auditor in the conduct of his audit. The 'Generally Accepted Auditing Standards' enunciated by the American Institute of Certified Public Accountants are a good guide to the practice of standard audit.

The five concepts of auditing, viz. evidence, due audit care, fair presentation, independence, and ethical conduct (outlined by Mautz) contain and state about the standards to be developed for an independent audit function. Thus, standard audit refers to an acceptable level of quality in certain basic areas which must be maintained by an independent auditor.

The standard audit is fundamentally based on the premises that an auditor should :

(i) maintain an independence in mental attitude; (ii) have technical competence in adequate measure; (iii) exercise due professional care; (iv) adequately plan and supervise the work; (v) evaluate properly the internal control as a basis for determining the extent of the tests to be made; (vi) obtain sufficient competent evidential matter; (vii) ensure consistency in information disclosures in accordance with Generally Accepted Accounting Principles and within the framework of legal requirements and general custom and (viii) give definite expression of opinion or 'no' opinion on the financial statements with a clear statement of responsibilities taken.

Q.3.13 : What do you understand by Compliance Audit? State its objectives and important components.

Ans. : The traditional government audit is usually referred to as compliance audit. Compliance audit seeks to establish stewardship accountability of public servants in various govt. departments. It is concerned with the examination of financial records and internal control to determine :

(1) Whether there has been proper recording of receipts;

(2) Whether the resources have been legally and honestly spent;

(3) Whether the financial statements are complete and reliable in all respects; and

(4) Whether the public servants have faithfully adhered to the constitution, statutes and administrative policies and budgetary provisions.

The objectives of compliance audit are :

(1) Reviewing financial operations and compliance with applicable laws and regulations;

(2) Reviewing economy and efficiency of management practices; and

(3) Reviewing the effectiveness of programmes in achieving a desired level of results.

Thus, three **important components of compliance audit emerge,** viz. (i) traditional financial audit, (ii) management practices audit and (iii) programme audit. It can, therefore, be stated that this audit makes an examination to ascertain whether all reasonable steps have taken :

(a) to safeguard the collection and custody of public moneys or other moneys;

(b) to ensure that issues and payments of moneys were made in accordance with proper authority and payments were properly chargeable and are supported by sufficient vouchers or proof of payment; and

(c) to ensure that the provisions of the constitution and of other laws relating to moneys or stores have been complied with in all respects.

Q. 3.14 : Distinguish between : (a) Statutory audit and Non-statutory audit, (b) Continuous audit and Periodical audit, (c) Continuous audit and Interim audit, (d) Statutory audit and Management audit, (e) Balance Sheet audit and Detailed audit, (f) Balance Sheet audit and 'Vouch and Post' audit.

Ans. (a) Statutory audit *vs.* Non-statutory audit :

Statutory audit is authorised and governed by law or a statute; whereas the audit got done voluntarily and without any legal or statutory force is non-statutory. Examples of statutory audits are the audits of companies, banks, insurance, charitable trusts, corporate bodies and co-operative societies. Examples of non-statutory audits are the audits of partnership firms and individual proprietory concerns.

The main points of distinction are :

Statutory audit	*Non-statutory audit*
1. It is compulsory.	1. It is voluntary.
2. The relevant statute or law determines the scope of work.	2. The employer or partners determine the scope of work.
3. The academic or professional qualification is prescribed for the auditor.	3. The auditor need not possess any academic or professional qualifications.
4. The statute dictates the powers, rights and duties of an auditor.	4. The agreement between an auditor and firm decides these matters.
5. The auditor has independence in status and in mental attitude.	5. The auditor does not enjoy such independence.
6. The auditor is liable for negligence under the Common Law and for misfeasance under the relevant statute governing the audit.	6. The auditor is liable for negligence only under the Common Law.
7. The audit report is published for the public.	7. The audit report is made known to the employers or partners.

(b) Continuous audit *vs.* Periodical audit :

The main points of distinction are :

Continuous audit	*Periodical audit*
1. The coverage of the period is determined conveniently by both the client and the auditor.	1. The coverage of the period is usually one complete accounting / financial year.
2. The books of account and statements are examined continuously throughout the year.	2. The books of account and statements are examined at the close of the financial year.
3. The annual report and accounts can be published quickly.	3. The annual report and accounts are difficult to be published quickly.
4. Sufficient time is available for thorough and detailed examination of records.	4. Thorough and detailed examination of records is not possible due to time constraints at year-end.
5. It is an effective means to detect and prevent errors and fraud.	5. It is not an effective means in these directions due to time constraints.
6. It is suitable for large business houses.	6. It is suitable for small business houses.
7. Frequent visits of the auditor may cause inconvenience to the client and may develop unfriendly relations with the auditees.	7. Few visits of the auditor at the year-end are convenient to both the client and the auditor and a friendly relationship exists.
8. It helps an assessment of the current financial conditions of the business at short period intervals.	8. It affords an assessment of the financial conditions of the business on an annual basis only.

(c) Continuous audit *vs.* Interim audit :

The main points of distinction are –

Continuous Audit	*Interim Audit*
1. The coverage of the period is determined conveniently by both the auditor and the client.	1. The coverage of the period is entirely decided by the client.

2. The assets and liabilities are not verified during the period but these are verified at the end of the accounting period.	2. The assets and liabilities are verified after having decided the interim period.
3. The preparation of the Trial Balance, Profit and Loss Account and the Balance Sheet may be dispensed with.	3. The preparation of the Trial Balance, Profit and Loss Account and the Balance Sheet is necessary.
4. Its purpose is to examine the books of accounts with a view to making substantial progress in audit work so that, the final audit is completed without delay.	4. Its purpose is to ascertain the interim profit or loss with an aim to assist the management in deciding the interim dividend.

(d) Statutory audit *vs.* Management audit :

Statutory audit	*Management audit*
1. It is mandatory as per the relevant law or statute.	1. It is not mandatory by any law or statute.
2. The professional qualifications are prescribed by law, e.g., a chartered accountant for statutory financial audit; a cost accountant for statutory cost audit.	2. The professional qualifications are not prescribed. Any body having required knowledge and skill can be engaged.
3. The rights, powers, duties and responsibilities of a statutory auditor are laid down in the relevant statute.	3. The rights, powers, duties and responsibilities of a management auditor are determined by the management.
4. The work of statutory auditors is in the public spotlight.	4. The work of management auditors is for use within the management.
5. The statutory auditor is liable for negligence and misfeasance and can be used in the court.	5. The management auditor is liable to the management for his negligence only.
6. The scope and extent of audit are well defined in the relevant law.	6. The wisdom and pragmatic outlook of the management determine the scope and extent of audit.
7. The thrust of audit is to ascertain the 'true and fair view' of profit or loss (in case of financial audit) and of cost of production and / or marketing of products (in case of cost audit).	7. The audit thrust is entirely different and extends to the examination of organisational structure of a concern, its plan, policies, objectives, means of operation and the use of physical facilities.

(e) Balance Sheet audit *vs.* Detailed audit :

Balance Sheet audit	*Detailed audit*
1. Here, the auditor considers the Balance Sheet and the Profit and Loss Account at the apex. He then identifies the individual items to a stage at which these can be effectively audited.	1. Here, the auditor considers all the transactions recorded in the books of original entry. He then identifies the ledger accounts for detailed scrutiny and examination.
2. It assumes the existence of reliable systems of internal check, internal control and internal audit.	2. It examines and evaluates the reliability of the systems of internal check, internal control, etc.
3. The procedures of vouching, casting, posting, etc. are dispensed with.	3. The procedures of vouching, casting, posting, etc. form the core of this audit.

4. It can be made applicable in big businesses where the volume of transactions is very great.

5. It requires an exacting standard on the part of an auditor as he should possess the ability to interpret the accounts in depth.

4. It may be practically difficult to conduct in big businesses due to large volume of transactions.

5. It does not require such highly skilled auditor and the less qualified staff can be engaged for routine examination.

[See also : Q. 3.19]

(f) Balance Sheet audit *vs.* 'Vouch and Post' audit :

[Same answer as indicated against (e) above]

In a balance sheet audit, the thrust is on the critical review and assessment with respect to the changes in the gross and net profits, fund flows, fixed assets position between two successive balance sheets. **In contrast,** the 'vouch and post' audit puts emphasis on the detailed examination of the books of accounts and the financial statements for the current year without recourse to any critical studies by any method of comparison.

The former is a partial audit, whereas the latter is a complete audit.

Short Answer Questions :

Q.1 : Name the *five* accounts suitable for evidence gathering through direct personal knowledge.

A.1 : Marketable securities, physical inventory count by the client, Titles to land and other fixed assets, Income taxes computations and Depreciation and amortisation on a test basis.

Q.2 : Name *four* accounts for which : (a) the balance can be verified independently and (b) the balance cannot be verified.

A.2 : (a) Cash, marketable securities, accounts receivable and accounts payable.

(b) Deferred income tax charges, goodwill, sales and cost of products sold.

Q.3 : Identify *three* characteristics for the existence of accounts that an auditor, as a general rule, will attempt to verify from an independent source.

A.3 : (i) Tangible commodities held by the outsiders, (ii) Debts owed to or by the client and (iii) Items for which there is reason to believe that an outside source can verify authenticity.

Q.4 : Audit may be classified from the point of view of the practical approach to the work. Write out the classifications.

A.4 : (a) Continuous audit, (b) Periodical (or Final or Complete) audit, (c) Interim audit, (d) Occasional audit, (e) Partial audit, (f) Procedural audit, (g) System audit, (h) Balance Sheet audit, (i) Cost audit (j) Performance audit, (k) Efficiency audit, (l) Operational audit, (m) Management audit, etc.

Q.5 : List *four* potential benefits of operational auditing to the management.

A.5 : (i) Increased profitability, (ii) More efficient allocation of resources, (iii) Identification of problems at an early stage and (iv) Improved system of communication.

Q.6 : Of the two auditing practices — Continuous audit and Periodical audit, which one is satisfactory and why?

A.6 : The nature, size and complexities of a business need serious consideration in order to choose either of the auditing practices. However,

(a) For small firms : Periodical audit is satisfactory as it is less expensive and can be completed without undue delay at the end of an accounting year.

(b) For large firms : Continuous audit followed by the Final audit at the end of the accounting year (preferably by another auditor) is the most satisfactory.

Q.7 : Is 'Interim audit' a necessity? If so, when?

A.7 : An interim audit is not a necessity under normal conditions of a business and unless the company has a definite purpose. It is necessary when a company desires to determine interim profits for the purpose of declaring interim dividend.

CHAPTER 4

TYPES OF AUDIT

Learning Objectives : *After reading and carefully studying this chapter, the student should :*

- Know about the auditing practices envisaged under different legislations.
- Understand the auditing procedures followed in cases of trusts, partnership firms and co-operative societies.

Q. 4.1 : List the various kinds of auditing practices existing under the different legislations in India. Write short notes against some of them.

Ans. :

Relevant Acts or Legislations	Types of auditing practices
1. Companies Act, 1956.	Financial audit, cost audit, special audit, audit of Govt. Companies.
2. Companies (Auditor's Report) Order 2003.	Internal audit.
3. Co-operative Societies Act (in various states).	Audit of co-operative societies.
4. Banking Companies Regulations Act, 1949.	Audit of Banks.
5. Indian Trust Act, and similar enactments of States.	Audit of Public Charity Trusts.
6. Electricity Supply Act, 1948.	Audit of Electricity Companies.
7. Insurance Act, 1938, read with Companies Act.	Audit of Insurance Companies
8. Indian Income Tax Act, 1961.	Tax audit.
9. Central Excise Act, 1944.	Excise Revenue audit undertaken by the govt. audit department, valuation audit and CENVAT audit.
10. Article 149 of Indian Constitution and Companies Act, 1956.	Audit of Govt. departmental undertakings by a statutory auditor and under the direction of CAGI.
11. Various Corporation Acts of the Parliament and of the State Legislature	Audits of L.I.C., Food Corporation of India, Central & State Warehousing Corporation, Damodar Valley Corporation, S.B.I., I.F.C., Air India, Industrial Development Bank, Reserve Bank of India, Air Corporation, etc.
12. Special Enactments for Institutions.	Audits of educational and charitable Institutions.
13. General Provident Funds Act.	Audits of Employees' Provident Funds.
14. Customs Act, 1962.	Customs valuation audit by Cost Accountants.

Short Notes on :

(a) Financial Audit or Company Audit : It is the audit conducted under sections 224—232 of the Companies Act, 1956. It is also known as the statutory audit. This audit can be described as a systematic examination of financial statements, records and related operations of a business or an undertaking to enable the auditor to determine adherance to generally accepted accounting principles, management policies, or stated requirements and to satisfy himself whether the accounts thereof are properly drawn up so as to exhibit a 'true and fair view' of the state of affairs of the organisation. This audit culminates to a statutory report expressing an opinion whether : (i) the balance sheet and profit & loss account give a true and fair view of the financial position and profit and loss respectively; (ii) the necessary records as prescribed have been maintained or not, (iii) the balance sheet and profit & loss account are in agreement with the books of accounts of the company. This audit exercise is an annual feature and applicable to all companies irrespective of the size and nature of operations. It covers sanction audit, regularity audit, propriety audit and to some extent, performance audit.

(b) Cost Audit : It is the audit conducted under section 233B of the Companies Act, 1956. This audit can be described as 'a system of audit introduced by the Govt. of India for the review, examination and appraisal of the cost accounting records and attendant information required to be maintained by specified industries' (ICWAI). It is not organisation—oriented. It is limited to particular product (s) of those companies which are engaged in production, processing, manufacturing or mining activities. It involves systematic examination of cost accounting records pertaining to utilisation of material, labour and other items of costs as prescribed by the Central Government. The end result of this audit is a report expressing an independent opinion whether; (i) the cost records prescribed by law have been maintained or not and (ii) the cost statements give a 'true and fair view' of the cost of production, processing and marketing of the product under audit. The annexure to the cost audit report provides information in respect of various matters which not only assist the management in cost control in particular but also diseminates information to the Government for various policy decisions at a national level. Cost audit checks the cost aspects and economic utilisation of resources and covers responsibility audit, performance audit, productivity audit and to some extent, propriety audit and efficiency audit.

(c) Special Audit : It is undertaken when the Central Government directs to conduct such audit in certain cases enumerated under section 233A of the Companies Act. The Central Government is empowered to direct this kind of audit if it is of opinion that : (i) the affairs of a company are not being managed in accordance with sound business principles or prudent commercial practices; or (ii) a company is being managed in a manner likely to cause serious injury or damage to the interests of the trade, industry or business to which it pertains; or (iii) the financial position of the company is such that it endangers its solvency. In this audit, the Central Government is the ultimate authority to specify in its order the different aspects, viz. — period (s) to be covered, the qualification of a person to become an auditor, directing any person to furnish information to the auditor, taking actions on the audit report, determining the audit-related expenses and the remuneration of the special auditor, etc.

(d) Audit of Govt. Companies : This audit is extended to the public enterprises that are established under section 617 of the Companies Act. It is conducted by the Comptroller and Auditor General of India under sections 619 and 620 of the Act. In this case, the CAGI is empowered to direct the manner in which the company's accounts shall be audited by the appointed auditor and to conduct a supplementary or test audit of the company's accounts by such person(s) as he may authorise. This audit has a speciality in the sense that the details of the questionnaire under the heading 'Direction of the CAGI under section 619(3) of the Companies Act' will have to be filled up by the auditor within two months from the date of his signing the audit report. Another feature is that under section 619A of the Act the audit report of the Professional auditors (i.e., a chartered accountant) of each Government Company along with the supplement made by the CAGI to that report has to be placed before the Legislature. Each year the CAGI makes a critical review on the workings of each company. The characteristics of auditing practices involved in this audit are that it covers regulation audit, authorisation audit, efficiency audit and propriety audit.

(e) Internal Audit : It is an independent appraisal function established within an organisation to examine and evaluate its activities as a service to the organisation. This audit is not necessarily to be conducted under any provision of Companies Act. It is generally indirectly insisted upon under the provisions of MAOCARO (Companies Auditor's Report Order, 2003), as promulgated by the Company Law Board of Govt. of India. This has been made applicable only to those companies whose paid-up share capital and reserves exceeds a specified monetary limit. This audit attempts to measure the degree to which various functions of an organisation adhere to the stated policies or requirements of the management. Broadly, this auditing practice operates in one or more of the following areas :

(i) Review of accounting system and related internal controls;

(ii) Examination for management of financial and operating information, including review of the means used to identify, measure, classify and report such information; and

(iii) Examination of the economy, efficiency and effectiveness of operations including non-financial controls of an organisation.

(f) Bank Audit : It is the audit conducted under the Banking Companies Regulation Act, 1949. The different aspects of banking business viz. Restrictions of business, Capital & General Reserve, Cash Reserve, Dividends, Annual accounts, etc. are subjected to audit with a view to obtaining the overall picture about the progress of the business. The audit procedure and the powers, liabilities and duties of an auditor are well defined in the Act. One special feature to be noticed is that the non-financial banks are governed by the Banking Regulation Act, 1949, while the nationâlised banks are governed by Banking Companies Act, 1970. Co-operative Banks are guided by the Co-operative Societies Act. Similarly, the Rural Banks are governed by the Regional Rural Banks Act, 1976 and the State Bank of India Act, 1955 guides the State Bank of India, and State Bank of India (Subsidiary Banks)Act, 1959 is applicable to all subsidiaries of the State Bank of India. It is to be noted that Agricultural Credit Society and Co-operative Land Mortgage Banks do not come within the purview of Banking Regulations Act, 1949.

Q. 4.2 : Identify the Acts or Legislations against the following types of Audit : (i) Internal audit, (ii) Provident Fund Audit, (iii) Central Excise Audit, (iv) Special Audit, (v) Govt. Companies' Audit, (vi) Tax Audit.

Ans. : See : Q.4.1.

Q. 4.3 : Explain the concept of Operation Audit or Operational Auditing and state its objectives.

Ans. : *Concept* : A control system via. appraised system to keep the management informed of 'opportunities gained' and 'opportunities lost' is Operation Audit or Operational Auditing. William Leonard describes operational auditing as 'a comprehensive and constructive review of organisational structure or components thereof, i.e., method of operation and use of physical facilities'.

The AICPA describes Operational Auditing as "a systematic review of an organisation's activities (or a stipulated segment of them) in relation to specified objectives for the purposes of assessing performance, identifying opportunities for improvement and developing recommendations for improvement or further action."

Objectives : The objectives of the operational auditing may be stated as below :

(i) Appraisal of company's objectives;

(ii) Evaluation of company's policies, **plans,** organisational structure and related controls;

(iii) Appraisal of performance; and

(iv) Evaluation of company's social responsibilities, e.g., extent of benefits passed on to the consumers, creation of employment opportunities, etc.

Q. 4.4 : Differentiate between Financial auditing and Operational auditing.

Ans. : Financial auditing is "a systematic examination of financial statements, records and related operations to determine adherence to generally accepted accounting principles, management policies or stated requirements". Whereas, Operational auditing is "a systematic review of an organisation's activities (or a stipulated segment of them) in relation to specified objectives for the purposes of assessing performance, identifying opportunities for improvement and developing recommendation for improvement or further action".

The basic differences between these two audits can, therefore, be charted as under :

Financial auditing	Operational auditing
1. It examines the books and records of a business or other organisation in order to ascertain or verify and to report upon the facts regarding its financial operation and the result thereof.	1. It does not exactly do so. It takes assistance from the financial books and records of a business for a systematic review of the facts relating to an organisation's activities.
2. It is concerned with 'true and fair view' of the financial state of affairs of the business.	2. It deals with the affairs extending to financial and non-financial areas of the business and is concerned with whether the management is getting sufficient information relevant to the decisions and actions.
3. It aims at gathering of evidence on the financial statements assertions and uses such evidence to ascertain adherence to generally accepted accounting principles and the legal requirements (the statutory or conventional objectives).	3. It aims at gathering of operational information both from internal and external environment, for more intensive analysis with the objective of rational evaluation of performance in relation to plans and policies for each segment as well as for the whole of the organisation.
4. The criteria for evaluating the amounts and disclosures contained in the financial statements are fairly well-defined.	4. The criteria for evaluation of effectiveness, efficiency, economy, or performance are not well-defined, rather difficult. Some surrogates are necessarily to be used.
5. The results of this audit are reported to parties outside the entity (e.g., share-holders, Govt. and general public).	5. The results of this audit are roported to the management for assisting the various functional levels in the effective discharge of their responsibilities.
6. The report is submitted in a standardised format stating the facts and fairness of the financial statements. It does not provide analyses, appraisals, comments and recommendations concerning the activities of the organisation.	6. The report is not submitted in any standardised format. The report is rather flexible enough to include objective analyses, appraisals, comments and recommendations concering the activities of the organisation.
7. Its scope is strictly limited within the framework of accounting policies and statutory or conventional requirements.	7. Its potential scope is practically unlimited as this audit seeks to identify opportunities for improvement or further action.
8. It looks back at the history of accounting transactions of a business.	8. It looks forward and aims at improving the future business operation.
9. It is done by an independent auditor (usually a professionally qualified chartered accountant in practice) who issues either an unqualified or qualified opinion, or disclaims an opinion on the financial statements.	9. It is not done generally by an independent auditor. Professional accountancy qualification is not obligatory. The auditor, here, expresses his opinions in the form of recommendations in a spirit of kinship with the management.

Q. 4.5 : (A) What is Sole Proprietor Audit? (B) State Its advantages.

Ans. : (A) *Sole Proprietor Audit:* The audit examination of the books of account of a sole trader or proprietor, which aims at (i) ascertaining the true and fair view of the state of affairs of his business, and (ii) detecting and preventing the errors and frauds and irregularities committed by his staff, is known as sole proprietor audit.

Here, the agreement or contract between the sole trader and the auditor determines the nature, scope and duties of the auditor. Unlike company audit, this is a private audit. The auditor has to act according to the instructions of the client. Therefore, it is very essential that an agreement is drawn up defining the scope of work, partial audit or complete audit to be performed. This becomes a valid document for the auditor to defend his position, if any charge of negligence under the common law is brought against him. Whenever auditor is asked by the client to conduct 'full audit', he should not only ascertain the purposes of this audit but also be careful about the liabilities as his client might use his audit report to take a loan from the financial institutions. In such a case if the bank later on finds that the balance sheet represents incorrect financial position, the auditor is likely to be liable to the banker to make good the loss in the light of the case law State Street Trust Co. *vs.* Ernest (1938). Here, the Court held : "A refusal to see the obvious, a failure to investigate doubtful, if sufficiently gross, may furnish evidence leading to an inference of fraud so as to impose liability for losses suffered by those who rely on the balance sheet".

(B) *Advantages :* An individual trader derives the following specific advantages, in addition to the general benefits of audit :

1. Detection and prevention of errors, frauds and irregularities, that might be committed by the staff.
2. Audited accounts of the deceased would be of direct assistance to the Executors and Administrators in the preparation of the Death Duty Accounts.
3. Audited accounts will satisfy the Income Tax Authorities and the Insurance Companies for claims settlements.
4. The position of the business with respect to financial solvency and profitability is known.
5. The audited accounts provide a firm base for assessment of Wealth Tax.

Q. 4.6 : State the circumstances that may motivate a sole proprietorship business to get its accounts audited by an auditor.

Ans. : The circumstances that may motivate a Sole Proprietorship concern to get its accounts audited are :

1. To ascertain the true and fair view of the state of affairs of the business.
2. To detect and prevent errors, frauds and irregularites that may have been committed by the staff.
3. To secure loans from the Banks and other Financial Institutions who insist on the audited accounts.
4. To comply with the requirements of the Income Tax Act (Tax Audit under Sec. 44AB) particularly when :
   (a) the total sales, turnover, or gross receipts exceed Rs. 40 (lakhs in any previous year relevant to the assessment year (In case of a person carrying on business).
   (b) the gross receipts exceed Rs. 10 lakhs (in case of a person carrying on a profession).
5. To receive compensation from the Insurance Companies in case of losses sustained by fire, flood or earthquake.
6. To obtain an independent opinion on the maintenance of the books of account.

Q. 4.7 : Messrs. Auto Agencies, a partnership firm, approaches you and inquires whether it is necessary for them, under any statute or otherwise, to get their accounts audited.

You are required to advise them, explaining briefly the objects and advantages of an audit of a partnership firm.

Ans. : The audit of the accounts of Messrs. Auto Agencies, a partnership firm, is not a legal necessity under any statute. But, in view of the following objects and advantages derived, it is advisable to incorporate an 'audit' clause in the partnership deed of the firm.

Objects :

1. To sort out the differences among the partners.
2. To ensure that there exists no fraud.
3. To provide a basis in the valuation of goodwill or in the settlement of accounts in case of death or retirement or admission of a partner.

Advantages : The audit of a pertnership firm offers the following advantages :

1. Improvement in the management of operations and maintenance of uptodate records are possible on the basis of recommendations of the auditor.
2. The Income Tax Department relies on the audited accounts for tax assessment purposes.
3. The Court of Law considers the audited accounts as a reliable evidence.
4. Mistrust and differences among the partners are avoided by having the audited accounts.
5. The partners who provide finance but do not take part in the administration feel satisfaction that there exists no fraud or irregularities in the accounts.
6. The audited accounts provide a firm basis for the valuation of goodwill or settlement of accounts when any of the partners dies or retires, or an outsider is admitted as a partner.

Q. 4.8 : (A) You have been appointed auditor to a partnership firm under partnership deed. To what special clauses in the partnership deed would you direct your attention during your first audit ?

(B) State your decision with reasons in respect of the following transactions : Commission received by Mr. X on the purchase of a property acquired for and in the name of the firm in which he is a partner. Mr. X feels that he is entitled to the commission since he negotiated the transaction.

Ans. : (A) Special Clauses in the Partnership Deed : The auditor, during his first audit, should direct his attention to the following special clauses in the partnership deed —

1. The nature and duration of the business.
2. The capital sum contributed by each partner.
3. The maximum amount each partner is allowed to withdraw and the conditions therefor.
4. The provisions in regard to: Interest on the partners' capital, withdrawals, loans, profit-sharing ratios, salary, commission and rights, duties and powers of each partner.
5. The terms regarding — the admission and retirement of partners, the determination of amounts payable to the representative of a deceased partner.
6. The clauses in respect of the accounting period, depreciation and reserve, the valuation of goodwill and other assets and the appointment of auditors (if agreed to).
7. Arbitration clause.

(B) The transaction, illustrated here, relates to the purchase of a property acquired for and in the name of the firm. Mr. X, a partner of the firm, negotiated this transaction for and on behalf of the firm and in the interest of the firm. Mere feeling of Mr. X that he is entitled to the commission as he negotiated this transaction is no justification to claim the commission. In the absence of any objective clause in the partnership deed regarding the commission payable to a partner for negotiation of a particular transaction, Mr. X cannot be entitled to receive such commission.

Q. 4.9 : (A) Discuss the steps to be taken by an auditor before commencement of new audit of a partnership firm.

(B) Enumerate the essential points that an auditor should look for during the course of the audit of partnership firm.

Ans. : (A) Considerations before audit commencement :

1. Ascertaining from the previous auditor (if any) the reason for his non-acceptance.

2. Obtaining instructions in writing about the nature and content of audit examination to be made especially with respect to : work of the nature of accounting or auditing, partial audit or complete audit, etc.

3. Obtaining a copy of the Partnership Deed (if any) with a view to getting the full knowledge about : nature of business, partners and their capital, sharing of profits or losses, partners and their duties, accounting period, names of account books, name(s) of the partner(s) or staff keeping the accounts, etc.

4. Obtaining a written statement (in the absence of a partnership deed) duly signed by all the partners incorporating the matters at (3) above.

5. Obtaining the Minute Book of the meetings of the partners.

6. Getting the copy of the previous auditor's report along with the last audited accounts (if any), and noting down the points which require special consideration.

(B) *During audit :* The auditor should pay particular attention to the following essential points :

1. The system of internal checks and internal controls in operation.
2. The valuation of current assets and accounting.
3. The valuation of goodwill.
4. The recording of transactions in the books of original entry and the related evidences.
5. The agreements relating to the contracts that have been entered into with the third parties and connected evidences of the work / services executed.
6. The classification of expenses between the capital expenditure and revenue expenditure.
7. The division of profits or losses among the partners.

Q. 4.10 : While auditing the accounts of (a) proprietorship business and (b) partnership business, you have noticed that certain quantity of controlled materials have been bought without vouchers. Your clients do not want qualified reports. How would you deal with the situation ?

Ans. : In the instant case, it can be assumed that the clients concerned had to buy some quantities of materials at prices higher than the controlled rates, and that is why, they request the auditor to give unqualified reports. The clients, in order to run the business without any interruption in the activities, purchased the materials from those parties who refused issuance of cash memos or invoices to avoid litigations.

In these circumstances, the auditor may do the following before issuing his report :

(a) *Proprietorship business :* A certificate should be obtained from the proprietor.Such certificate should clearly state that (i) the materials were purchased with his consent; (ii) the prices of which bought were within his full knowledge; and (iii) the cash memos or invoices could not be obtained from the concerned buyers.

(b) *Partnership business* : A certificate should be obtained from the firm, stating clearly the points as at (a) above. The auditor should see that the certificate is signed by all the partners signifying their full knowledge of the facts.

Q. 4.11 : Write a note on 'the audit of Trust Accounts' and the advantages derived therefrom.

Ans. : The word : 'Trust' means the property held and managed by one or more persons (trustees) for another's benefit (beneficiaries). The beneficiaries may be minors, widows, and other institutions created under the Indian Trust Act. Thus, a Trust is created or formed with the following objectives :

1. To protect the interest of the beneficiaries,
2. To look after the assets and properties covered under a testament,
3. To determine the mode and manner about the collection of property rents, share dividends, crop procurements from landed properties and the incomes of other tangible assets, and
4. To distribute the net income to the beneficiaries in terms of the provisions laid down in a trust deed.

Thus, trust accounts refer to the maintenance of the books of account so as to encompass the objectives indicated above.

As the beneficiaries of the trusts are innocent, they do not understand the accounts. This leaves a scope for the trustees to manipulate the accounts with an ulterior motive of defrauding the beneficiaries. Herein lies the inportance of trusts audit by an independent auditor. A Trust Deed should, therefore, incorporate a clause for the appointment of an auditor to verify the trust accounts. Trust audit can satisfy two-fold main objectives, such as (i) Safeguarding the interests of beneficiaries, e.g., proper maintenance of accounts, avoidance of fraud or misappropriation of trust income, equitable distribution of imcome as per the trust deeds etc. (ii) Guiding the trustees in the observance of the formalities of the trust laws and of the fundamentals of book keeping and avoiding the undesirable criticisms generally levelled against the trustees.

Thus, this audit offers the above-noted advantages.

The audit of trust accounts is not mandatory under any of the Central Govt. Legislations. But it is interesting to note that the Bombay Public Trust Act 1950 and certain state laws have made the trusts audit compulsory and contain well defined powers and duties of an auditor.

Q. 4.12 : 'The auditor of an individual or a firm has no statutory obligations to comply with'. Discuss fully the implications of this statement.

Ans. : The audit of an individual proprietorship business or a sole trader or a partnership firm is not mandatory under any Indian legislation. Hence, the duties and liabilities of an auditor, with respect to these concerns, are not laid down in any statute. Whenever these concerns desire to get their accounts audited, an agreement between them and the auditor is entered into. The terms of the agreement determine the nature, scope and extent of audit. Thus, the liability of an auditor is governed entirely by such agreement. If the auditor commits a breach of any of the terms of the agreement, he becomes liable to compensate damage for any loss suffered by the client.

The statement in question focuses to state that as the auditor of an individual or a firm is not appointed under any statute he is not under any statutory obligation like the auditor of a company. The company auditor has to comply with the provisions of the Companies Act 1956 in so far as his duties and responsibilities are concerned.

The given statement is not wholly correct on the following grounds :

1. If the auditor fails to exercise reasonable duty of care and skill in the performance of his duties, he would be guilty of misconduct.
2. If the auditor is negligent in his duties, he would be liable under the Indian Contract Act or Law of Torts.

Thus, it can be stated that the auditor, to some extent, is under statutory obligation to comply with even when he is appointed by an individual or a firm.

Q. 4.13 : Outline the special features of the audit of : (a) Co-operative Union, (b) Co-operative Bank.

Ans. : (a) *Co-operative Union :* The special features of its audit are :

1. The accounts must be audited at least once in a year.
2. The Registrar of the Co-operative Societies should audit the accounts or get the accounts audited by some person authorised by him by a special order in writing.
3. The Registrar is vested with a full control over these institutions in respect of accounts by creating departmental audit.
4. The Co-operative department of the State Government or an auditor chosen from the Panel of Auditors (this panel is prepared by the Registrar, and consists of Chartered Accountants and retired officials of the State Govt.) conducts this audit.
5. Section 17 of the Co-operative Societies Act 1912 provides for the guidelines on the audit procedures.
6. It is a statutory audit.

7. A co-operative union or society may, if it so wishes, appoint its statutory auditor from the panel of auditors prepared by the Registrar but such appointment should be confirmed by the Co-operative department of the State Government.
8. The co-operative department approves the appointment of a statutory auditor to a society when — (i) the activities of a society are well managed and (ii) the accounts are properly maintained.
9. The right of a statutory auditor so appointed includes access to the books of account, papers, and securities of the institution.
10. Every officer of the union or society is bound to furnish information in regard to all the transactions with a view to smooth running of the audit work.

(b) *Co-operative Bank :* In addition to the features enumerated above, the provisions of Sec. 56 of Chapter V of the Banking Companies Regulations Act 1949 apply to a co-operative bank. These are briefly as follows :

1. A co-operative society cannot carry on a business of banking unless the name of such society is added with the words 'bank' or 'banker'.
2. A co-operative bank can commence its banking business provided the aggregate value or the paid-up capital and reserve is not less than Re.1 lakh except under certain circumstances stated in Sec. 56(h).
3. The bye-laws of a co-operative bank cannot over-ride the provisions laid down in the Banking Regulations Act.
4. A co-operative bank shall not hold shares in any other co-operative society except to such extent subject to such conditions as may be specified by the Reserve Bank of India.
5. A co-operative bank shall maintain a cash reserve of at least 3% of its total time and demand liabilities in India with itself or with the Reserve Bank of India or the State Bank of India or the State Co-operative Bank. A primary Co-operative Bank shall maintain such reserve with the District Co-operative Bank or partly in cash with itself and partly in such account.
6. The Balance Sheet and the Profit and Loss Account should be drawn according to the forms specified under Sec. 56(21) or as near thereto as possible unless the Registrar has prescribed another form.

Over and above, the following points need special attention :

(a) The auditor's report should be in the proforma prescribed by the Registrar.

(b) The loan taken from the Central Co-operative Bank should be within the limit prescribed by the Co-operative department of the State.

(c) The District or Central Cooperative Bank and the State or Appex Co-operative Bank do not have the right to appoint a statutory auditor. It may appoint a statutory auditor for internal audit work only.

Further, the system of internal checks is seldom in operation with a Co-operative Bank. Thus, the audit of a Co-operative Bank should be more detailed than that of a Commercial Bank.

Q. 4.14 : You are appointed the auditor of the Central Government Employees Co-operative Society Ltd. State the matters, apart from verification of its trading transactions, which would receive your attention.

or,

State in brief the rights and duties of a Co-operative Society's auditor.

Ans. : The following matters should receive the attention of the auditor of the Central Government Employees Co-operative Society Limited :

1. The bye-laws of the Society in the context of Co-operative Societies Act, 1912.
2. The share capital amounts held by members to see that an individual does not hold more than 10% of the capital.
3. Vouching of transactions, like : (a) Cash receipts, deposits and on hand; (b) Borrowings from Central Co-operative Bank, their interest rates, etc. with reference to the resolutions passed; (c) Loans to members and

non-members, interest rates, agreements and the relevant resolutions; (d) Over-due debts and all expenses; (e) Investments and surplus funds to see whether these have been invested in accordance with the rules — e.g., with the Savings Banks as per the approved list, in Securities under Sec. 20 of the Indian Trust Act, etc.; (f) Sales, purchases, stocks and their valuation, if it has a Consumers department.

4. Verification of : (a) Ledger accounts; (b) Stock register; (c) Asset records; (d) Liabilities, etc.
5. Cash reserve, and the transfer of profits of the Society to the Reserve fund and the Welfare fund.
6. Whether the accounts have been maintained according the Co-operative Societies Act.
7. Whether the Balance Sheet and the Profit & Loss Account have been drawn up in accordance with the proformae prescribed by the State Authorities.

Q. 4.15 : (a) What is the statutory provision for the audit of a registered Co-operative Society ? (b) A creditor of a Co-operative Society wants to inspect its books. How should he proceed in the matter ? (c) In what manner and from whom can the Government recover moneys due to it from a registered Co-operative Society ?

Ans. : *(a) Statutory provisions are :*

(i) The audit of accounts of a registered Co-operative Society is to be conducted by the State Co-operative department at least once a year.

(ii) The Registrar of Societies should get the accounts audited by a chartered accountant or a retired official of the co-operative department enlisted in the panel approved by him.

(iii) The auditor shall have right of access to the books of account and documents.

(iv) Every officer of the Society must furnish all information required by the auditor.

(b) The creditors, desirous of inspecting the books of a Society, should make an application to the Registrar. The Registrar, on being satisfied, shall inspect or direct some other person to inspect the books of the Society.

(c) The Government can recover moneys due to it from a registered Co-operative Society in the following manner and from the following persons :

(i) Firstly, from the Society's property.

(ii) Secondly, from the members subject to the limit of their liability in case of a limited liability Society.

(iii) Thirdly, from the members in the case of other Societies.

Short Answer Questions :

Q.1 : 'Audit of Partnership Accounts is not compulsory under the law'. Is it correct?

A.1 : It is correct to state that neither the Indian Partnership Act 1932 nor any other law in India has made the audit of a partnership firm mandatory.

Q.2 : Is audit essential for a partnership firm?

A.2 : The Indian Partnership Act 1932 does not enforce a legal obligation to audit the partnership form of business. But the audit of such a firm becomes essential when the Partnership Deed provides for the audit clause. This audit helps avoidance of possible friction and dissatisfaction among the partners of the firm.

Q.3 : The Partnership Deed is silent about the settlement of accounts on the dissolution of a firm. Indicate the priorities how the following items should be squared up :

(i) Losses including deficiencies of capital, and

(ii) Assets including any sums contributed by the partners to make up deficiencies.

A.3 : The provisions of the Partnership Act, 1932 would apply in these cases — which are as follows :

(i) Losses, etc.— These should be paid in the following order :

(a) Firstly, out of profits, (b) secondly, out of capital, and (c) lastly, by all the partners individually in their profit-sharing ratios.

(ii) Assets, etc. — These should be applied in the following order :

(a) Firstly, in paying the firm's debts to third parties, (b) secondly, in paying proportionately to the partners due for loans, (c) thirdly, in paying off proportionately to the partners' capital, and (d) fourthly, the balance to be divided among the partners in profit-sharing ratio.

Q.4 : Outline in brief the audit programme of a partnership firm.

A.4 : An audit programme should cover —

(i) Partnership deed or a written agreement regarding the partners' capitals, shares of profits or losses, clauses as to admission or retirement or death, etc.

(ii) Vouching of partners' drawings and incomes and expenses of the firm.

(iii) Valuation of goodwill and other assets.

(iv) Rights and liabilities of partners, etc.

Q.5 : Co-operative Societies may be divided into two categories with respect to the liability of its members. What are these ?

A.5 : (i) Limited Liability Society and (ii) Unlimited Liability Society.

Q.6 : The audit of Co-operative Banks is more detailed as compared to Commercial Banks. Why ?

A.6 : The internal check system in not in operation in the case of Co-operative Banks.

CHAPTER 5

AUDIT PROCESS

Learning Objectives : *After reading and carefully studying this chapter, the student should :*

- Know process of audit planning and of arranging the audit work.
- Identify the 'Phases' into which the total audit function is carried out.

Q. 5.1 : Discuss the matters that require preparation on the part of an auditor before commencement of a new audit.

Ans. : The new audit work requires the following considerations / preparations :

(i) **Planning Documentations** — This includes :

1. Consideration of the nature, extent and timing of work to be performed; and
2. Preparation of written audit programme.

Particularly for large and complex companies preparation of a memorandum on the preliminary audit plan is desirable for the efficient performance of audit within the time constraints.

(ii) **Planning Considerations** — These include :

1. The nature of business and industry.
2. Accounting policies and procedures.
3. Methods used for significant accounting applications.
4. Internal accounting control and internal operations control.
5. Preliminary estimate of 'materiality' in the examination.
6. Problems with regard to :
   (a) The items in the Cost and / or Financial statements requiring adjustment, and
   (b) Conditions requiring modification of audit tests, such as related party transactions or possible material irregularities.
7. Reports to be issued, such as filing with the Registrar of companies and other regulatory agencies or special reports on compliance with the financing institutions for loans, etc.

(iii) **Knowledge of Business and industry, such as :**

1. Type of business; 2. Type of products and services;
3. Capital structure; 4. Related parties;
5. Business Locations; 6. Production and distribution methods;
7. Compensation methods.

(iv) **Specific Planning Procedures** — These involve :

1. Review of his own records on the company; e.g., correspondence files, prior year's audit working papers, permanent files, and prior year's financial statements and / or cost statements.
2. Discussions with the firm personnel for non-audit services.
3. Inquiring about current business trends and developments.
4. Reading current interim financial and / or cost statements.
5. Discussions about the scope and timing of the examination.
6. Considering implications of relevant cost accounting or financial accounting and cost auditing or financial auditing pronouncements, particularly recent pronouncements by the country's legislature.

7. Co-ordinating the assistance of client personnel in preparing data and schedules.
8. Determining the involvement of consultants, specialists and internal auditors.
9. Reviewing various sources of specific information details on industry such as audit guides*, industry publications and annual reports of other companies in the industry.

The supervision aspect of the audit work require :

(i) **Instructing Assistants about**

(a) their responsibilities;

(b) the objectives of the procedures they are to perform;

(c) matters that may affect the scope and characteristics of the procedures they are to perform, such as, possible accounting and auditing problems;

(d) significant accounting and auditing questions raised during the examination.

(ii) **Reviewing Work** of each assistant to

(a) Determine whether the work was adequately performed.

(b) Evaluate whether the results are consistent with the conclusions to be expressed in the report.

(iii) **Consultations** to attempt resolution of differences of opinion that may arise among firm personnel about accounting or auditing issues in an examination.

** The Institute of Cost & Works Accountants of India issues Cost Audit Booklets and the Institute of Chartered Accountants also issues Guidance Notes, etc.*

Q. 5.2 : Write notes on : (a) Audit Programme, (b) Audit Note Book, (c) Audit Memorandum, (d) Audit Manuals, (e) Audit Files, (f) Audit Working Papers, (g) Working-paper Triangle.

[C.U. B.Com (Hons.), 1990, 1991, 1992]

Ans. : (a) *Audit Programme* :

The audit programme is the most important control mechanism in an audit. It is a carefully and flexibly written plan or scheme or layout of the audit procedures necessary by the auditor before he expreses his opinion. The principal auditor chalks out a programme as to the extent of audit work, allocation to the senior and junior audit staff and the time duration for the completion of work. Some auditors use preprinted programmes for their audits, whereas others believe that the programme must be specifically tailored to each audit engagement.Professor Meigs defines Audit Programme as "a detailed plan of the auditing work to be performed, specifying the procedures to be followed in verification of each item in the financial statements and giving the estimated time required".

Thus, the audit programme is a tool for planning, directing and controlling audit work. It is a blueprint for action, specifying the procedures to be followed and delineating steps to be performed to meet audit objectives. The audit programme is the culmination of the planning and survey processes.

There are two types of Audit Programmes :

(1) General Audit Programme : It contains general instructions, sometimes standardised. It covers the broad areas, such as (i) Related section of questionnaire on internal control; (ii) Ascertainment as to whether existing internal control system is adequate or not; [If not, appropriate considerations as to the steps for additional auditing procedures] (iii) Follow-up of the outlined procedures; (iv) Co-ordination plan of sectional audit programmes; (v) Propriety of expenditure of exceptional nature and (vi) Interviews with the officials of the company.

(2) Special or Specific Audit programme : It is prepared for each of the specific functional areas. The contents are designed to commensurate with the relevancy of the objectives of the functional area. It is tailored to suit circumstances, and allowed to grow as the audit work progresses. It incorporates the changes, wherever necessary, in the cunduct of audit. It covers the broad functional areas, e.g., Purchase, Stores, Inventory, Material Control, Production, Work-in-progress, Finished Goods, Accounts Records, Cost Statements, Fixed Assets and Investments, Sales, Capital / Revenue & Deferred Revenue Expenditure, Internal Control, Internal Audit, Inter-Company Transactions, etc.

An audit programme is considered **important** for the following reasons :

(i) Each staff of the audit firm is made responsible for his assignment. He understands the auditing areas to be covered by him.

(ii) The extent of audit work can be assessed and determined in advance.

(iii) The allocation of work is made easier.

(iv) The audit approach, revision plan for analytical review and co-ordination are facilitated.

(v) The audit objectives for each audit area become clarified, and the audit procedures in sufficient details serve as a set of instructions to the staff.

(vi) The audit evidences are possible to be collected.

(vii) Programme-wise time-table can be prepared keeping in view the company's own time-table of work schedule and the total time available for completion of audit work in all respects, and

(viii) It serves as a complete guide and as a means to control the proper execution of audit work, and becomes a documentary evidence whenever required.

An audit programme, when properly prepared and used, serves the following **purposes :**

1. Provides evidence of proper planning and allows a review of the proposed audit scope. The partner, manager and other members of the audit team get an opportunity for modification of the proposed audit procedures before the work is actually performed.
2. Provides guidance to less experienced staff members.
3. Provides evidence of work performed.
4. Provides a means of controlling the time spent on an engagement.
5. Provides evidence of the consideration of internal accounting control in relation to the proposed audit procedures.

The audit staff should keep in mind that an audit programme is only tentative based on assumption about the client's accounting procedures and internal controls. When the work begins and the conditions are not as anticipated, the auditor may need to revise the audit programme on the basis of conditions actually found.

(b) *Audit Note Book* :

It is a record, used chiefly in recurring audits, containing data on work done and comments outside of the regular subject matter of working papers. It generally contains such items as the audit programmes, notations showing how sections of the audit are carried out during successive examinations, information needed for the auditor's office and for staff administration, personnel assignments, time requirements and notations for use in succeeding examinations.

It is a diary, usually a part of permanent audit file, maintained by the audit staff for the purpose of recording certain points which require further clarification, explanation and investigation. This book generally includes any errors, difficulties observed, and doubtful queries of various accounting records, etc. The usual contents of A. N. Book are, progress of the audit work together with the dates on which the work was undertaken and completed, extracts from correspondence with different authorities (e.g., government, banks, debtors, creditors, etc.) system of accounts, notes on missing vouchers and invoices, suggestions, audit programme, extracts for minutes/contracts/agreements, notes on errors and/or irregularities, explanations of typical terminology used by the client, and such matters requiring future reference.

The importance or value of A. N. Book lies in the fact that it can be produced as an evidence to show the nature and type of audit examination done particularly when an auditor is charged with negligence. Thus, it acts as a documentary evidence in the courts of law. Further, subsequent audits become easy as the book serves as a guide to audit staff.

(c) *Audit Memorandum* :

It is a kind of brochure which contains information about the client, its organisation, business and business policies. Thus, this should always be gone through by a new audit team, or where the audit is new. This record should be compiled at the very start of a new audit assignment by reference to various important documents, e.g., partnership deeds, memorandum and articles of association, etc. It should also be updated with changes in information from time to time. The contents of audit memorandum may be summarised as below :

1. The client's name, address and those of factories and branches.
2. The ownership and control of business and brief history.
3. The details of products manufactured and sold, marketing and distribution channels and advertisement methods adopted.
4. Raw materials and their price trends and procurement sources.
5. The names of directors, principal officers and other responsible officials together with a detailed organisation chart outlining their rights and powers.
6. Details about a holding or subsidiary company, if any.
7. Details of books of accounts of the client and the names of personnel maintaining them and the accounting year as also its break-ups.
8. Details of the client's policies with respect to advertisement, accounting and costing, system of internal accounting and administrative controls, investments, marketable securities, tax returns, contingency reserves, product prices, etc.

It can, therefore, be concluded that an audit memorandum should be reviewed every year and must remain open for the knowledge of all audit staff engaged.

(d) *Audit Manual* :

An audit manual is a written auditing document. it refers to the standard audit guides as to the objectives of auditing, detailed auditing mechanism, timing and extent of examination and preparation of audit report, etc. It provides broad guidelines to the development of audit programmes needed for adaptation to the functional or organisational scope of the review.

The form and contents of audit manual are not the same with all audit firms. The general feature is that it is flexible to incorporate new and improved ideas and techniques. The format usually contains audit objective, development of definitive audit programmes, preparatory activities, operational activities and procedures of audit. The following matters or information are covered in the audit manual :

1. Policies and procedures with respect to the minimum audit steps and audit supervision and review.

2. Different specimen of business or management letters and guidelines about the maintenance of audit records and files.

3. Guidelines in the form of solution-packages to various ticklish audit problems.

4. Outlines of (i) correspondence with the clients, (ii) audit working papers, (iii) audit programmes, (iv) internal control questionnaires, (v) internal controls evaluation, (vi) instructions about the timing, extent and scope of the use of compliance tests, substantive tests and statistical sampling methods and (vii) the important extracts of various legal and professional pronouncements concerning the audit.

Thus, in nutshell, it can be stated that the manual provides a mental flowchart of the important auditing functions and operations to the audit staff. Now-a-days, the elements of audit work quality controls and the extent and scope of delegation of audit work to staff and assistants and/or to experts or specialists are also incorporated in order to bring an uniformity in the auditing mechanism and standards.

(e) *Audit Files* :

Auditors normally maintain two types of audit working-paper files. One is referred to as a 'permanent or continuing audit file' and the other one called the 'current-year audit file'. In addition to these, the auditors sometimes maintain :

(i) tax working-paper files (to maintain a record in connection with the review or preparation of a client's tax returns),

(ii) correspondence files (to maintain a record of all communications with each client),

(iii) billing files (to maintain the current status and historical record of billings to and collections from each client) and

(iv) client files (for developing a record of the relationship with each client).

Permanent Audit Files : It is composed of documents, schedules and other data that are of continuing significance to several years' audits. For example, an auditor requires a copy or an extract of the client's articles of incorporation to verify the types (ordinary and preferred) par values and number of authorised shares that the client company may issue, as well as restrictions on payment of dividends, or other matters requiring disclosure in the financial statements. The auditor need not ask for the same document each year and he can place one such copy in his permanent file, which is a part of each year's audit evidence. In that case, he must check each year the nature and kind of amendment to the articles of incorporation and note down the changes on the document in the permanent file.

Although there are variations in the arrangement and organisation of permanent files from one audit firm to another, most would contain the following particulars :

1. Historical information about the client company : It includes a memorandum describing the company and its operations, major plants and processes of manufacture, products, distribution network and important customers, organisation chart and recurring audit administrative matters.

2. Description of accounting procedures and internal accounting controls : It consists of narrative descriptions of the client's accounting procedures and internal accounting controls, internal accounting control check lists, flow-charts, decision tables, or any combination of these items; a chart of accounts and samples of certain records or forms that aid in understanding the company procedures.

3. Corporate documents : It may include : The articles of incorporation, copies or extracts of loan agreements, prospectus, import or export agreements, bond indentures, minute books, management contracts, labour or employees' union agreements, pension plans, important long-term operating contracts. The auditor must have evidence of the provisions of these documents and reviews thereof, as they could significantly affect the company's operations and financial statements.

4. Continuing analysis of certain accounts : Some auditors suggest to maintain cumulative or carry-forward schedules in the permanent file for certain accounts than to prepare them each time during the current year. Such schedules for continuous analysis may include : capital stock, long-term debt, check-lists against loan agreements, equity earnings, gross profit ratios by major product line, etc.

5. Audit planning : This could include a master copy of the audit programme; schedules of plant capacity, volumetric measurement data for tanks/vessels, etc.; schedules of cost centres, bank accounts and of branch offices/subsidiaries, etc.; EDP accounts systems and the description of previous audit tests.

Current Audit Files : The current-year audit files may contain the information such as : evidences gathered and conclusions reached, schedules and analyses of accounts, memorandum of audit work performed, audit problems considered and resolved, audit programme, correspondence with third parties confirming balances, review sheets containing questions and comments, time schedule of audit engagement, etc.

(f) *Audit Working Papers* : They refer to the records kept or prepared by the independent auditor of the following :

1. Procedures applied,
2. Tests performed,
3. Information obtained,
4. Pertinent conclusions reached. *Examples* are audit programme, analysis, memorandum, letters of confirmation, representation letters.

The preparation of audit working papers is of prime necessity for auditors to conduct their examination properly and provide adequate support for their opinion.

Types of audit working papers : See : Audit File, discussed above. According to Meigs, the term 'working papers' is a comprehensive one and it includes 'all the evidence gathered by the auditor to show the work he has done, the methods and procedures he has followed, and the conclusions he has developed', "Audit working papers are the 'bridge' or 'connecting link' between the opinion of the auditor and the different books and records of the client".

Taylor and Gleezen have listed the following general guidelines as to what working papers should include or show :

1. The work has been adequately planned, supervised and reviewed, indicating observance of the first standard of field work.

2. The system of internal accounting control has been studied and evaluted as a basis for reliance thereon and for determining the extent of tests to which auditing procedures are to tbe restricted, indicating observance of the second standard of field work.

3. The audit evidence obtained, auditing procedures followed and the testing performed provide sufficient competent evidential matter to afford a reasonable basis for opinion, indicating observance of the third standard of field work.

Thus, there is no denying the fact that the audit working papers should :

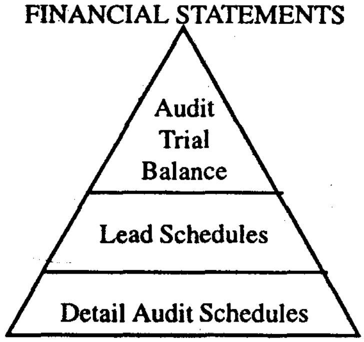
(i) Show how the work was planned (primarily by the use of audit programmes);

(ii) Show the extent of supervision of assistants (indications of reviews made by the auditor) and

(iii) Contain sufficient and competent evidence (such as internal accounting control check-lists, confirmations from creditors, bank reconciliations, etc.) on which to base an opinion.

(g) *Working-paper Triangle* :

The concept of working-paper triangle refers to the organisation of audit working papers. Here, the term 'organisation' denotes 'indexing' of working papers. The concept, according to Taylor & Gleezen, can be illustrated by the following triangle :



Considering the financial statements at the apex, the auditor identifies the individual financial statements to a stage at which these can be effectively audited. The uppermost portion of the triangle refers to 'audit trial balance' — which should agree with the amounts shown in the client's financial statements. Again, the total accounts balances shown in the financial statements are difficult to be audited effectively unless these are broken down into sub-accounts (such as, customers, notes, officer, interest and accounts receivables). These break-ups on a schedule are referred to as the 'lead schedules' indicated at the mid-level in the triangle. This level illustrates the division of the total amount into sub-groups by stage of completion. The nature and type of subgroups shown on the lead schedules are determined by the classifications used by the client in its accounting records. Thus, in this, as in many other aspects of auditing, no single format is applicable to all audit engagements and each must be tailored to the particular aspects of each audit. Thereafter, the more significant of the subaccounts or subgroups would be analysed further by such classification that the auditor can subject to audit tests. The base of the working-papers triangle symbolizes these classified analysis schedules — the 'detail audit schedules', which is 'a myriad of schedules and document', each representing a specific piece of evidence gathered, Thus, the base expands as each account is analysed in greater detail.

Q. 5.3 : What are the essentials of a good audit programme?

Ans. : See Q. 5.2 (a).

Q. 5.4 : How should an audit programme be constructed?

Ans. : See Q. 5.2 (a).

Q. 5.5 : Give four examples of 'audit working papers'..

Ans. : See Q. 5.2 (Permanent audit files).

Q. 5.6 : "Planning and programming are essential to the efficient conduct of an audit regardless of its size". — Justify the statement highlighting the various 'phases' involved in planning and programming the flow of audit work.

Ans. : *Audit Planning & Programming by 'Phases'* :

Proper planning and programming of audit is advantageous to both the auditor and the client as much of the detailed audit work can be performed outside the peak audit period. However, the total audit work can be split into :

Phases :

I. Scheduling, planning and programming ;
II. Preliminary audit work ;
III. Year-end audt work ;
IV. Final audit work ;
V. Post-audit work.

Phase I : The auditor should consider the following pertinent aspects :

(a) Employment of more efficient audit methods and procedures, such as — the use of (i) more clerical assistance form the client, (ii) statistical sampling techniques, (iii) generalised comuter-assisted audit programmes, and (iv) better organisation of audit working papers.

(b) Shifting of additional work to a preliminary period out of the busy audit period, such as study and evaluation of internal control systems. If the auditor is satisfied with the reliability of internal controls, he may decide to perform some audit procedures, which are normally done after the end of the year, at this phase.

(c) Elimination of non-essential work, particularly those which have become embedded in an audit programme over a period of time.

Phase II : At this phase, the auditor should do the following :

(a) Review of the minutes of meetings of shareholders and board of directors (and any sub-committees thereof);

(b) Review, test and evaluation of internal accounting control;

(c) Substantive tests, such as confirmation of accounts receivable/accounts payable, observation of physical inventories and review of transactions in the accounts from the interim date to year-end to be satisfied of the validity of the account balances at the year-end;

(d) Substantive tests of additions to and reductions of accounts with balances that tend to carry forward rather than turn over rapidly (examples are property and equipment, deferred charges, long-term debt and shareholders' equity) and of the transactions in these accounts;

(e) Tests of all transactions (by choosing a population) from one preliminary date to the next so as to secure an additional assurance of consistency of accounting procedures.

Phase III : This phase begins at the end of a client's year. The auditor should do substantive tests with respect to : observation of physical inventories (i.e., annual stock-taking), physical count of cash, inspection of marketable or investment securities. This audit work must be done on the specific year-end date with a view to determining that the asset was actually on hand at that date.

Phase IV : This phase begins as soon as the client has prepared and posted the final accounting entries, and totalled, balanced and closed the accounting records. Auditing procedures, not previously performed, are executed at this phase. These could include : tests of accrued liabilities, review of loan agreements for compliance with restrictions, examination of stock-books. The preparation and issuance of audit report to the client organisation are finalised at this stage.

Phase V : This phase in not actually a part of the total audit planning and programming process. Some audit firms, at this phase, prepare staff evaluation reports, send billings to clients and review audit programmes with the incorporation of ideas, that are fresh in the minds of those who performed the audit work for increasing audit efficiency.

Q. 5.7 : Define and explain the concept of : Auditing in depth.

[C.U. B.Com (Hons.), 1991]

Ans. : *Definition* : According to the Institute of Chartered Accountants of England and The expression 'auditing in depth' is a system of audit, which involves tracing a transaction through its various stages from origin to conclusion, examining at each stage to an appropriate extent the vouchers, records and authorities relating to that stage and observing the incidence of internal check and delegated authority. For example, verification of a payment to a creditor for goods supplied could be made by examination of a paid cheque which has been drawn in favour of a creditor and crossed 'account payee' only.

Complete verification of this transaction 'in depth' might involve the examination of the transaction at all stages including the following documents or records :

(a) The invoice and statement from the supplier.

(b) The evidence that the goods had been recorded in the stock records.

(c) The goods received note and the inspection certificate.

(d) A copy of the original order and the authority therefor.

Concept : As the depth of the examination increases, the number of transactions selected for audit should be progressively reduced. The scheme (for example) is as follows:

1. Select 100 payments to creditors for goods supplied.

2. Verify them by examining the paid cheques, properly crossed and stamped by the paying bank.

3. Select only a portion of these 100 payments and verify with the suppliers' in voices and statements.

4. Select a still smaller portion for verification as to the evidence that the goods had been recorded in stock registers.

5. Select a still smaller proportion (out of 4 above) for other audit tests and so on, till a particular item or transaction has been completely verified in depth.

The objective of 'Auditing in depth' is to detect fraud or irregularities and errors of principle or omission or commission and negligence to duties. It concerns itself not only with figures recorded but also with facts (assets or liabilities) represented by these figures. It seeks to achieve all audit assertions relating to existence or occurence, completness, rights and obligations, valuation or allocation and presentation and disclosure. It is, thus, an extended concept of test-checking or selective verification and contains the elements of propriety audit.

Short Answer Questions :

Q.1 : Write (in 3 lines) the object of audit planning.

A.1 : Adequate audit planning helps to ensure that appropriate attention is devoted to important areas of the audit, potential problems are promptly identified and work is completed expeditiously. Planning also assists in proper utilisation of assistants and in co-ordination of work done by other auditors and experts.

Q.2 : Identify the factors on which the extent of audit planning varies.

A.2 : The extent of planning will vary according to the size and complexity of the audit, the auditor's previous experience with the client and his knowledge of the client's business.

Q.3 : Point out the objects of maintaining 'audit working papers'.

A.3 : The objects are to document —(i) how the audit work was planned; (ii) the extent of supervision of assistants, their efficiency or inefficiency; (iii) sufficient and competent evidence on which to base an opinion; (iv) matters as a guide for future audit and (v) pertinent information so as to defend or substantiate in case of any legal proceedings on the ground of negligence, etc.

Q.4 : Define the term : test checking.

A.4 : This refers to a check on a selection of entries, generally made at random or by scientific sampling, to prove the reliability of accounting procedures and internal control.

Q. 5 : What is 'Cut-Off checking'?

A.5 : Alternatively termed 'cut-off examination' in audit, the scope and content include :

(i) **Cut-Off Date :** A date specified in the annual accounts of a company to which the balance sheet is to relate;

(ii) **Cut-Off Examination :** The examination of transaction and related evidential matter for a test period before and after the balance sheet date; and

(iii) **Cut-Off Period :** Refers to a short period before and after the cut-off date.

Q.6 : Give four examples of Auditor's working papers.

A.6 : (i) Draft Trial Balance, Profit and Loss account, and Balance Sheet; (ii) Schedule of Debtors and Creditors; (iii) Previous year's audited accounts and (iv) Audit Note books and Programmes.

CHAPTER 6

INTERNAL CONTROL AND INTERNAL CHECK

Learning Objectives : *After reading and carefully studying this chapter, the student should* :

- Understand the concepts of internal check, internal control, ICQ, and ICE and the traditional model for studying and evaluating the internal control.
- Be able to appreciate how internal control and internal check determine the scope of statutory auditor's work.

Q. 6.1 : Define and explain the concept of : Internal Control System.

Or,

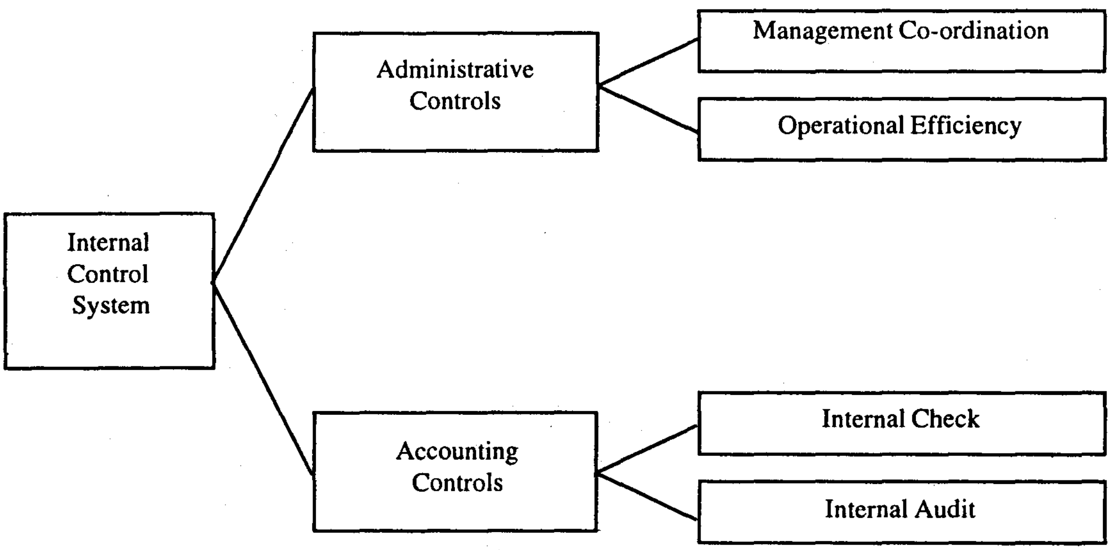
State the elements of 'internal control'.

Ans. : *Definition* : **Internal Control System :** The plan of or anisation and all the methods and procedures adopted by the management's objective of ensuring, as far as possible, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information. The system of internal control extends beyond those matters which relate directly to the function of the accounting system. The elements of the system of internal control are referred to as internal controls and are collectively known as internal control. (IAG).

Concept : The above definition amply explains the concept in a broader sense keeping in view the changing socio-economic conditions now-a-days where the society expects to get more from the Accounting and Auditing profession.

The concept includes the systems of administrative nature of control in addition to the traditional area of accounting control. This can be charted as under :

Internal Control System Chart :



(i) *Accounting controls* comprise the plan of organisation and all methods, procedures and records that are concerned mainly with, and relate directly to, safeguarding of assets and reliability of the financial records. They generally include such controls as the system of authorisation and approval, separation of duties concerned with record-keeping and accounting reports from those concerned with operations or asset custody, physical controls over assets, and internal auditing.

(ii) *Administrative controls* : comprise the plan of organisation and all methods and procedures that are concerned mainly with operational efficiency and adherance to managerial policies. They usually relate only indirectly to the financial records via decision processes leading to management's authorisation of transactions. They generally include such controls as statistical analysis, time and motion studies, performance reports, employee training programmes and quality controls, etc.

On most statutory cost financial audits, accounting controls are more important than administrative controls.

Q. 6.2 : (A) Enumerate the objectives and characteristics of a satisfactory system of Internal Control.

(B) What are the inherent 'limitations of Internal Control'? Mention them.

Ans. : (A) *Objectives* :

Internal Controls relating to the accounting system are concerned with achieving the following objectives :

(a) Transactions are executed in accordance with the management's general or specific authorisation.

(b) All transactions are properly recorded in the correct amount in the appropriate accounts and in the accounting period in which executed so as to permit preparation of cost and financial information within a framework of recognised accounting policies and to maintain accountability for asset.

(c) Access to asset is permitted only in accordance with management's authorisation.

(d) The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any difference.

Special internal control procedures designed to achieve the above objectives could include :

(i) Checking the arithmetical accuracy of the records.

(ii) Introducing the system of reconciliations and drawing up factual statements.

(iii) The institution of Audit Routines, Control Accounts and Trial Balances.

(iv) The approval and control of ducuments.

(v) Comparison with external sources of information.

(vi) Comparing the results of cash, security and inventory counts with accounting records.

(vii) Limiting direct physical access to assets and records.

(viii) Comparison of results with the Budgets or standards or other acceptable norms.

To sum up, the introduction of these internal control procedures would aim at :

(a) safeguarding the assets and resources of the business against losses from any sources, waste, frauds and errors, inefficiency, carelessness and ohter casualties, viz, accident, fire etc.

(b) promoting accuracy in the compilation and presentation of accounting and operating data ; and

(c) ensuring reliability in accounting, cost and financial statements and accounts;

Characteristics :

The characteristics of a satisfactory system of Internal Control are two-fold; Personal level and Institutional level.

Personal levels include :

(a) The delegation to specific individuals of powers of the approval, and the institution of checks to see that transactions are approved by individuals within the scope of their authority.

(b) A division of record-keeping such that one record is checked by another record created independently.

(c) Proper physical control of assets, including dual custody of negotiable and valuable assets.

(d) Separation of the custody of assets from the recording of the same assets and related transactions.

(e) Periodic independent verification of the existence of assets with the recorded accountability of these assets.

(f) Employment of trained and able personnel.

Institutional levels include :

(a) A plan of organisation which provides segregation of functional responsibilities, such that no person is in a position both to perpetrate and conceal irregularities in the normal course of his duties; to accomplish this, different individuals perform the functions of (i) authorising a transaction, (ii) recording a transaction, etc.

(b) A system to provide reasonable assurance of accounting control over assets, liabilities, revenues and expenses.

(c) Sound practices to be followed in the performance of duties and functions of each of the organisational departments, together with managerial supervision and reviews.

In short, adequacy of the procedures and practices and competence of officers, departmental heads and other key personnel are called for.

(B) *Inherent Limitations* :

Internal Control System can only provide reasonable assurance that the objectives of the management have been achieved and nothing else. The inherent limitations are as follows :

(a) The cost of a control procedure should be economic and proportionate to the potential loss due to fraud or error.

(b) The most of the controls tend to direct an anticipated type of transactions and not aimed at controlling unusual transactions.

(c) The potential for human error due to carelessness. distraction, mistake of judgement or the misunderstanding of instructions.

(d) The possibilities of circumvention of controls through collusion with parties outside the entity or with the employees of the entity.

(e) The possibility that a person responsible for checking and exercising control could abuse that responsibility, for example, a member of the management overriding a control.

(f) The possibility that procedure may become inadequate due to changes in condition.

Q. 6.3 : The evaluation of an Internal Control System of any functional activity of an organisation is done in two stages: Internal Control Questionnaires and Internal Control Evaluation.

Define and distinguish between two concepts, with suitable illustrations.

Ans. : *Internal Control Questionnaires (ICQ)*:

These are the documents developed and used by the Auditor to ascertain and pinpoint specific weaknesses by drawing out a long list of questions. The questions ask about the normal controls expected to be found in existence in any functional system or sub-system. The ICQ's are worded in such a fashion that if the answer to a question is in the affirmative; i.e., 'yes', then this gives an indication that there exists no weakness, while 'no' indicates the existence of weakness or deficiency.

ICQ is a means for securing detailed information about the systems in operation, and in the process, assists the auditor in Internal Control Evaluation. It, thus, constitutes a part of an audit programme. It should, however, be noted that ICQ's are by no means the only way of recording and assessing the client's system of internal control.

Internal Control Evaluation (ICE) :

It is designed to assess the overall effectiveness of the system or sub-system (i.e., a functional activity) of an organisation. It evaluates a system by asking if certain types of error could creep into the system unnoticed and undetected. The ICE procedures are aimed at using a small number of questions on key areas or factors for each system or sub-system. If the answers show that the errors involved can occur, then the form necessitates further details and enquiries as to the ascertainment of the reasons. Several audit firms conduct ICE for overall assessment and for materiality of the issues under system consideration. The ICE attempts to measure the performance of the system under review.

Distinction between ICQ and ICE :

Thus, The points of distinction between ICQ and ICE are :

(i) ICQ incorporates a large number of detailed questions but does not attempt to distinguish their relation in materiality, ICE isolates (in the form of a 'control question') the main control objective within the area under review.

(ii) Weaknesses are highlighted by the answer 'yes' on ICE, compared with 'no' on ICQ.

(iii) Answer 'no' in ICQ indicates a weakness, real or potential but its significance is not revealed on the form itself; whereas ICE requires audit personnel to state whether, in the particular context, an apparent weakness may prove to be material in relation to the accounts as a whole.

(iv) The 'control checklist' in ICE is no more than a summary of key control factors, and is no substitute for ICQ.

Illustration :

To cite an illustration with reference to a 'Purchasing System', the ICQ may be developed in the following manner.

Among the other questions : the ICQ may include,

1. Are the persons who record the invoices in the books of account prevented from also :
   (i) Working in the stores ?
   (ii) Authorising purchase orders ?
2. Are the stores staff prevented from also :
   (i) Working on the purchase orders ?
   (ii) Working on the accounting records ?
3. Are the staff of the purchase department prevented from also :
   (i) Having custody of the goods purchased ?
   (ii) Working on the books of account ?

The ICE, in connexion with the 'Purchasing System', may include the follwing types of **key control questions :**

1. Is it possible for a creditor to be raised in the books for goods that have not been received ?
2. Is it possible for goods to be returned to the suppliers without the liability being cancelled ?
3. Is it possible for a creditor to be raised in the ledgers for goods that were received but not ordered ?
4. Is it possible that goods were purchased on credit without any liability being entered in the books ?

If the answer to any of these questions indicates a general weakness, the Auditor cannot place much reliance on the system and the accounts it produces. He will then have to do further tests in the areas of weaknesses.

Q. 6.4 : Give six important questions that can be included in the internal control questionnaire regarding 'Purchasing System'.

Ans. : See : Q.6.3 (illustration).

Q. 6.5 : Draft an Internal Control Evaluation check-list showing four key control questions relating to 'Purchasing System'.

Ans. : See : Q. 6.3 (illustration).

Q. 6.6 : Discuss the importance of Internal Control and Internal Auditing functions in an organisation.

The Statutory Auditor (cost auditor or financial auditor) in forming his opinion on cost and financial information needs reasonable assurance that the accounting system is adequate, that the transactions are properly recorded in the Accounting Records and that significant transactions have not been omitted. Such assurance is usually drawn by him from a combination of reliance on certain internal controls and performance of substantive audit procedures. Internal controls coupled with Internal Auditing, even if fairly simple and unsophisticated, may contribute to the reasonable assurance the Auditor seeks, thus assisting him to reduce the extent of application of substantive tests of audit.

Therefore, it should be obvious that unless an organisation has the machinery or a system to check the accuracy of the records, accounts and primary documents, the Auditor cannot have sufficient and appropriate evidence to certify the correctness of the data, which, in all probability, have to be accomplished through a vast volume of detailed work. The special aspects of Internal Control or Internal Audit would, in relation to the accounting records, include checking the arithmetical accuracy of the records (e.g., stocks or raw materials ledger, wages and salaries under different accounting heads etc. control accounts and trial balances, and comparing the results of inventory counts with accounting records.

Further, the Auditor has to give an opinion on the credibility of the company's Cost and Financial Statements as required by law. It could be possible for him to collect and assess the audit evidence within a reasonable time and at a reasonable cost provided that the organisation has an existence of Internal Control and Internal Auditing systems commensurate to its size and complexity. The existence of such control systems would also assist him to evaluate, judge and become aware of the nature and extent of weakness in them, and to draw the attention of the management, on a timely basis, to the material weaknesses for improvement.

Q. 6.7 : Identify the auditor's approach to the study and evaluation of internal control system operation in an organisation.

Or,

As an auditor how would you determine the effectiveness of a system of internal control ?

Ans. : Although specific techniques for studying and evaluating internal control system differ among auditors, a general model illustrated below shows the review and evaluation process.

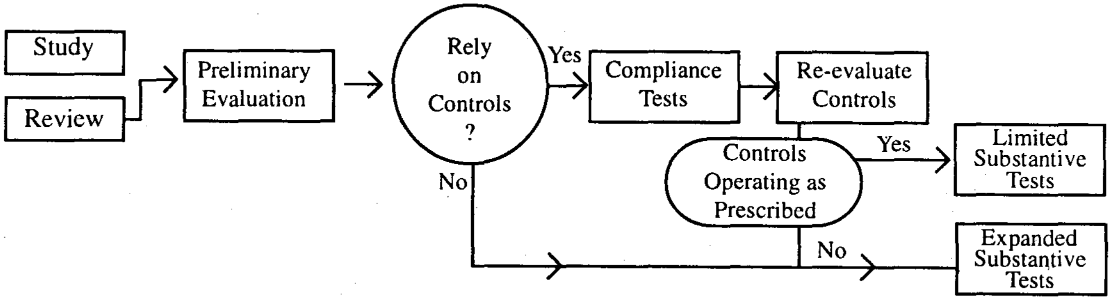
The review of a system of internal controls involves six steps :

1. *Obtaining* information about the system and the environment in which it operates.
2. *Testing* the validity of information obtained in Step I.
3. *Documenting* the auditor's understanding of the system.
4. *Performing* a preliminary evaluation of the system.
5. *Undertaking* 'compliance tests' if controls are reliable.
6. *Undertaking* 'substantive tests' if controls are unreliable.

For obtaining information about the system, the auditor should be alert to the general controls that ensure the functioning of the control system. He should gather information through inquiry and observation of appropriate personnel and reference to procedures manuals, flowcharts, job descriptions, or other information prepared by the client. The general controls here refer to the control environment.

Q. 6.8 : The extent and efficacy of internal control largely determines the scope of Statutory Auditor's work — Elucidate the statement.

Ans. : The above definition suggests two types of internal control, viz, administrative controls (i.e., the orderly and efficient conduct of business, and adherance to management policies) and accounting controls (i.e., the accuracy and completeness of the accounting records, timely preparation of reliable information, the prevention and detection of fraud and error, including the proper accounting



for safeguarding of assets). The ultimate aim and scope of auditor's work is the examination of financial statements, viz, Profit & Loss Account and the Balance Sheet, and to certify that the statements present 'true and fair view' of the state of affairs of a business enterprise. In order to discharge this responsibility and liability, the auditor should have a firm basis for reliance on the accounting records. This is possible only when he finds that the internal control measures are appropriate to provide him a reasonable assurance about the reliability of accounting records and information.

Again, unless an organisation has a system to check the accuracy of the records, accounts, and primary documents, the auditor cannot have sufficient and appropriate evidence to certify the correctness of the data which, in all probability, have to be accomplished by him through a vast volume of detailed work. The existence of adequate internal control system, commensurate to the size and complexity of an organisation, would assist him to evaluate, judge and become aware of the nature and extent of weaknesses in them, and to draw the attention of the management, on a timely basis, to the material weaknesses for improvement.

With the above perspective, the Institute of Chartered Accountants of India (in its 'Guide to Company Audit') recommends that the auditor should study and evaluate the systems of internal control and internal audit and their effectiveness while determining the scope and extent of an auditing exercise. The Companies Auditors' Report Order, 2003 makes a provision that the auditor has to report specifically on the system of internal control in regard to the purchase of materials, stores, etc., and also to state whether there is an internal audit system commensurate with the nature and size of the company.

Q. 6.9 : List the important aspects that an auditor should consider in evaluating the effectiveness of the internal controls operating in a computerised accounting function in a large organisation.

Ans. : Computerised Accounting Function — Internal Controls :

The important internal control aspects that are normally built into a computerised (EDP-based) accounts function may be listed as follows :

1. **Administrative Controls :** These include —

   (a) Division of responsibilities, (b) Control over computer operators, (c) File control, (d) File identification procedures, (e) File reconstruction procedures and (f) Fire precaution and stand-by arrangement.

2. **System Development Controls :** These include —

   (a) Standard procedure and documentation, (b) System and programme test, (c) File conversion, (d) Acceptance and authorisation procedure, and (e) System and programme amendments.

3. **Procedural Controls :** These include —

   (a) Input controls — establishment of control, verification of conversion, and authorisation of input; (b) Processing controls; (c) Output controls — general, directly related to input, indirectly related to input, exception reports, and distribution of output; (d) Master File Controls — amendment to standing data, maintenance of standing data, and maintenance of transaction data.

Q. 6.10 : Draft internal control questionnaires for the following audit areas : (a) Purchases and creditors, (b) Fixed assets, (c) Stores and materials, (d) Salaries and wages, (e) Cash and cheques receipt and (f) Cash disbursements.

Ans. : (a) Purchases and creditors :

At purchase department :

1. (a) Is the department separate and organised centrally ?

   (b) Is it independent of Receiving and Accounts departments ?

2. (a) Are purchases made only from approved suppliers ? If so, is there any list ? If not, why not ?

   (b) Is a 'Master list' maintained indicating different supply sources for all important materials ?

3. Is there any system of Preparing purchase Requisitions by the indenting department ? If so, are these requisitions duly signed by those persons who have been authorised by the management in this behalf ?
4. What is the scheme of approval in case of —
   (a) Purchases from employees, directors and companies in which directors are interested ?
   (b) Purchase of capital goods ?
   (c) Inter-company transactions relating to purchases ?
5. Are the competitive quotations obtained from two or more suppliers before placing Purchase orders for the same material ?
6. Does the system provide for preparation of Comparative Quotations Schedule before authorising purchases ?
7. Is the lowest of all the quoted rates always accepted ? If not, is it approved by an official at a senior level ?
8. Are Purchase Orders serially pre-numbered ? If so, what kind of control is exercised over the order forms remaining unused ?
9. Are all Purchase Orders duly approved and signed by those officials who are authorised in this behalf by the higher management ?
10. Is there any system of delegation of authority (powers) 'value-wise' for approval of purchase orders at different levels of management ?
11. Do the Purchase Orders contain the minimum information as to —
    (a) Name of supplier (b) Delivery terms (c) Quantity (d) Quality (including specifications) (e) Price (including cash and /or quantity discounts) (f) Freight terms (g) Terms of payment (including advances) (h) Extras, such as excise duty, octroi, sales tax ?
12. Are the Purchase Orders kept in safe custody against fraud or misuse ?
13. (a) How frequent is the revision of the Terms of Purchase Orders ?
    (b) Are the revisions or amendments in each case got approved by a next higher official ?
14. (a) Are copies of Purchase Orders and all revisions, if any, sent to the Accounts and Receiving departments ?
    (b) If so, are these being sent well in advance ? Or, just immediately before deliveries received ?
15. Is there any follow-up system for unexecuted Purchase Orders at regular intervals ? If so, how are the interval periods ? Are they specified by any authority ?

At Receiving department :

16. (a) Are all supplies received only at the Receiving department ?
    (b) If not, are some of the supplies received directly by user departments (i.e., at consuming points) ?
    (c) What is the procedure, in such cases, for obtaining acknowledgements as to the quantity and the condition of supplies of goods ?
17. Is the receiving department denied authority to issue Purchase Orders or to approve Invoices ?
18. (a) What is the arrangement for the inspection of incoming materials and supplies on receipt ?
    (b) Does this arrangement exist in the Receiving department ? If so, is the arrangement adequate ? If not, is there any separate Inspection department ?
19. Are description and quantities received duly checked against Purchase Orders, and with Goods Inspection Reports for quality and conditions ?
20. Does the receiving department deliver or supervise the delivery of each item received at the concerned stores or the user department location ?
21. What kind of documents are prepared for goods/containers returned to the suppliers ?
22. Are Goods Receipts Notes prepared for all receipts of materials and supplies ?
23. Are copies of Goods Receipt Notes endorsed to the Accounts department : sent to Purchase department without undue delay ?

24. Are all cases of returns, shortages and rejections informed to the Accounts department, for raising 'Debit notes' on suppliers and / or 'claim bills' on the transporting agents and insurance companies, as the case may be ?

At Accounts department :

25. (a) Are all 'debit notes' serially pre-numbered ?

    (b) Are adequate controls exercised for recording, etc ?

26. (a) Are all suppliers' Invoices received direct at the Accounts department ?

    (b) Are the entries thereof made in the Bill Register before being sent to the other departments for check and/or approval?

    (c) Are advance payments verified and/or entered on the Invoices before being sent to the concerned departments ?

27. Does the system adequately ensure that all Invoices and 'Credit notes' are duly processed ?

28. Are reconciliations of quantities (and/or value) received, as shown in the Purchase Invoices, made with all kinds of receipts into Stock Records ?

29. (a) Are duplicate invoices properly marked immediately on receipt to guard against duplicate payment ?

    (b) If double payments against duplicate Invoice were made even occasionally, what precautionary measures have been devised ?

30. Does the Accounts department match the suppliers' Invoices with the Goods Receipt Notes and Purchase Orders ?

31. (a) What kinds of check and review are exercised on Goods Receipt Notes and on records at Receiving department, especially for the item for which invoices have not been received ?

    (b) Are all such items thoroughly examined and provisions made for the liability in respect of them ?

32. Are all Invoices properly stamped as evidence of being checked for —

    (a) Prices (b) Freight terms and (c) Extensions and additions ?

33. Do the suppliers always attach relative Purchase Orders with their Invoices ?

34. Are all payments of 'advances to suppliers' routed through the Accounts department ?

35. (a) Is a list of pending 'advances to suppliers' drawn up at regular intervals ?

    (b) Are appropriate follow-up measures maintained ?

36. Are the Ledger accounts compared with the Suppliers' statements ?

37. What kind of follow-up action is taken in case of differences, if any, between the Suppliers' statements and Ledger accounts ?

38. Does the Accounts department prepare a statement of outstanding accounts payable at regular intervals ?

39. Is the statement referred to in (38) above reconciled with the General Ledger Control Account ?

40. Is there any system by which the Accounts department could fully ensure that the cash discounts, quantity discounts, trade discounts, etc., are availed of, whenever offered by the suppliers ?

(b) Fixed Assets :

Purchases and disposals :

1. Is there any Budget for capital expenditure ?

2. Are capital expenditures approved by the Board ?

3. Are the Budgetary provisions communicated in writing to —

   (a) Purchase department (b) Accounts department (c) Department originating the capital request ?

4. Is there any sound policy to differentiate between Capital expenditure and Revenue expenditure ?

5. (a) How are the Capital expenditures authorised?

   (b) Have specified officials been delegated with such authority ?

6. Are the Capital asset items subject to same control procedures as applied to purchases of Raw materials and other supplies, etc.?

7. Are receipts of Capital asset items subject to same procedures as applicable to Raw materials, stores, etc.?
8. What kind of control is exercised to ensure that the amounts spent do not exceed the amounts authorised ?
9. Are excess expenditures scrutinised before supplementary sanctions are obtained and/or made ?
10. Is there an established procedure for the transfer of plant and machinery from one location to another ?
11. Is a written authority necessary for (a) Declaring a Fixed asset scrapped (b) Selling a Fixed asset ? If so, is it restricted to specified senior officials ?
12. Are sales of Fixed capital assets subject to same procedures as applied to the sales of Finished products.
13. Are reports prepared and issued in respect of capital assets sold/scrapped/transferred (from one location to another) ?

Records :

14. Are Fixed assets under construction —
    (a) Subject to separate Control account in the General Ledger ?
    (b) Controlled by Capital Job-in-progress Number ?
15. Are shares of expenses on wages, materials and stores reasonably determined and charged to the Capital Asset Account ?
16. Are proper records of Fixed assets, including fully depreciated assets maintained ? If so, are they being regularly written up throughout the year ?
17. Are the records reconciled with the financial accounts at regular intervals ?
18. What are the basic information details kept ? Do they include —

    Suppliers' name, date of purchase, cost (including additions, improvements, exchange rate adjustments, installations, erections, modifications, etc.). Location and identification number, Rate of depreciation, Estimated life, Accumulated depreciation, Estimated salvage value ?
19. Is a record maintained of the plant,equipment, machinery, etc., used by the company, but owned by others ?
20. Does the company maintain a list of Title for all landed properties and buildings ?
21. Does the company keep the Title Deeds of properties in a safe custody ?
22. Does the company maintain Registration Books of all kinds of vehicles ? If so, are they periodically verified ?

Verification :

23. Are the Capital Assets verified at regular intervals ? What is the periodicity ?
24. What is the procedure followed for such verification ?
25. Does it provide for verification or confirmation of the Assets with third parties ?
26. Who are generally assigned the task of verification ?
27. Are Verification Reports prepared ?
28. Do such verification reports indicate the damaged and obsolete items of Assets ?
29. In case of discrepancies disclosed by such reports, what kind of action is taken ?
30. Are the adjustments in Asset Records made with proper authority ?
31. Are damaged and obsolete items struck off from the Records and Financial accounts ?

    If so, how are they made, and how are they authorised ?

Insurance :

32. (a) Are the following Risks covered by appropriate Insurance Policies in respect of plant and machinery and buildings, etc. —
    Fire, Flood, Earthquake, Riot, Civil commotion, War, Sabotage ?

    (b) If any of the above Risks not covered, was it in accordance with the management's policy ?

33. Are the new Assets acquired during the year also covered by Policies ?

34. Who are the officials authorised to decide on the Value of assets for the Insurance policies taken ?

35. What is the basis adopted for the Insurance ? Replacement basis ? Any other basis ?

36. Is there any arrangement to review the adequacy of Insurance coverage ?

37. (a) What kinds of Insurance coverage are in existence, e.g.,

    Loss of profits insurance cover ?

    Machinery breakdown cover ?

    Any other insurance cover ?

    (b) If either of the coverage not in existence, was it in accordance with the policy of management ?

(c) Stores and Materials :

1. Are incoming materials and stores stocked in assigned location ?

2. Are they under the direct control of the Stores Officer ?

3. Are adequate measures taken for their protection ?

   (a) Insurance to cover risk of :
   Fire, Flood, Riot, Civil commotion, etc.?

   (b) Limited access to stores areas ?

   (c) Storage spaces' fencings ? Enclosed rooms ? Locking arrangements, etc.? If any of the above is not adequately provided for, was it in accordance with the management's policy ?

4. Are Stock Records, perpetual or otherwise, maintained by way of the following classifications :

Raw materials,	Component parts,
Indirect materials,	Stores and spares,
Tools and implements,	Sub-assemblies,
Work-in-process,	Finished Goods, etc.?

5. Are the Records contemplated at 4 above maintained by those who are independent of the stores personnel ?

6. Are the Records contemplated at 4 above reconciled with the Accounting records at regular intervals ?

7. Is there any arrangement for continuous stocktaking ? If not, what is the periodicity ? If so, who are the officials authorised in this behalf ?

8. In case of continuous Stock Checks :

   (a) Are Reports of shortages and excesses made out ?

   (b) Do the Reports highlight damaged and/or obsolete items ?

   (c) How are these viewed by the management ? Investigations initiated ? Results of investigation recorded ?

   (d) Are these discrepancies or observations adjusted in the Stock records and Financial records ?

   If so, are these done based on written approvals from higher levels of management ?

   Is there any approved list of officials authorised in this behalf ?

9. Are appropriate Stock Records, e.g., Bin cards maintained for all goods in the stores ?

10. What kind of control is in vogue in respect of :

    Scrap materials ; Salvage materials; Defectives ; seconds, thirds, etc,; Waste materials (having value) ?

11. What is the scheme of Internal Checks in operation to ensure about correct recording in stores ?

12. Is there any Inventory Control Systems based on (say) :

    A – B – C – analysis (High – Medium – Low value) ?

    V – E – D analysis (vital – Essential – Desirable) ?

    F – S – N analysis (Fast – Slow – Non-moving) ?

    S – A – P analysis (Scarce – Available – Plenty) ?

    H – M – L volume analysis (High – Medium – Low) ?

13. Is there a well-laid out written Manual specifying procedures for inventory control ?

14. Are written instructions issued by the management for guidance of staff employed in physical stock-taking in respect of the following matters in particular :

    (a) Classification of stores and materials ?

    (b) Stocking arrangements of stores — their identification by location codes, stores codes ?

    (c) Cut-off points of receipts and issues ?

    (d) Condition as to stocks' quality — oiling and greasing of spare parts and important dies and tools ?

    (e) Preparation of stock-check sheets ?

15. What are the procedures followed with respect to the matters, e.g.,

    (a) Checking of Stock sheets ?

    (b) Summarisation of quantities ?

    (c) Summarisation of Stock cards ?

    (d) Reconciliation between the quantities shown in the Stock sheets and those declared to the Insurance and/or Banks ?

    (e) Checking of stocks :

    ------ in public warehouses ?

    ------ in company's warehouses ?

    ------ in bonded warehouses ?

    ------ in consignees' godowns ?

    ------ with the outside contractors for fabrication work, job work, conversion work, etc.?

16. Does the company's Stock Verification scheme extend to —

    Third parties' stocks ? consignment stocks ?

17. (a) What are the norms fixed for Stock Levels ?

    (b) What are the factors usually considered for Stock Levels determination ?

    (c) Do the company officials review these levels periodically ?

    If so, who are generally assigned this task ?

18. What is the company's procedure for issue of stores and materials ?

    (a) Are Requisition Notes always prepared ?

    (b) If so, are they serially pre-numbered ?

    (c) Has the company issued any list of officials authorised in this behalf ?

19. What are the procedures followed for :

    (a) Return of excess of the materials issued to Jobs or Processes ?

    (b) Transfers from one job to another ? Is the system compatible ?

20. In case of Job orders :

    (a) Is the 'bill of materials' prepared in advance ?

    (b) Is the copy of 'bill of materials' distributed to the stores department ?

    (c) Are the piece-meal issues against Requisition Notes reconciled with the 'bill of materials' ? How and when ?

    (d) Is Standard Costing system followed for materials issued against job orders ?

       (i) If so, how are the cost rates determined ?

       (ii) How are the variances between standard and actual cost rates adjusted ?

       (iii) Are the standard cost rates reviewed periodically ?

    (e) Are separate Job Control Accounts maintained where the consumption of materials contributes to the maximum of total Job cost?

    (f) Is Job-wise 'Materials Issue Analysis Sheet' prepared periodically for — Costing jobs in-progress ? Reconciling with stocks and issues ?

21. (a) In arriving at the cost of materials, supplies, packages, etc., which of the following charges are included or excluded — Carriage, Excise, Sales tax, Customs, Octroi, Insurance, etc.?

    (b) If included, are they in conformity with the

Cost Accounting Records Rules for the 'product' under cost audit ?

(c) If any of the charges excluded, is it in accordance with the Rules indicated above ?

22. (a) What is the procedure followed by the industry under cost audit in regard to the following factors — Dryage, Evaporation, Shrinkage, etc.?

(b) Has a standard or norm been evolved by the industry ?

(i) Is it consistent with other industries of the same class ?

(ii) If not, what studies have been made by the management in these areas ?

23. (a) How does the company ensure that values of 'Stores and Spare parts' have been appropriately debited to the proper Heads of accounts, viz — Repairs to building, Repairs to plant, other repairs, etc.?

(b) Is there any guideline of the management for the information of concerned staff ?

24. (a) What is the system followed for Inter-company Transactions in regard to the materials and stores ?

(b) How are the rates determined ?

(c) Who are the officials associated with the determination of rates ?

(d) Salaries & Wages :

1. (a) What are the Records maintained for each employee in regard to the following specifically :

Employment, Retirement, Dismissal, Payscales, Increments, Leave, Promotions, etc.?

(b) How are these Personnel records controlled ?

2. (a) Is there an arrangement for the issue of 'identity cards' to all employees ?

(b) If so, (i) are they periodically checked up?
(ii) are they taken back when an employee's terms of service cease ?

3. Is the 'Salaries and wages' department separate and independent from other departments ?

4. Are the company's policies clear, and the powers of company officials well defined with respect to :

Appointment, Dismissal, Retrenchment, Payscale Fixation, General pay increase, Special allowances, Leave availment, Leave encashment, Holiday pay, Reimbursement of medical and other expenses in accordance with the company's scheme ?

5. Are there appropriate records with respect to Piece-work and Timework ?

6. Are there approved schemes of Fringe benefits to employees :

Pension, Gratuity, Leave travel ? Are the records maintained adequate ?

7. (a) Is the Attendance department (entrusted with time-keeping and attendance recording functions) separate from the 'salaries and wages' department ans also from other departments ?

(b) If not, is it under a separate official so as not to be incompatible with the existing organisation pattern ?

8. Are 'check-in and check-out' times of employees adequately supervised by a competent official ?

9. (a) What procedures are followed in regard to the approval of :
Time cards or Clock cards, Job cards ?

(b) Does the procedure provide for verification by the Department officer only or also with Time Office's official ?

(c) Are the Time cards and Job cards matched periodically, at least in each week or month? Which department is assigned this responsibility ?

10. (a) Is the attendance on overtime work of employees approved by an official authorised in this behalf ?

(b) Does the scheme of overtime work ensure parity in so far as the engagements of employees are concerned ?

(c) Are selected few individuals only engaged ?

11. Is the preparation of Pay-roll based on the verification of (a) Original time cards (b) Original job cards (c) Original rates of pay advices (d) Original leave and absenteeism records (e) Original overtime records ?

12. Is there a segregation of work between Payroll preparation and Payroll checking?

13. Are test checks of Payrolls done by an official ?

14. Is the official authorising Payroll different from the person who carried on test checks or supervised preparation ?

15. Are the persons engaged in 'salaries and wages disbursement' independent of the preparation of payroll ?

16. Are surplus checks exercised by a senior level official (independent of cash or wages section) on the wages disbursement function?

17. Are the employees :

    (a) advised of their Gross earnings, Deductions and Net earnings?

    (b) identified at the time of wages disbursement?

    (c) informed beforehand of the 'cost of living index' appropriate to their different classes/categories?

18. Is payment to absentee employees made on 'letters of authorisation' duly endorsed by an official, having knowledge of absenteeism of the concerned employees?

19. Is the gross amount payable as per payroll for current wage period reconciled with the amount corresponding to the previous wage period?

20. Is the Payroll sorted out for payments to be made by — cash and cheques?

21. (a) Is a record of Unclaimed and/or Unpaid wages made out immediately after the wages disbursement is completed ?

    (b) Who are the officials of the Cash department authorised to retain unpaid or unclaimed wages ?

    (c) What is the time-limit after which the unclaimed or unpaid wages will be deposited into the Bank ?

    (d) Is there a system of regularly checking the unpaid or unclaimed wages ?

    (e) Is a separate Cash Voucher made out at the time of disbursing unpaid wages ? Is the Payroll cross-referenced to such voucher payments ?

22. Are the various deductions — statutory and non-statutory — from salaries and wages appropriately recorded in the Control Accounts ?

23. Is the Payroll properly classified for well defined (a) departments and (b) cost centres ?

24. Are all Pension disbursements approved by appropriate authority with reference to 'living certificate'?

(e) Cash and Cheques Receipt :

1. Is the custody function separate from the accounts section ?

2. Is the periodic verification function by the management independent of cash section ?

3. Are all employees who handle or have any direct or indirect access to cash adequately covered by guarantee bonds ?

4. Are the work assignments including the bank accounts reconciliation independent ?

5. Are the receipts with respect to : (a) Cash at the counter, (b) Cheques accompanied by remittance advices, (c) Cash against money orders, and (d) Postal orders etc. classified ?

6. Are the systems and control records relating to 5 above independently maintained ?

7. Are the receipts listing and their distribution to — (i) the cashier along with cash and cheques, and (ii) the accounts receivable and the general ledger departments for reconciliation and clerical verification, etc. prepared ?

8. Are the systems adopted for (i) deposits to the bank, and (ii) checking of deposit slips and of the counterfoils of each receipts issued adequate ?

9. Are all cash sales supported by invoices ?

10. Are all dishonoured cheques properly accounted for and informed to the accounts/sales departments ?

(f) Cash Disbursements :

1. Are the different modes of disbursements : (i) cash at the counter, (ii) cash against departmentalised payrolls, and (iii) cheques relating to suppliers and others, classified and systematised ?
2. Are the procedures of : voucher preparation, authority to pass vouchers for payment, cheque writing by authorised personnel, cheque signing by authorised officials, cheque linking to vouchers, etc. adequately streamlined ?
3. Are the controls over the credit cards and the documents for payments adequate?
4. Is a test of cash transactions with a 'block reconciliation' for a selected period made to obtain the proof of cash?
5. Are the physical safeguards and insurance coverages of the persons concerned adequate?

Q. 6.11 : Stores and spares constitute nearly half the total expenditure of a manufacturing company. The Managing Director has apprehensions that certain malpractices are going on in the receipt, storage, issue and accounting of stores. He requests you, as an internal auditor of the company, to examine the procedures followed and to suggest an effective internal control system for the receipt, storage and issue of stores.

Make a suitable report outlining the various control procedures you would suggest.

Ans. : Ref. No. : TA/4/IC Dated 25.4.2004.

To
The Managing Director,
X Y Z Mfg. Co. Limited.,

Dear Sir,

<u>**Sub : Report on Inventory Control Procedures**</u>

Kindly refer to your letter no. XYZ/MC/5 Dated 2.4.2004, I express my sincerest gratitude to you for the confidence reposed in me, and for requesting me to examine the procedures followed and to suggest effective internal control system for the receipt, storage, issue and accounting of stores in your works.

My observations vis-a-vis recommendation to bring about the improvements in the system are reported as under :

Observations based on present practices	*Recommendations*
1. **Purchase & Receipts :**	
(i) No Purchase Officer. (ii) Stores Officer initiates the purchases. (iii) System of tenders or quotations except for capital goods is absent. (iv) Incoming materials, on many occasions, are received from the supplier's end based on the verbal orders of the stores. Purchase Orders to regularise them are prepared based on the suppliers' invoices. (v) The purchase records kept are neither systematic nor comprehensive. (vi) Receipts of stores are not recorded daily. (vii) No system of preparing Goods Received Note. (viii) No intimation in advance to the accounts deptt. of the stores received.	The purchasing function should be divorced from the stores. It should be centralised. Wholetime Purchase officer should be engaged and authorised to carry out the following : (a) Scrutinising the purchase requisitions; (b) Maintaining and updating the list of suppliers and their performance; (c) Obtaining quotations or tenders from the right suppliers; (d) Presenting a comparative statement of quotations as to price, quality, quantity, delivery terms, payment terms, special clauses, etc., and obtaining approval from the Finance deptt; and (e) Issuing Purchase Orders to the Suppliers — with copies to receiving/stores/accounts/indenting departments. The Receiving function should be independent of Stores. It should prepare G. R. Note for each stores received and send copies to stores/accounts/indenting departments.

2. Storage & Issues :	
(i) Predetermination of Stores stock levels is not done. (ii) Stocks are not verified at regular intervals but at random only at the year end. (iii) Year-end stocks submitted by the Stores Officer are taken for granted. (iv) No system of Bin tags. (v) Issues to the consuming departments are not always based on authorised documents. (vi) Store-keeping arrangements are not systematic.	The function of store-keeping and stores issuing should be streamlined on the following lines : (a) Verifying incoming materials with the information contained in G. R. Note; (b) Storing/stacking/placing materials at the right bins/containers/spaces; (c) Maintaining Bin Cards for each item as a perpetual inventory measure; (d) Issuing the materials only against — Stores Requisitions authorised by a Competent Official; (e) The entries for each receipt and issues, including transfers and returns of stores should be made in Bin Cards promptly; (f) Material Control deptt. should Advise about the stock levels to the Stores Officer; and (g) Stock checks should be on continuous basis by the Officials independent of this deptt.
3. Accounting & Control :	
(i) List of stores discrepancies is not made out.	(a) Stores Ledger should be maintained both in quantity and value.
(ii) No Stores Ledger at the accounts deptt.	(b) Stores discrepanies should be investigated before book adjustments.
(iii) Classification of stores based on values is not done as a measure of inventory control.	(c) Periodic reconciliation between the Stores Ledgers and the Bin Cards should be introduced to locate the differences for further investigation as to the causes.

I would be glad to have further discussions on any of the points indicated above, should you require any clarifications.

With kindest regards.

Yours faithfully,

Internal Auditor.

Q. 6.12 : (A) What do you understand by the term 'Internal check'? Or, State the principles of internal check. (B) Distinguish it from 'internal control' and 'internal audit'. (C) How far does 'internal check' affect the work of an auditor? (D) What are the objects, advantages and disadvantages of internal check?

Ans. : **(A) Internal check :** An arrangement of staff duties whereby no one person is allowed to carry through and to record every aspect of a transaction so that, without collusion between two or more persons, fraud is being prevented and at the same time the possibilities of error are reduced to a minimum.

It is, thus, a system whereby the work methods are so laid out that the accounts and procedures are not under the absolute control of anybody. The work of one employee is complementary to that of another. A continuous audit is made by employees.

(B) Distinction :

Internal control	Internal check
1. It is an integrated concept incorporating the element of internal check.	1. It is one of the elements or components of internal control system.

Internal control	Internal check
2. It is wider in scope and application.	2. It has a narrower meaning than internal control.
3. It aims at regulating the whole system of controls, financial or otherwise, established by the management in order to carry on the business of the company in an orderly manner.	3. It is a systematic arrangement of accounting routines among the staffs in such a way that the work of one clerk interlocks with and cross-checks the work done by another.
4. It is designed to assist management in its functions, such as in regard to operational efficiency and adherence to managerial policies outside the strict scope of accounting.	4. It is designed to prevent and/or detect errors and frauds and irregularities, and assists in achieving the reliability of accounting records only.

Internal check	Internal audit
1. It is a routine system whereby the day today business transactions are checked automatically and continuously by the employees themselves.	1. It is a kind of continuous audit carried on by an internal auditor who is independent of the staff maintaining the day-to-day business transactions.
2. It is the result of allocation of work and duties among the clerical staff.	2. It is an independent appraisal function established within the organisation to examine and evaluate its activities as a service to the organisation.
3. It is a device to minimise the chances of errors and frauds.	3. It is a device to discover errors and frauds already committed.
4. It is concerned with the systems of efficient working of a business.	4. It is concerned with the actual verification of operations and records of a business.

(C) Auditor and Internal Check :

The auditor may be relieved of undertaking detailed checking if there is an efficient system of internal check. He can plan to utilise the time saved thereby in auditing the other important areas. But he himself has to decide as to the extent of reliance he can place on the internal checks depending on the particular circumstances. He should test the systems of internal check for his satisfaction. In the event of his dissatisfaction or suspicion, he must probe the matter to the bottom. In the absence of any suspicious circumstances, he may rely upon the internal checks in force but is not totally relieved of his responsibility. He runs the risk of being held liable for negligence if errors and frauds are detected afterwards. The internal check system is introduced not by the auditor but by the client organisation. So, the auditor should appraise the system for reliability with reasonable skill and care.

In short, the existence of an efficient internal check system may reduce the auditor's work volume but does not reduce his liability.

(D) Objects :

(1) To prevent errors or frauds or irregularities; (2) To pinpoint responsibility on the person(s) and to locate vulnerable stages where frauds and errors occur or are likely to occur; (3) To increase the efficiency of the staff; (4) To protect the integrity of the business and to facilitate business control by achieving the reliability of accounting records and data; and (5) To provide rational allocation of work among the staff.

Advantages :

(1) It prevent errors or frauds or irregularities; (2) It pinpoints responsibility on the person(s) and locates vulnerable stages where frauds and errors occur or are likely to occur; (3) It increases the efficiency of the staff; (4) It protects the integrity

of the business and facilitates business control by achieving the reliability of accounting records and data; and (5) It provides rational allocation of work among the staff.

Disadvantages :

(1) The internal check system is suitable in a big organisation. A small organisation cannot afford to it. (2) Collusion in disguise among the staff is sure to defeat the very purpose of the system. (3) An auditor. in all probability, relies on the system and is therefore tempted to apply test-checks rather than thorough checks.

Q. 6.13 : (a) What do you understand by 'Test Checks'? (b) Indicate the factors to be considered by an auditor when deciding upon the extent of test checks to be made. (c) State the advantages and disadvantages of test checks.

Ans. : **(a) Test Check :** A check on a selection of entries, generally made at random or by scientific sampling to prove the reliability of accounting procedures and internal control.

It, thus, involves checking a few transactions out of a large number of transactions keeping in view the time at the disposal of the auditor.

(b) When deciding upon the extent of test checks to be applied, the auditor should consider the following factors.

(1) **Circumstantial factors :** (i) The volume of transactions involved is fairly large; (ii) The vouching of each and every transaction is rendered difficult; (iii) The detailed checking is cumbersome and a costly exercise ; (iv) Time available for audit is a constraint; and (v) The verification of a large nember of similar items does not provide extra reliance on the audit results.

(2) **Precautionary factors :** (i) Selection of entries, even if at random, must be representative; (ii) Selection of periods and of entries for checking must be different every year; (iii) System of internal checks in force must be efficient, as otherwise the auditor may be liable for negligence.

(c) Advantages : (i) It minimises the work of the auditor; (ii) It affords economy of time and cost of audit; (iii) It facilitates audit planning and programming; and (iv) It allows more time to be sepnt in the audit areas where test checks are not suitable.

Disadvantages : (i) The errors and frauds may remain undetected; (ii) The auditor needs to be very careful and must have a keen sense of judgement to apply the system; and (iii) The auditor runs the risk of being held responsible for negligence for non-detection of errors and frauds.

Q. 6.14 : Under what circumstances, 'test checks' are undertaken by an auditor ?

Ans. : See Q. 6.13(b)

Q. 6.15 : Point out the main precautionary measures to be taken while applying 'test checks'.

Ans. : See Q. 6.13(b)

Q. 6.16 : What steps would you suggest for internal checks with respect to : (1) Cash sales, (2) Credit sales, (3) Cash purchases, (4) Credit purchases, (5) Preparation of wages sheets, (6) Payment of wages, (7) Purchase of raw materials and stores, (8) Discounts and rebates to customers, (9) Sales returns, (10) Settlement of claims against suppliers, (11) Mail order sales, (12) Cash receipts, (13) Cash payments, (14) Payment by cheques, (15) Petty cash payments, (16) Issues of stores and materials in a manufacturing company, (17) Purchases returns, (18) Cash transactions.

Ans. : The suggested steps for internal check system are as follows :

(1) Cash Sales :

(a) Sales at the counter : (i) Preparation of cash memo in triplicate by Salesmen, the original and duplicate copies being handed over to the customer and the triplicate retained in the book; (ii) Payment of cash by the customer along with cash memo (2 copies) to the cashier; (iii) Marking cash memos as 'Paid' by rubber stamp by the cashier who should hand over them to the customer and record the amount as a receipt in Cash Register Machine; (iv) Verifying the total cash sales for the day as per cash register statement with the cash memos retained by the salesmen and the gatekeeper.

This system is followed in a big departmental retail stores.

(b) Sales by travelling Salesmen/Agents :

For 'direct sales' promotion and collection by them, the system should be : (i) Authorising them to issue money receipt; (ii) Specifically instructing them to deposit the entire cash collection daily to the cashier or to company's bank account; (iii) Asking them to submit daily report of sales and collection for bank deposits; (iv) Strictly advising them neither to keep any collection with them nor to allow any collection to remain outstanding.

(c) Sales through post : For this, the system should be : (i) Maintenance of separate registers for VPP sales, postal sales, and sales returns for non-acceptance by customers; (ii) Recording in respect of goods despatched/received from stores/ returned to stores, cash received against sales, expenses on postage for despatches, etc.; (iii) The person despatching goods should not receive cash; (iv) Accounting of cash in the Cash Book and deposit thereof in the bank; (v) Accounting and adjustment of advances to avoid double despatches.

(d) General Checks : (i) Verification and accounting of outstation cheques by reference to the sales bills; (ii) Verification of cash or cheque receipts with the Order Receipt Book to find out unrealised amounts, if any; and (iii) Preparation of Bank Reconciliation Statement by the cashier to confirm bank balance.

(2) Credit Sales :

(i) Separation of sales department from the despatch department; (ii) Functional sub-divisions, e.g., receiving orders, accounting of goods supplied, invoice preparation, etc. within the dept.; (iii) Recording of all customers' orders serially in the book; (iv) Endorsement of customers' orders to the despatch dept.; (v) Authorisation by a competent official as regards terms of sale, discount allowed, bad debts write-offs; (vi) Verification of invoices against orders executed with the orders received prior to despatch; (vii) Preparation of invoices in triplicate and matching the third copy with the duplicate received from the customer duly signed for the goods received; (viii) Daily verification of the Goods Outward Book (containing entries for goods supplied to customers) with the Order Book and the Invoice Book; (ix) Maintenance and checking of the Sales register written up from invoice copies; and (x) Periodical follow-up measures on the collection of customers' accounts.

(3) Cash Purchases :

(i) Preparation of purchase orders based on the purchase requisitions duly authorised by a competent official ; (ii) Deciding the terms of purchase based on the comparative tenders and quotations; (iii) Verification of purchased materials as to quantity and quality by a deptt. independent of purchase and stores deptts.; (iv) Verification and accounting of purchase invoices with the purchase order, goods receipts and the prevailing market prices to prevent/detect manipulation or fraud; (v) Authorisation of payment against invoices by a responsible official; and (vi) Recording of all details in the purchases register.

(4) Credit Purchases :

In addition to the internal checks outlined at (3) above, the system should include — (i) Separation of records between cash purchases and credit purchases; (ii) Functional separation of the main items of work, e.g., purchase ordering, tender committee, tenders and quotations, contracts, acceptance of purchases, etc; (iii) Record of approved suppliers; (iv) Pre-numbered purchase orders and their distribution to the concerned deptts.; (v) Pre-numbered goods receipt notes and their distribution; (vi) Recording of advances paid and adjustments before final payment; and (vii) Checking of credit terms and discount receivable.

As regards **Purchases Returns (Returns Outward),** the system should be : (i) Maintenance of Purchase Returns Book for goods returned to suppliers on account of rejections; (ii) Preparation of Goods Returned Notes and their distribution to — Stores and Accounts deptt. and to Suppliers; (iii) Obtaining Suppliers' credit notes for accounting adjustments and entries in purchase returns book; (iv) Matching Invoices (not paid-off) and the credit notes, or filing credit notes with the current invoices awaiting payment.

(5) Wages Sheets preparation :

(i) Separation of the main functions, like attendance, preparation of wages sheets, and payment of wages, etc.; (ii) Use of Separate Wages Sheets/ books for time-workers and piece-workers; (iii) Preparation of wages sheets (i.e., checking the time records, piece-work records, overtime records, and computation of wages payable and deductions) by one set of staff; (iv) Checking the wages sheets by another set of staff; (v) Recording, computation, and checking of each element of wages should be by different clerks independent of each other; (vi) Initialling by each clerk of the work done by him, and countersignature of the wages sheets by the incharge before these are finally approved and authorised by the departmental chief or the employer.

(6) Payment of Wages :

(i) Entrusting the disbursement function to those staff who have not taken part in the wages sheets preparation; (ii) Withdrawal of the exact amount of the wages bill from the bank; (iii) Distribution of identity slips to the workers; (iv) Disbursement of wages to workers, in presence of the departmental foremen concerned, after obtaining signature and thumb impressions on the sheets; (v) Making special arrangements for payment of wages to night-shift workers with an authority delegated to the foreman; (vi) Regulating the payment of wages to absentee workers on their behalf to others against appropriate letters of authority only; (vii) Attestation of payments by the persons who made disbursements, the foremen, and the manager; (viii) Preparation and authentication of unpaid wages list for necessary adjustments ; (ix) Handing over the unpaid wages list and the amounts to the cashier; (x) Preparation and authentication of cash vouchers for payment out of unpaid wages account of workers by the cashier, foreman and the manager; and (xi) Selecting different day for wages payment to casual workers.

(7) Purchase of Raw Materials and Stores :

See : Answers to (3) and (4)

(8) Discounts and Rebates to Customers :

(i) Separation of the Customers' accounts into two groups : Customers to whom discounts and rebates are applicable and those not applicable; (ii) Written approval and authorisation as regards the rates of discounts and rebates and changes thereto; (iii) Verification of the amounts incorporated in the invoices by the staff independent of the staff who computed these amounts while preparing the invoices; (iv) Separate accounting of discounts and rebates allowable and allowed; (v) Issuing credit notes to or obtaining debit notes from the customers in case of variations in amounts compared to predetermined allowances; and (vi) Verification of credit or debit notes by the accounts department for necessary adjustments in current invoices.

(9) Sales Returns :

(i) Recording of returns inwards from the customers in the Returns Inward Book; (ii) Issue of credit notes, duly signed by an authorised sales official, to the customers for each return; (iii) Preparation of a statement of goods returned by the sales departments; (iv) Verification of the goods as per the statement so received by the despatch deptt.; (v) Making adjustment entries in the accounts deptt.; and (vi) Comparison between the Returns Inwards Book and the Warehouse's record of returns.

(10) Settlement of Claims against Suppliers :

Although the system of internal checks with respect to this would depend on the exact nature and type of claims, the general procedure should be :

(i) Review and check of the credit terms, the rates of discounts and rebates receivable, etc.

(ii) Review and check of the excess quantities supplied by the suppliers with reference to purchase orders, Goods Receipt notes, etc.

(iii) Rechecking of the bill amounts by reference to price and tax charges consequent on the revision of these items by any legislation.

(iv) Review and check of the advances and adjustments.

In all these internal checks to be exercised for processing such claims, a responsible official should be entrusted with the task. The final settlement must, however, rest with the top official who would decide on the merits of each case.

(11) Mail Order Sales : See : Answer to 1(C).

(12) Cash Receipts :

(i) Use of pre-numbered and pre-printed receipt book for all cash collections; (ii) Adopting the same practice even for cash collection by travelling salesman; (iii) Making entries of all cash receipts in the Cash Book; (iv) Depositing daily all cash receipts in the bank; (v) Verification of such deposits daily by another person; (vi) Acceptance of cash only by one person i.e., cashier; (vii) Opening of incoming letters and remittances by the cashier in presence of a responsible official; (viii) Making entries thereof in the register; (ix) Marking them with the words 'Not Negotiable' or 'A/c. Payee only'; (x) Safe custody of unused receipts; (xi) Cancellation of spoiled receipts; (xii) Preservation of receipted counterfoils for accounting and verification; (xiii) Non-accessibility of the cashier to books of accounts other than the cash book; and (xiv) Preparation of a bank reconciliation statement by the cashier for bank balances ascertainment.

(13) Cash Payments :

(i) Payments by A/c Payee cheques as far as practicable; (ii) Safe custody of unused cheques; (iii) 'Pay Order' authorisation; (iv) Payment always by reference to appropriate documentary evidence; (v) Signing of cheques by the authorised official only; (vi) Payment for Rs. 2,500/- or more always by 'A/c Payee' cheques; (vii) Use of revenue stamps for cash payments exceeding Rs. 500/-; (viii) Cash payment of Salaries and wages in presence of a responsible official;(ix) Preparation of vouchers for all payments; (x) Continuous serial numbering of all cheque/cash vouchers; (xi) Obtaining receipts for all payments; (xii) No payments against I.O.U. and 'on account' without the sanction of an appropriate authority; (xiii) Recording all payments in the cash book; and (xiv) Preparation of bank reconciliation statement by a person who is not in-charge of writing the cash book.

(14) Payment by Cheques : See : answer to (13) above.

(15) Petty Cash Payments :

(i) Maintaining an imprest system of cash and a petty cash book; (ii) Separate serial numbering of petty cash vouchers; (iii) Preparation of vouchers by persons other than petty cashier; (iv) Non-payment of any loans from the petty cash; (v) Signing the statement of expenses and the petty cash book by a responsible officer.

(16) Stores and Materials Issues :

(i) Preparation and authentication of 'Stores/ Materials Requisition' by a department in-charge; (ii) Actual issues to be made by weight or measurement; (iii) Recording the same in the Requisition and the Bin Card or Kardex; (iv) Endorsement of requisition slips (duly receipted by indenting deptt.) to Stores Accounts; (v) Entries in the Stores Ledger at works accounts office; (vi) Stores debit/ credit/transfer notes preparation and checking etc.

(17) Purchased Returns : See : Answer to (4).

(18) Cash Transactions : See : Answers to (12), (13) and (15).

Q. 6.17 : Design a system of internal check for the Cash Sales of a big departmental store.

Ans. : See : Q. 6.16(1)(a).

Q. 6.18 : When travelling salesmen are allowed to collect cash from customers, what type of internal check/control would you suggest to your clients who are manufacturing and distributing pharmaceutical products ?

Ans. : See : Q. 6.16 (1)(b).

Q. 6.19 : What precautions should the proprietor of a business concern adopt to guard against misappropriation of cash by the cashier ?

Ans. : See : Q. 6.16 (12, 13, and 15).

Q. 6.20 : 'The auditor faces two risks when performing an audit". — Indicate the two risks in clear and precise terms.

Ans. : *Two Audit Risks :*

(1) The risks that the client will make an error or perpetrate an irregularity in the processes of accounting that will result in misstatements in the cost and/or financial statements. This risk is assessed by the auditor by means of study, test, and evaluation of the internal control system operated by the client. It is generally assumed by the auditor that the stronger the system of internal control, the lower the risk that the client will prepare mis-stated cost and/or financial statements.

(2) The risk that the auditor will not be able to detect errors or irregularities that result in mis-stated cost and/or financial statements.This risk can, how-

ever, be controlled by varying the nature, extent, and timing of the substantive tests (tests of financial statement balances and disclosures, transactions that affect these balances and disclosures, and analytical reviews).

Thus, it may be stated that an inverse relationship exists between an effective system of internal controls and the effort of an auditor in testing the balances and disclosures in the cost and/or financial statements.

Q. 6.21 : What do you understand by the following expressions : (1) Audit Risk and (2) Assessment of Audit Risk ?

Ans. : (1) *Audit Risk :*

A risk that the evidence an auditor gathers will be incomplete or insufficient to give him a valid basis for an opinion on the financial and cost statements is ordinarily expressed as 'audit risk'. To minimise this risk, the auditor exercises judgement on the type and amount of evidence he acquires. To cite an example of accounts receivable, the auditor's task is to decide whether in his opinion the figure of 'accounts receivable' is materially correct or not. Thus, a risk is assumed by the auditor to arrive at a decision before the expression of an opinion. Audit risk refers to this.

Audit risk has the following three components :

(i) the risk that material errors will occur (inherent risk).

(ii) the risk that the client's system of internal control will not prevent or correct such errors (control risk), and

(iii) the risk that any remaining material errors will not be detected by him (detection risk).

(2) *Assessment of Audit Risk :*

It is at the final phase of planning and audit. The auditor should obtain knowledge of the business and of economic and industry conditions to assess his risk. By estimating the areas of risk, he will be in a better position to determine the allocation of time and resources for completion of audit. The assessment of audit risk is usually made by seeking answers to a questionnaire suitably designed by the auditor.

Q. 6.22 : (a) Define and explain the concept of 'Materiality' in audit. (b) State the circumstances or indicators that have a bearing on the questions of 'Materiality'.

Ans. : See : Q. 3.7 of Chapter 3.

Short Answer Questions :

Q.1 : State the elements of : (i) Internal accounting controls and (ii) Internal administrative controls.

A. 1 : (i) (a) The plan of organisation (i.e., the allocation of duties); (b) the methods and procedures of authorisation, approval, recording and custodianship (i.e., internal checks); and (c) the management's supervision and reviews (i.e., internal audit).

(ii) (a) The plan of organisation for management co-ordination (i.e., the segregation of administrative functions); and (b) the methods and procedures for operational efficiency.

Q. 2 : State two main objectives for which an auditor reviews the internal control.

A. 2 :(i) To form an opinion as to the correctness and fairness of the cost/financial statements; and

(ii) To convey to the management its weaknesses.

Q. 3 : Give four instances of 'internal control' weaknesses.

A. 3 : (i) The same person is authorised to purchase, receive, and pass the bills of stores; (ii) The cashier has not taken leave during the last three years; (iii) The stores and stock verification is done by the personnel who are incharge of the same; (iv) A member of the top management or a responsible official has other business interests.

Q. 4 : How does the internal control system influence the audit ?

A. 4 : (i) The detailed work of audit can be suitably restricted in case of adequacy and effectiveness of the internal control system.

(ii) The detailed work of audit has to be undertaken in case of inadequacy of the internal control system.

Q.5 : What should the auditor do if he is not satisfied with the internal control system ?

A. 5 : The auditor should :

(i) draw the management's attention to the prevailing state of weaknesses; and

(ii) take additional precautions in the areas where the system is considered to be unsatisfactory.

Q. 6. : Name the three methods used to review the system controls.

A. 6 : (i) Narrative description, (ii) Systems flowchart, and (iii) Questionnaires.

Q. 7 : What are : (i) EDP general controls, and (ii) EDP application controls ?

A. 7 :(i) EDP general controls refer to a framework of overall control over the EDP activities. They provide an assurance that the overall objectives of internal control in EDP are achieved. These include organisation and management controls, system development and maintenance controls, system software controls, data entry and programme controls, and back-up and recovery controls.

(ii) EDP application controls refer to specific control procedures over the accounting applications and provide an assurance as to–controls over input, processing controls, and output controls.

Q. 8 : 'Test checking is based on presumption'. What is that presumption ? [C.U. B.Com. (Hons.), 1993]

A. 8 : Its presumption is to have a check on a selection of entries, generally made at random or by scientific sampling, to prove the reliability of accounting procedures and internal control.

Q. 9 : What are the essential tests of effectiveness of an efficient system of internal check ?

A. 9 : (i) Clarity of responsibility among the personnel engaged in identifiable accounting routines, (ii) Work division to achieve uninterrupted flow of work, (iii) Standardisation of the methods of accounts keeping in all spheres, and (iv) Periodical review of the system to correct the deficiencies noticed.

Q. 10 : What is meant by 'Weakness in Internal Accounting Control'?

A. 10: This refers to a condition in which the specific control procedures, or the degree of compliance with them, are not sufficient to achieve a specific control objective; that is, errors or irregularities may occur and not be detected within a timely period by employee in the normal course of performing their assigned functions.

Q. 11: Detail the system of internal check you should expect (i) In respect of wage payment in a manufacturing concern and (ii) Receipts of a cinema hall. [C.U. B.Com. (Hons.), 1990]

A. 11: See : Q.16(6) and (12) — items of (i), (iii), (iv), (v), (vi), (x), (xi) to (xiv) only].

Q. 12 : Your company manufactures metallic valves, which involve :

(a) purchase of metal ingots in substantial quantity;

(b) strict quality specification for metal ingots resulting frequent return of materials rejected;

(c) generation of valuable scrap in the production process and its disposal;

(d) sale of surplus stock of ingots, in case of substantial price variations.

Outline a suitable internal system that will adequately control all the aforesaid functions. [C.U. B.Com. (Hons.), 1991]

A.12 : [*Hints* : **(a) Purchases** : [See : Q. 6.10 (A) relevant items];

(b) Returns : (i) Rejection notes and segregation of ingots, (ii) Return notes to suppliers and acknowledgements thereof,

(iii) Adjustment or Refund advices received from them, (iv) Supplier-wise subsidiary record for reconciliation and reference, and (v) Test results or reports for quality, etc.

(c) Scrap : (i) Scrap generation notes and segregation of them including separate storage, (ii) Stock records, (iii) Disposal tender notices and accepted parties, (iv) Disposal advices and accounting and (vi) Authorisations, etc.

(d) Surplus ingots sales : (i) Sales invoices with separate running serial numbers, (ii) Cash or Credit sales documents, (iv) Despatch memos, (v) Accounting and (vi) Authorisations from the competent officials, etc.]

CHAPTER 7

AUDIT PROCEDURE : VOUCHING

Learning Objectives : *After reading and carefully studying this chapter, the student should* :

- Have an appreciation of the importance and necessity of vouching in relation to an audit assignment.
- Know the vouching techniques of receipts and payments in a business.

Q. 7.1 : (a) 'Vouching is the essence of auditing.' — Discuss. (b) State its purposes and objectives.

Ans. : (a) In Auditing the process of evaluation of evidence requires examination of evidence, documentary or otherwise. Vouching means the examination of documentary evidence in support of entries maue in the books of account. So, vouching is an essential part in the auditing process. Vouching implies testing the truth of the transactions appearing in the books of original entry. Through vouching, the auditor satisfies himself that the transactions (i) are in order (ii) have been properly authorised and (iii) are correctly recorded in the book. Thus, it can be stated that the whole structure of auditing rests on vouching.

(b) Purposes : Vouching, as a means to examine the evidence in support of any transaction or any entry, serves the following purposes –

1. Authenticity of transactions.
2. Correct recording of amounts.
3. Proper accounting of all receipts and payments.
4. Truth and fairness of entries by substantiating the propriety of their sources i.e., vouchers.

(c) Objectives : (1) To ascertain that all transactions and entries have been properly accounted for in the appropriate books of account; (2) To ensure that adequate documentary evidences exist for all transactions; (3) To see that the transactions and entries relate to the business and the period under audit; (4) To see that no fraudulent transactions have been recorded in the books of account, and (5) To ensure that the transactions and entries are properly authenticated by the responsible officials.

Q. 7.2 : (a) What is 'Routine checking'? (b) What are its objectives? (c) Distinguish it from 'Vouching'. (d) Are routine checking and vouching complementary to each other?

Ans. : (a) Routine checking is concerned with ascertaining the arithmetical accuracy of : (i) castings (of journals and ledgers), (ii) postings (of entries in the books of original entry and from these books to ledger accounts), (iii) balancing (of ledger accounts), (iv) carry forwards, (v) drawing up (of the trial balance), and (vi) final accounts.

(b) Objectives : (1) To ensure arithmetical accuracy of entries in the books of original entry; (2) To ensure correctness of postings in the ledger accounts and their balancing ; (3) To ensure, by the use of special 'ticks', that no figure has been altered after it has been checked.

(c) Distinction : [See : Meanings given at 7.1 and 7.2 (a) above]

The main distinguishing features are : (1) Vouching is much wider in concept and application than routine checking ; (2) Routine checking is limited to the entries as they appear in the books of account, whereas vouching must trace the source of information even beyond the books of account ; (3) Routine checking is a part of the total concept of vouching as the latter includes the former as one of the auditing procedures ; (4) While routine checking is done by junior-level audit staff, vouching is carried out by senior ones.

(d) The concepts of vouching and routine checking are not similar. Vouching incorporates in it the concept of routine checking. Routine checking and vouching are not complementary to each other on the basis of the following main considerations.:

1. Vouching establishes that the transactions recorded in the books are in order, have been authenticated and are correctly accounted for, but mere routine checking does not ensure them.

2. Substantiation of propriety results from vouching : which is not achieved by routine checking.

3. Routine checking establishes the reliability of entries in the books of original entry, but it can never establish the truthfulness, fairness, and completeness of the recorded transactions to which vouching aims at.

4. The aim of the auditor is : (i) to ascertain the real state of affairs by examining internal and external evidences, (ii) to ensure the confidence of third parties, (iii) to guard against all frauds, errors and irregularities, (iv) to have a greater precision in audit, etc. These are achieved by vouching and not by means of simple routine checking.

Q. 7.3 : State the important points to be considered while examining the vouchers (or while vouching).

Ans. : While vouching transactions or examining the vouchers, the points to be considered are : (1) Satisfaction as to three basic requirements of a voucher — genuineness of transaction, accuracy of amount, accounts classification ; (2) Consecutive numbering and orderliness in filing of vouchers ; (3) Agreement of the date and number of vouchers with those entered in the books ; (4) Clear explanation of the transaction as to — party's name, amount, account classification, etc. in a voucher so that it is capable of verification from the books of account ; (5) Recording of amount both in figures and words so as to eliminate the possibilities of alterations or frauds at later date.

While vouching transactions the auditor should ensure that :

(1) the payments relate to the business ; (2) the payments are authorised by a responsible official ; (3) the signatures of passing authorities are genuine ; (4) the vouchers exceeding Rs. 500 bear a revenue stamp; (5) the vouchers, after audit, bear initials or are cancelled ; (6) a list of missing vouchers is prepared for further inquiry or explanation ; (7) a special 'tick' mark is always used ; and (8) the vouching of a particular account or for a particular period is completed at one continuous process.

Q. 7.4 : "In vouching payments the auditor does not merely seek proof that money has been paid away." Discuss.

Ans. : The aim of audit is not simply restricted to obtain a proof of payment of money even if supported by a documentary evidence. Since most frauds or errors or irregularities occur in the area of transactions, the auditor needs to be very careful in vouching.

[Then : See : Q.7.1 (c) and Q. 7.3]

Thus, in vouching payments, the auditor has to assume a high degree of responsibility, care and intelligence. In case, he is negligent, he will be held guilty as was decided in the case law: Armitage *vs.* Brewer & Knott (1932).

Q. 7.5 : Give examples of vouchers you would refuse to accept although properly stamped and signed. Explain with reasons.

Ans. : The auditor should, on the following grounds, refuse to accept the undernoted vouchers though properly signed and stamped.

1. The date of voucher does not correspond with the date of payment entered in the cash book. Grounds — An old voucher might have been used to conceal misappropriation.
2. The voucher has not been passed by a responsible official. Grounds — May be an unauthorised payment.
3. The amount of the voucher differs in words and figures. Grounds — The correct amount is difficult to be ensured.
4. The nature of payment made in the voucher does not relate to the business. Grounds— An irregular payment.
5. The voucher is in the name of a company official without transactions detail. Grounds — May be unrelated to the business.

6. The amount of the voucher does not tally with the entry in the cash book. Grounds — Irregular voucher.

Q. 7.6 : How would you vouch the following :

(1) Petty Cash Book, (2) Cash Sales, (3) Underwriting Commission, (4) Purchase of investments, (5) Dividends from investments. (6) Sale of investments, (7) Rent from immovable properties, (8) Sale of Scraps, (9) Income tax refund, (10) Bad debts realised, (11) Wages, (12) Buildings, (13) Income tax and Sales tax, (14) Cash purchase, (15) Consignment Sales, (16) Drawings, (17) Travelling expenses, (18) Salaries, (19) Rent received, (20) Selling agency commission paid, (21) Payments to suppliers, (22) Customs duty and clearing charges, (23) Issue of shares for consideration other than cash, (24) Trade discount, (25) Cash discount, (26) Examiner's remuneration, (27) Claims paid by an insurance company under loss of profit policy, (28) Royalty paid, (29) Prepaid expenses, (30) Purchase of land, (31) Building repairs, (32) Purchase of shares at a premium, (33) Penalty levied on an unauthorised import, (34) Interest paid during the period of construction, (35) Directors' remuneration, (36) Directors' commission, (37) Redemption of redeemable preference shares, (38) Contribution to National Defence Fund, (39) Compensation for loss of office paid to directors, (40) Minimum subscription, (41) Advertisement expenses, (42) Building under construction, (43) Commission paid to a consignee, (44) Purchase of a motor car, (45) Hire-purchase payments, (46) Brokerage on issue of shares, (47) Freehold land and buildings, (48) Interests and dividends received, (49) Refund of insurance premium, (50) Purchase of machinery on hire purchase, (51) Part payment to a contractor for erection of new factory, (52) Bills receivable, (53) Bills payable, (54) Freight inwards, (55) Purchase of Patent, (56) Loan taken on Security from Bank.

[C.U. B.Com (Hons.) and C.A. (Inter), different years]

Ans. : (1) Petty Cash Book :

(i) Examining the adequacy of internal check and internal control systems in force; (ii) Ascertaining — the name of the petty cashier, the imprest amount, the authority fixing the amount, when and how it was fixed ; (iii) Vouching — the cheques drawn for petty cash by reference to cash book (credit side) and petty cash book (debit side), all vouchers over a certain sum with respect to supporting evidences/ receivers' signature/payment authorisation/stamped receipt/initialling of alterations/amounts in words and figures, etc ; (iv) Verifying the petty cash balance by actual inspection ; (v) Checking the receipts/payments columns, the total of subsidiary columns to ensure their agreement with the total payments, the postings of totals to the impersonal ledger (via. appropriate accounts), the amounts drawn for petty purchases (say, postage stamps, stationery articles) with the relevant account books (postage book, stationery book); (vi) Examining I.O.U.'s for confirmation with the high officials and money lent to any employee which is not allowed under the rules.

(2) Cash Sales :

(i) Examining the adequacy of internal checks and internal controls in force ; (ii) Checking the duplicate copies of the cash memo with the salesmen's copies/summaries or abstracts with the analysis of cash received by the cashier, the cashier's analysis with the duplicate copies of the cash memo ; (iii) Vouching — the cashier's cash book, the daily totals of cash received with the entries in the General cash book ; (iv) Verifying the entries in the cash sales book and in the cash book with the 'till' records, where automatic 'tills' are in use.

(3) Underwriting Commission on Shares :

(i) Examining the Articles of Association on the issue of shares and the rates of commission to underwriters ; (ii) Vouching and cross-checking of : the Articles of Association, the agreement with underwriters, the underwriters' stamped receipts, the record of the rates of commission, the underwriters' statements of accounts, the prospectus or statements in lieu of prospectus.

(4) Purchase of Investments :

(i) Examining the Company's Memorandum and Articles of Association in order to ascertain the company's powers to such purchase ; (ii) Examining the Board's/Shareholders' Minute Book for such resolution and the Central Govt's sanction in case of limited companies ; (iii) Vouching and cross checking of : Brokers' Bought Note, Share Certificates, Bonds, Allotment letters, Payee's receipts, etc ; (iv) Verifying — physical existence, ownership (in the company's/partners' name), the banker's certificates (if in bank custody), the entry of payment with the entry in the bank statement, and the allocation of interest or dividend received between the capital and revenue ; and (v) Checking the price indicated in the Brokers' Bought Note with Newspapers Quotations and also the price/ Brokerage paid to the stockbroker.

(5) Dividends from Investments :

(i) Examining the Investment Register and the counterfoils of the Dividend warrants ; (ii) Vouching dividend warrants with the entries in the cash book/ bank pass book ; (iii) Examining the broker's sold notes and/or broker's bought notes , where investments are sold 'ex-div'or purchased 'cum-div', to ensure, subsequent receipt of dividends, credit to dividend account, and proper allocation of dividend between capital and revenue.

(6) Sale of Investments :

(i) Vouching sale proceeds of investments with the broker's sold note, or with the Bank advice when sold through a bank ; (ii) Checking the adjustments made for any profit or loss, and also the transfers of profit or loss to the earmarked fund account in case of sales of investments pertaining to some earmarked funds; (iii) Verifying the receipt of dividend for investments sold 'ex-div' and also the allocation of dividend between capital and revenue in case of 'cum-div' sales.

(7) Rent from Immovable Properties :

(i) Ascertaining the amount of rents payable by the tenants, due dates, repairs provisions, etc. from the lease deeds and Agreements ; (ii) Vouching — (a) the counterfoils of rent receipts or rent account of collecting agent with the 'Rent Received' account after having checked the propertywise Rent Register ; and (b) the entries in respect of 'rent received in advance' made in the Rent Register with the advance receipts, their credit to the advance account and corresponding reversal entry in the following year ; (iii) Verifying the statement of rent outstanding with the Rent Register and also with the reversal entry in the following year ; (iv) Seeking confirmation from the tenants, with the clients permission, about the amount of arrears of rent outstanding against them to detect misappropriation or irregularities of rent receipts ; (v) Obtaining a certificate in respect of a vacant property from a responsible official to determine the non-receivable portion of rent.

(8) Sale of Scraps :

(i) Examining the contracts or agreements with the parties to whom sold ; (ii) Vouching sales authorisation and sales value computations, etc. by reference to the copies of the sales invoices or the purchasers' credit notes.

(9) Income Tax Refund :

Vouching and Checking of : (i) the Refund Order issued and the statement furnished by the Income Tax officer ; (ii) the statement of tax refund with the copy of the claim originally submitted by the client.

(10) Bad Debts Realised :

Bad debts may have been realised or recovered in two ways : (a) from a debtor who has become bankrupt, and (b) from a party whose debt is already written off in accounts. While the former category of recovery is known as 'bad debts dividend', the latter category is called 'bad debts recovery'.

In case of first category, the vouching extends to (i) the ascertainment of recovered amounts, whether in full or in part, (ii) the verification of a receipt with the carbon copy or counterfoil of the receipt issued to the party, (iii) the correctness of accounting treatment — that is, whether credited directly to 'Bad Debts Recovered A/c' or credited first to the relevant debtor's A/c and to the control A/c and thereafter transferred to 'Bad Debts Recovered A/c'.

For the second category, the amount received should be vouched with : (i) the dividend warrants received from the Official Receiver, (ii) the correspondence with the Official Receiver, (iii) the copy of a receipt issued to the Official Receiver, and (iv) the Bank deposit slip and Bank Pass Book. The documents, such as Notification from the Court or from Bankruptcy Trustee, letter from Collection Agents, etc., constitute the vouchers to be considered for the purpose of vouching.

(11) Wages :

(i) Examining internal checks and internal controls in force in respect of the various aspects, such as time records or piecework records, preparation of wages, disbursements of wages to workmen, unpaid wages, etc ; (ii) Checking at random the calculations and castings of various records connected with preparation and payment of wages ; (iii) Verifying the data with entries made in payrolls, and test-checking sanction and more authorisation by the responsible officials and also the initials of staff taking part in various stages of the work ; (iv) Vouching — the cheques drawn for wages as entered in the cash book with the wages totals, the schedules of ESI and Income tax deductions with the payrolls to ensure non-inclusion of 'dummy' names, the lists of advance wages and unpaid wages, the signatures of workmen of two or three periods for genuineness etc.

(12) Buildings :

(i) Examining the purchase agreements or lease deeds or title deeds, etc.; (ii) Vouching the directors' sanction for purchase, broker's note or the auctioneer's account, registration document as per Transfer of Property Act, solicitor's advice on the title of transfer, lease agreement, fixed assets records, etc.

For Buildings under Construction, vouching extends to : (i) Architect's fee receipts (ii) Builder's contract or agreement, (iii) Builder's bills or receipts, (iv) Board's resolution for construction, (v) Delegation of powers to the officials authorising construction expenditure, (vi) Engagement of own men and use of own material for construction, (vii) Allocation of own materials and wages to the building account, (viii) Completion certificate from the Architects, and (ix) Certificate from the Corporation or Municipal authorities for construction, etc.

For Buildings repairs — Same as above except the points at (vii) and (ix), Use the work 'repairs' against 'construction' wherever appears.

(13) Income Tax :

For Income Tax refund — See item no. (9).

Income Tax Payment : Vouching includes (i) inspection of receipted challans for payments, (ii) the accounting year and corresponding assessment year, (iii) the assessment order — provisional and final, (iv) the order on appeals, and (v) the interest payable and paid for late payment of tax, if any. In addition, the ledger accounts separately maintained for each accounting year should be checked by reference to advance payment of tax and credit allowed by I.T.O., year-wise payment of taxes provisionally, and payment against final assessment.

Sales Tax : Vouching includes (i) examination of the records to be maintained separately in respect of Central Sales Tax and State sales tax ; (ii) ensuring correctness of the returns as to the amounts calculated and paid ; (iii) checking payments with the receipted challans ; (iv) verification of the assessment order, order-in-appeal and that of the balance tax paid at the time of final assessment ; and (v) scrutiny of the refunds due and received.

(14) Cash Purchases :

(i) Examining the adequacy of internal checks and internal controls in operation; (ii) Vouching - (a) purchase authorisation, (b) payment authorisation, (c) receipted bill or invoice or cash memo with the goods receipt notes and (d) discounts and rebates received; (iii) Verification as to the amounts debited to the relevant account.

(15) Consignment Sales :

(i) Examination of the internal checks and internal controls in operation; (ii) Vouching the rates and amounts of *del credere* commission, proforma invoice, account sale, and receipted counterfoils; (iii) Verifying the sales realisation by reference to the bank statement, bank drafts, etc.; and the bills receivable book.

(16) Partners' Drawings :

(i) Examination of the clauses of the partnership deed in respect of (a) the time, manner, and maximum permissible amount of drawings by partners out of profit or capital and any interest chargeable thereon; (b) the allocable personal expenses and value of goods to which the partners are entitled, etc ; (ii) Vouching the entries made in the Partner's Drawing Account with the payments authorisation, partner's receipt, partner's signature, etc ; (iii) Verification of the annual statement of the partners' capital accounts, drawing accounts, and balances thereof duly confirmed and signed by each of the partners.

(17) Travelling expenses :

(i) Examination of the existing rules in respect of reimbursements including the advances, or the past practice followed ; (ii) Checking the systems of internal controls and internal checks in force ; (iii) Vouching the bills with regard to sanction, payment authorisation, supportings of evidence, advance, adjustments, receipts, etc.; (iv) Test checking the calculations or expenditure details with approved journeys and rates, and extraordinary expenses — whether sanctioned by a senior official.

Travelling expenses to the Directors : For attending the board meetings, vouching includes — (i) Examination of the Articles of Association permitting such payment, (ii) Verification of attendance book or minute book, resolution fixing the rates and amounts per meeting and also the receipts.

For other travelling expenses including foreign travel, vouching extends to — (i) Examining the Articles of Association allowing such payment, (ii) Checking the board's resolutions fixing the rates and amounts and approving the journeys including foreign travel, (iii) Verifying the Reserve Bank of India's permission, foreign exchange documents, travelling agent's bills, receipts, payments authorisation and vouchers, etc. and (iv) Ensuring separate disclosure of the amount of foreign exchange in the accounts as per the requirement of Part I of Schedule to the Companies Act.

(18) Salaries : Same as (11) . For the words 'wages' and 'workmen', read 'Salaries' and 'Staff' respectively.

(19) Rent Received : See (7) before.

(20) Selling agency commission paid :

(i) Examining the terms and conditions of the agreement to ascertain the rates and amounts of selling agency commission ; (ii) Checking the calculations ; (iii) Vouching the amounts paid, payment authorisation, agent's receipts, and entries in the cash book, etc., and (iv) Examining the compliance with the provisions of company law and other legal formalities.

(21) Payment to Suppliers :

(i) Examining the internal controls and internal checks in operation ; (ii) Checking the calculations in respect of cash or trade discount, invoice amount, etc., (iii) Vouching the amounts paid, payment authorisation, counterfoils of cheques, suppliers' receipts, Statement of accounts, 'on account' payments (if any), etc ; (iv) Referring to the Directors' minute book for resolution, if necessary, for credit terms ; (v) Examining the adjustments in case of difference between the amount of payment and the amount of invoice.

(22) Customs duty and clearing charges :

(i) Examination of the Customs Tariff to ascertain the rate of customs duty chargeable and of the Clearing Agents' schedule of rate for shipping, clearance, etc ; (ii) Inspection of the clearing agents' bills or monthly statements of accounts by reference to the Bill of Entry duly stamped by the customs department as to the amount of duty paid and the date of payment, and also to the receipts issued by them ; (iii) Vouching the cash payment of duty with the receipts issued by the customs department ; and (iv) Verification of the accounts to which the customs duty paid has been debited (e.g., duty paid for import of raw materials should be debited to the raw materials account, etc.).

(23) Issue of shares for consideration other than Cash :

(i) Ascertaining the specific circumstances for which such shares are issued (Circumstances may be — purchase consideration of a running business, remuneration to the promoters, underwriting commission to the underwriters of shares, shareholders to the old company absorbed or amalgamated or reconstructed, bonus shares out of reserves, etc.) ; (ii) Examining the documents like contract between the company and vendors, vendor's authorisation for issue of shares to its nominees, minute books of the directors and shareholders (regarding allotment of shares to the vendors, bonus shares out of reserves to existing shareholders, and the arrangement for absorption/amalgamation/reconstruction) ; and (iii) Vouching the entries in the financial books, the details in the prospectus or statement in lieu of prospectus in respect of Contracts, and the Register of Members for the shares allotted.

(24) Trade Discount :

(i) Examining the terms and conditions of trade discount ; (ii) Ascertaining the rates of discount receivable or payable and of special discounts and comparing them with the rates prevailing in the market ; (iii) Vouching the entries in the financial books by reference to the copies of sales/purchase invoices, counterfoils of receipts/payments, statements of account etc.

(25) Cash Discount :

(i) Examining the correspondence with the party (if any) and the calculations where applicable. [Then see (ii) and (iii) of (24) above]

(26) Examiners' Remuneration :

(i) Ascertaining the terms of remuneration, such as rate per answerscript and other charges and also the number of answerscripts subject-wise ; (ii) Checking the calculations contained in the bills (iii) Vouching the payments by reference to the financial entries, cheques, counterfoils of receipts, etc.

(27) Claims paid by an insurance Company under loss of profit policy :

(i) Verification of the insurance policy, copy of the claim and the basis of claim ; and (ii) Vouching the correspondence between the insured and insurer, the insurance company's advice to the insured, the receipt from the insured, and the entries in the bank book and the bank account after verification of the counterfoils of the Pay-in-slips.

(28) Royalty paid :

(i) Examination of the agreement to ascertain the rate and amount of royalty to be paid ;

(ii) Examination of the Deed for the lease or patent or copyright ;

(iii) Checking the rates, calculations and the period upto which royalty is payable ;

(iv) Vouching the entries in the financial books with cheques, counterfoils of receipts for payment, etc.

(29) Prepaid Expenses :

(i) Ascertaining the items of expenses and the future periods to which they relate ; (ii) Examining the nominal accounts, the demand notes, receipts, etc.; (iii) Vouching the adjustment for unexpired period in the financial books, and verifying that the amount so paid in advance is shown on the assets side of the balance sheet.

(30) Purchase of Land : Same as (12) before First paragraph.

(31) Building Repairs : Same as (12) before Third paragraph.

(32) Purchase of Shares at a premium :

(1) Examining the compliance of the provisions of Section 78 of the Companies Act, 1956 by a company with respect to (a) Transfer of a sum equal to the aggregate amount or value of the premiums on the shares to an account called 'Share Premium Account' whether for cash or otherwise ; (b) Share premium amount not being mixed up with the share capital ; (c) Use of Share Premium Account actual for the purposes of : (i) Paying up unissued shares to be issued to the members as fully paid up bonus shares, (ii) Writing off the commission paid or discount allowed on, or the expenses of any issue of shares or debentures, (iv) Providing for the premium payable on the redemption of any redeemable preference shares or any debentures ; (2) Verifying the memorandum and articles of association and the board's minute book to confirm authorisation for issue of such shares ; (3) Inspecting the prospectus and the rate and amount of premium to be received ; (4) Vouching the accounting entries to confirm utilisation of premium as stated under (1) (C) above ; and (5) Confirming the premium amount that actually appears in the liabilities side of the balance sheet under the head 'Reserve and Surplus',

(33) Penalty levied on an unauthorised import :

(i) Examining the relevant clause of the import procedure under which the penalty has been imposed ; (ii) Checking the payment of penalty with the receipt and order issued by the Govt. authorities, with the pass book in case of payment through the bank ; and (iii) Verifying the accounts to which the penalty levied and paid has been debited (e.g., penalty paid for unauthorised import of raw materials should be debited to the raw materials account).

(34) Interest paid during the period of construction:

The expenditure during construction is usually incurred to keep the construction going and therefore, it is indirectly related to construction. Interest being is a general expense should, however, be capitalised as a part of the construction cost. Hence, vouching extends to : (i) examination of the entries in the bank pass book, (ii) checking of the calculations of interest, and (iii) board's resolution authorising such payment of interest and accounting treatment as to capitalisation, etc.

(35) Directors' Remuneration :

The directors of a company, as a general rule, are not entitled to any remuneration on a monthly basis unless the Articles of Association make provision in clear terms in this regard. However, the auditor should see that the remuneration paid in the form of fees or commission is separately disclosed in the Profit and Loss Account. (also see : Q.7.7 (7).

(36) Directors' Commission :

(i) Examination of the terms and conditions of the Agreement to find out the rate of commission payable ; i.e., whether as a percentage on profits of the company ; (ii) Verification as to the compliance of the provisions under Sections 349, 350 and 351 of the Companies Act in respect of calculation for profit ; (iii) Vouching the calculations of commission, payment of commission with the receipts, and the entries in the financial books, etc.

(37) Redemption of Redeemable Preference Shares :

Section 80 of the Companies Act Governs the issue land redemption of redeemable preference shares, Thus, the steps are : (i) Verifying from the articles of association that the company is authorised to issue such shares for redemption. (ii) Examining the fulfilment of the conditions to the effect that — (a) the shares have been redeemed only when they are fully paid up ; (b) the shares have been redeemed out of the profits which would otherwise be available for dividend, or out of the proceeds of the fresh issue of shares made for the purposes of redemption ; (c) the premium, if any, payable on redemption has been provided for out of the company's profits or share premium account, before the shares are redeemed ; (d) a sum equal to the nominal amount of the shares redeemed has been transferred to Reserve fund called 'Capital Redemption Reserve Account,' when shares are redeemed out of the profits ; (e) the capital redemption reserve account, where utilised, has been utilised in paying up unissued shares to be issued to the members of the company as fully paid up bonus shares ; (f) the Registrar of Companies has been notified within one month of the redemption of shares ; and (g) the redeemable preference shares have actually been specified in the balance sheet, (iii) Verifying that an amount equal to the shares redeemed has actually been invested, and the interest on such investment has been properly accounted for.

(38) Contribution to National Defence Fund :

(i) Examination of the company's Memorandum of Association to ascertain that it has the power to give such contribution, and of the Board's resolution to confirm that it has sanctioned the payment of contribution ; (ii) Verification to confirm that the amount of contribution is within the statutory limits ; and (iii) Vouching the entries in the financial books with the receipt and also with the Income Tax exemption certificate received from the National Defence Fund.

(39) Compensation for loss of office paid to directors :

(i) Examination of the compliance with the provisions under Section 318 of the Companies Act, 1956 ; (ii) Verification of the calculations and the accounting treatment to confirm that it has been debited to the current year's Profit and Loss Account ; and (iii) Vouching the transactions recorded in the financial books of account with the receipt, board's resolution, etc.

(40) Minimum Subscription :

It is the minimum amount which, in the opinion of the directors or of the signatories of the Memorandum, must be raised by the issue of shares. Vouching, in this respect, aims at examining the following items which have been considered to decide the total amount of minimum subscription : (i) Any preliminary expenses payable and any commission payable to any person in consideration of his agreeing to subscribe for, or for his procuring or agreeing to procure subscriptions for any shares in the company ; (ii) The purchase price of any property bought or to be bought which is spent in whole or in part out of the proceeds of the issue ; (iii) The repayment of any borrowings in respect of (i) and (ii) above and (iv) The working capital and any other estimated expenses .

Further, the following points need verification : (i) Whether shares offered to the public for subscription have been irregularly allotted without raising the minimum subscription ; (ii) Whether all moneys received from the applicants have been refunded to them within 130 days in the event of the minimum subscription not received within 120 days after first issue of the prospectus ; and (iii) If not so refunded within 130 days, whether such refunds have been made with the appropriate rate of interest from the expiry of 131 day.

(41) Advertisement expenses :

(i) Verification of the advertisement bill with the contract or order, its calculations and its entries in the financial books ; and (ii) Vouching the bill with the receipt and the copy of the advertisement.

(42) Building under construction : See (12) before. Second paragraph.

(43) Commission paid to a Consignee :

(i) Examination of the terms and conditions of the agreement to ascertain the rates and amounts of commission ; (ii) Checking the calculations ; (iii) Vouching the amounts paid, payment authorisation, consignee's receipts, and entries in the cash book, etc.

(44) Purchase of a Motor Car :

Vouching extends to : (i) examination of purchase order, purchase invoice, registration certificate or blue book, auctioneers' accounting, etc.; (ii) Checking customs duty, clearing charges, etc. in case of imported car ; and (iii) Verification of entries made in the financial books and capital assets record.

(45) Hire-purchase Payments (or Instalment Payments) :

(i) Examination of the terms and conditions of the agreement as to mode and manner of payments, insurance coverage, interest charges, etc.; (ii) Checking the initial deposit and future instalment payments, made with the challans and receipts and with the clauses as per the agreements ; (iii) Verifying : (a) the actual dates of payment with the due dates to confirm correctness of the interests paid, (b) the apportionment of payments under capital and revenue heads, (c) the entries in the financial books in respect of instalments and other charges including interest, and (d) the final instalment paid along with interest in order to determine the ownership of the asset purchased under the scheme.

(46) Brokerage on issue of shares :

(i) Examination of the Board's Minute Book regarding the approval of this arrangement, and of the Articles of Association authorising such payment ; (ii) Verifying the disclosures in the prospectus ; (iii) Vouching the receipts and the calculations of such brokerage paid to each broker ; and (iv) Checking the entries in the financial books as well as seeing that this item has been shown separately on the asset side of the balance sheet under the head Miscellaneous Expenditure until it is written off.

(47) Freehold Land and Buildings : See (12) before.

(48) Interests and Dividends Received :

Interest is generally received from sources, like bank deposits (fixed or savings), debentures subscribed, government securities, loans to parties and customers for late payments.

Interest on bank deposits :

(i) Verifying that the deposits are in the name of the client ; and (ii) Vouching the credit entries in the bank statements or bank pass books with the interest on fixed deposits as per the terms and conditions of each deposit certificate, and \ or with the interest on Savings on half-yearly basis after having checked the calculations ; and (iii) Obtaining certificates from the banks in some cases.

Interest on debentures subscribed :

(i) Verifying that the debentures and debenture interest warrants are in the name of the client ; (ii) Vouching the entries in the bank statements for the credit of interest with the interest warrants and the income tax deduction certificates, and also with the credit side of interest account ; and (iii) Confirming that the interest is received and credited regularly on an half-yearly basis.

Interest on Govt. Securities :

(i) Verifying that the Govt. Securities, tax deduction certificates and interest warrants are in the name of the client ; (ii) Vouching the entries in the bank statements or bank pass books for credit of interest with the documents at (i) above ; (iii) Confirming that the interest is received and credited half-yearly on the due date and month as indicated in the Securities themselves ; and (iv) Ensuring that a provision is made of the 'interest accrued but not due' in the accounts.

Interest on loans to Parties :

(i) Examining the terms of the agreement with borrower to find out the rate of interest and the due date of its receipt from the borrower ; (ii) Verifying that : (a) the cheques for interest received are in the name of the client, and (b) the same is credited to interest account ; (iii) Vouching the interest account with (a) the bank statements and (b) the counterparts of receipts issued.

Interest from Customers :

(i) Examine that the interest received is for late payments only; (ii) Verifying that the interest account is credited with the element of interest only where the same is received along with the debts ; and (iii) Vouching the interest account with the copies of the receipts issued.

Dividend received : See (5) before.

(49) Refund of Insurance Premium : Vouching and checking of :

(i) the statement of refund with the relevant cheques issued by the insurance company ; (ii) the relevant adjustment entries in the financial books of accounts ; (iii) the bank pass book or statement for the amounts received ; and (iv) the copy of the claim for refund by the insured, etc.

(50) Purchase of Machinery on Hire-purchase : See (47) before.

(51) Part payment to a Contractor for erection of new factory :

(i) Examining the terms and conditions of the contract or award for the release of part payments ; (ii) Verifying : (a) the stagewise completion of erection jobs as per the details of contract with architect's certificate, (b) the 'on account' bills paid with the rate schedule of the contract, (c) the board's resolution sanctioning the Contract, (d) the delegation of powers to the officials authorising such part payments ; (iii) Vouching : (a) the entries made in the financial books of account, (b) the allocation of own materials and labour to the various accounts such as buildings/plants/machinery/roads, etc.and (c) the payments made by reference to vouchers, receipts, cash book or bank statements, etc.

(52) Bills Receivable :

(i) Verifying and vouching : (a) the entries in the Bills Receivable Book with those in the Cash Book, Bank Pass Book or Statement to ensure the receipt of the amount on due date, and (b) the entries for dishonour of bills to make further inquiries ; (ii) Conducting inquiry as to the bills themselves and their existence or otherwise to ascertain the bonafide of dishonour with the object of detecting a fraud like misappropriation of the proceeds of the bills ; (iii) Confirming that the amount of bills receivable discounted but which have not matured as on the balance sheet date is determined as a part of contingent liability.

Bills Receivable discounted but dishonoured : (i) Verifying the bills returned by the bank (after dishonour) and the payments subsequently made by the client to bank or the debit entry appearing in the bank statement (due to dishonour of bills) ; (ii) Vouching : (a) the bank's advice attached to the payment voucher, (b) the amount credited to the bank account, (c) the amount debited to the debtors account, (d) the commission charged by the bank and its recovery from the debtor.

(53) Bills Payable :

(i) Examining as to whether the returned bills have been duly cancelled and attached to the payment voucher or filed separately ; (ii) Vouching the payment with reference to the bank statement or pass book and with the entries made in the Bills Payable Book.

(54) Freight Inwards :

(i) Examining the system of internal checks in operation ; (ii) Verifying the bills or receipts of transporters, railway authorities, cargo agents, etc.; (iii) Checking : Goods received notes, Goods inward book and the freight account ; and (iv) Scrutiny of payment authorisation and of allocation between revenue and capital heads.

(55) Purchase of Patent :

(i) Examining the purchase agreement to ascertain the payment terms — that is, whether a fixed amount as lumsum or royalty on a period basis ; (ii) Seeing the assignment deed made in favour of the client ; (iii) Verifying the purchase price and other expenses and the relevant accounting entries ; and (iv) Checking as to : payment authorisation, capitalisation of initial expenditure, booking of periodical renewal fees to revenue head, etc.

(56) Loan taken on Security from Bank :

(i) Examining the Memorandum/Articles of Association and the compliance of Section 292 and 293 of the Companies Act in case of loans taken by a company ; (ii) Scrutiny of the loan agreement between the client and the Bank to ascertain the terms and conditions ; (iii) verifying as to : company's borrowing powers, purposes for which borrowed, purposes for which spent, securities pledge, registration of charges, interests charged and paid, balance confirmed by the bank, etc. ; and (iv) Ensuring adequacy of disclosure i.e., whether accounted for as a 'Secured loan'.

Q. 7.7 : What are the special points that the auditor will consider while vouching the following items in connection with the audit of a public limited company ?

(1) Mortgages and Charges, (2) Fixed and Floating Charge, (3) Redemption of Debentures, (4) Preliminary expenses, (5) Interest paid out of Capital, (6) Profit or loss prior to incorporation, and (7) Directors' Fees.

Ans. : (1) Mortgages and Charges : (i) Inspecting Directors' Minute Book which contain authorisation for raising loans, (ii) Refering the Articles and Memorandum of Association authorising the company to raise loans against mortgages and charges, and (iii) Vouching the Registrar's Certificate, receipt of loans, and that the loan has been shown as liabilities in the balance sheet of the company.

(2) Fixed and Floating Charges : (i) Examining the conditions for creation of fixed charge and verifying as to whether the company deals with the property pledged as securities to the debenture-holders subject to the provision of a prior right of the shareholders ; (ii) Examining the conditions for creating a floating charge, i.e., whether (a) the charge is based on the property in the ordinary course of business, (b) the debentureholders have a right to be paid out of the assets' sale proceeds and (c) the preference shareholders have been given priority before the right of debentureholders.

(3) Redemption of Debentures : (i) Refering the Directors' Minute Book to ascertain the terms, viz, whether the debentures are redeemed by periodic withdrawals or by paying off on a predetermined rate ; (ii) Refering the Articles for authorisation for redemption ; and (iii) Vouching and verifying the creation of redemption reserve, periodical payments, and the cancelled debentures.

(4) Preliminary expenses : (i) Identifying the expenses incidental to the Articles, Memorandum, Prospectus and preliminary contracts (i.e., costs of stamp duty, registration, company's seal, printing documents, legal charges, etc.) and capitalisation thereof; (ii) Vouching by reference to the documentary evidences, such as bills, receipts, agreements, etc.; (iii) Comparing the actual expenses with the estimates specified in the prospectus ; (iv) Verifying as to whether these expenses have been written off from the future profits, etc.

(5) Interest paid out of Capital : (i) Examining the compliance of the provisions of Section 208 of the Companies Act, 1956 ; (ii) Verification with respect to the Govt's sanction, Board's resolution, authorisation by the Articles, period of interest payment determined by the Central Government, rate of interest ; and (iii) Vouching the interest amounts and their accounting treatment (e.g., showing the expenditure as 'Miscellaneous Expenditure' under the asset side of the balance sheet).

(6) Profit or loss prior to incorporation : (i) Examining the treatment of profits earned, i.e., whether (a) it is capitalised as reserve, (b) it is used for payment of interest to vendors on the purchase consideration, and/or (c) it is used for writing off goodwill or other fixed assets ; (ii) Examining the treatment of losses incurred, i.e., whether (a) it is charged to Goodwill Account, or (b) it is transferred to Suspense Account for adjustment against the Capital profit.

(7) Directors' Fees : These refer to the amounts to be paid to the directors for the services rendered and for attending the board meetings. The directors themselves fix up the fees normally and include the same in the Articles of Association. Sometimes, these are fixed by the Shareholders in a general meeting. However, vouching involves the verification of related documents, like Articles of association, shareholders' resolution, directors' minute book, directors' attendance register, and the payment vouchers.

Q. 7.8 : (a) What is Teeming and Lading ?

(b) The cashier of a company of which you are the auditor has control of financial books. Besides he is authorised to open letters and acknowledge receipt of letters and cheques. Enumerate the possible frauds likely to be committed by a delinquent cashier in respect of both receipts and payments and the checks you would exercise to detect such malpractices.

Ans. : (a) Also termed 'Lapping', it is a procedure in which the individual handling the money withholds some portion of the day's receipts and also fails to record proper credit to certain customers' accounts. When subsequent receipts come in, some portion of these receipts is issued to credit the previous customers' accounts. This process continues on a day-to-day basis. It is difficult for such an irregularity to be carried out successfully unless the custody and recording of cash are handled by the same person or there is collusion between the people performing these two functions.

(b) Possible frauds by Cashier	Checks to detect them
(1) Cash receipts misappropriation : A delinquent Cashier, having control of all the financial books, may misappropriate cash by falsely crediting the customer's account without corresponding entry in the cash book. He may issue a forged receipt for the money received from the customer.	(1) Careful Scrutiny of : counterfoils of receipts, cash book entries and counterfoils of pay-in-slip for deposit of money to the bank. This way, any evidence of 'teeming and lading' would be brought to light.
(2) Cash Sales misappropriation : A delinquent cashier, in absence of any good internal check system regarding the cash sales, may misappropriate cash.	(2) Judging the efficiency of the system of internal checks and careful scrutiny of : cash summaries, Salesmen's statements and Gate-keeper's statements in the case of a departmental stores.
(3) Misappropriation of cash proceeds of sales of assets, etc. : Same as at (1) above.	(3) Careful scrutiny of the correspondence, broker's note, auctioneer's statement and the bank pass book.
(4) Discounts manipulation.	(4) Scrutiny of correspondence, rate and amount of discount, counterfoils of receipts, etc.

Short Answer Questions :

Q. 1 : Define the terms : Vouching, Voucher, Verification, Routine checking.

A. 1 : Vouching : The examination of documentary evidence in support of entries.

Voucher : It is a documentary evidence in support of a transaction.

Verification : It consists in establishing whether a state of 'existent fact' recorded in the books is truly so recorded or not.

Routine checking : It is concerned with ascertaining the arithmetical accuracy of casting, posting and carry forward in an audit.

Q. 2 : Distinguish between : 'Primary Vouchers' and 'Collateral Vouchers'.

A. 2 : The original vouchers are 'primary vouchers'; whereas, the copies of the original vouchers are known as 'collateral vouchers'. A purchase invoice or a cash memo is a primary voucher, and their carbon copies are collateral vouchers.

Q. 3 : Give examples of vouchers (a) origination within the organisation and (b) originating from outside the organisation.

A. 3 : (a) — (i) Purchase invoice, (ii) Sales invoice, (iii) A receipt, (iv) Counterfoils, (v) Stores requisition, (vi) Bank's pay-in-slip, (vii) Debit/Credit notes, (viii) Minute book, etc.

(b) — (i) Mortgage deeds, (ii) Consignment statement, (iii) Bank pass book, (iv) Banker's certificate, (v) Insurance policy, etc.

Q. 4 : What is a 'Voucher System' ?

A. 4 : It is a system by means of which invoices and other evidences of liability are collected, audited, recorded and settled. It involves the use of vouchers, voucher checks, a voucher register, etc.

Q. 5 : Identify the essential features of a valid voucher.

A. 5 : Written in the client's name or business. (2) Agreement of the date of voucher with the date of transaction recorded in a book. (3) Agreement of the voucher amount with the amount recorded in the account books, (4) Proper authorisation. (5) Free from any error. (6) Authentication of any change in the voucher. (7) Agreement of transaction description in both the voucher and the account book. (8) Affixation of a revenue stamp on a cash voucher exceeding Rs. 500.

Q. 6 : What is 'Vouching in depth' ?

A. 6 : It involves tracing a transaction through its various stages from origin to conclusion, examining at every stage to an appropriate extent the vouchers, records and authorities relating to that stage and observing the incidence of internal check and delegated authority.

Q. 7 : Mention five chances of frauds in the payment of wages.

A. 7 : (i) Clerical frauds, (ii) Frauds in time or piece-work records, (iii) 'Ghost' or 'dummy' workers, (iv) Overstating wages rates or overtime or work hours, (v) Understating deductions.

Q. 8 : What is 'Padding' in the wages sheets ?

A. 8 : This refers to a deliberate method of incorporating fictitious names in the payrolls, such as entering the names of ex-employees, to defraud the employer.

Q. 9 : List the documents you would rely on while vouching the following items : (i) Fees received in School/College, (ii) Hire-purchase instalments received, (iii) Subscriptions received, (iv) Payments to creditors.

A. 9 : (i) Counterfoils, Periodic reconciliation statement. (ii) Agreement, Counterfoil or copy of a receipt, (iii) Counterfoils, subscription record, and periodic reconciliation, (iv) Contracts, receipts for payments, and Statement of account.

CHAPTER 8

STATUTORY AUDITOR : HIS APPOINTMENT, RIGHTS, DUTIES AND LIABILITIES, ETC.

Learning Objectives : *After reading and carefully studying this chapter, the student should :*

- Understand the evolution of auditor's responsibilities and duties under the common law and the Companies Act.
- Know the summary facts and the auditing implications of the major legal cases in auditing during the last 100 years.

Q. 8.1 : How does the Companies Act, 1956 define the term : Financial Auditor or Company Auditor ?

Ans. : The Companies Act, 1956 lays down a provision that an auditor shall be a chartered accountant within the meaning of the Chartered Accountants Act, 1949.

The Chartered Accountants Act makes a provision that no other member of the Institute of Chartered Accountants of India shall be entitled to practice as an auditor, whether in India or elsewhere, unless he / she has obtained from the Council of the Institute a certificate of practive. A Financial Auditor is thus a Chartered Accountant in practice. He is also called a Statutory Auditor.

Q.8.2 : What are the qualifications and disqualifications of a Financial Auditor? What do you think to be the objectives behind such regulations ?

Ans. : *Qualifications :* A person is qualified for appointment as a Statutory Auditor of a Company, under Section 226 of the Companies Act, 1956, if - (a) he is a chartered accountant within the meaning of the Chartered Accountants Act, 1949, and (b) he has obtained, from the Council of the Institute of Chartered Accountants of India, a certificate of practice under the Chartered Accountants Act, 1949.

Further, a firm whereof all the partners practising in India are qualified for appointment as aforesaid is also fit and qualified to be appointed by its firm name to be the Statutory Auditors of a company, in which any partner so practising may act in the name of the firm.

Disqualifications : The following persons, though otherwise qualified, shall not be qualified for appointment as Statutory Auditors of a company :

(a) a body corporate;

(b) an officer or employee of the company ;

(c) a person who is a partner, or who is in the employment, of an officer employee of the company ;

(d) a person who is indebted to the company for an amount exceeding one thousand rupees or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding one thousand rupees.

A person is also not qualified for appointment as a Statutory Auditor of a company if he is disqualified, under any of the above four clauses, for appointment as an auditor of any other body corporate or would be so disqualified if that body corporate were a company which is :

(a) that company's subsidiary, or

(b) its holding company, or

(c) a subsidiary of its holding company.

A person appointed under Section 224 as an auditor of a company shall not be appointed or re-appointed as Statutory Auditor of that company. If the auditor becomes disqualified after his appointment, he shall cease to conduct the audit of the financial accounts from the date of disqualification.

In the case of a firm of auditors, the firm name shall not be fictitious, indicative of specialisation or misleading as to the type of organisation.

Objectives behind such regulations :

(i) The objective behind the prescription of qualification is to ensure that the auditor possesses professional qualification and is independent of all influences, controls and personal interests of the Directors of the company.

(ii) The objectives behind the prescription of disqualifications are :

(a) to preserve the independence of the auditor in the performance of his duties,

(b) to ensure that the auditor shall remain honest, sincere, and straightforward in his approach towards professional work, and shall maintain impartial attitude while reporting on cost and financial matters, and

(c) to obviate any possibility of bias or prejudice to override objectivity on the part of an auditor.

Q.8.3 : (A) How is the first auditor of a limited company appointed ? (B) Discuss the circumstances in which an auditor of a limited company is appointed by (i) Annual general meeting, (ii) Board meeting and (iii) Central Government. (C) How is the auditor of a Government Company appointed ?

Ans. (A) : *First Auditor :* He is to be appointed by the directors in the first meeting of the Board of Directors to be held within one month of the incorporation of the company. Such appointment may be decided at an extraordinary general meeting. The auditor so appointed shall hold office till the conclusion of the first annual general meeting [Sec. 224(5) of Companies Act].

(B) (i) *Annual General Meeting :* Except in the case of the first auditor, every company shall, at each annual general meeting, appoint an auditor or auditors to hold office from the conclusion of that meeting until the conclusion of the next annual general meeting [Sec. 224(1) of Companies Act].

At any annual general meeting, a retiring auditor, by whatsoever authority appointed, shall be reappointed unless — (a) he is not qualified for appointment ; (b) he has given the company a notice in writing of his unwillingness to be reappointed ; (c) a resolution has been passed at that meeting appointing somebody instead of him or providing expressly that he shall not be reappointed; or (d) where notice has been given of an intended resolution to appoint some person or persons in the place of a retiring auditor, and by reason of death, incapacity of disqualification of that person or all of those persons, as the case may be, the resolution cannot be proceeded with [Sec. 224(2) of Companies Act].

If there is a casual vacancy by the resignation of an auditor, such vacancy shall not be filled by the Company in general meeting. [Sec. 224(6.a)]. Such auditor shall hold office until the conclusion of the next annual general meeting. [Sec. 224(6.b)].

In the case of a company holding subscribed share capital of 25% or more whether singly or jointly by public financial institutions, government, banks, insurance companies, etc., the auditor(s) shall be appointed or reappointed at each annual general meeting only by passing a special resolution. [Sec. 224A].

(ii) *Board Meeting :* [Add the following to the answer at (A) above]

If the Board fails to make the appointment within the stipulated period, the company in general meeting may appoint the first auditor. In addition, the Board, under Section 224 (6.a), may fill any casual vacancy in the office of an auditor. Where such vacancy is caused by the resignation of the auditor, the Board is not empowered to fill such vacancy, and in this case, the power to fill up such vacancy vests with the company in general meeting.

(iii) *Central Government :* Where no auditors are appointed or reappointed at an annual general meeting, the Central Government may appoint a person to fill the vacancy. [Section 224 (3)]. The company must notify to the Central Government the fact of non-appointment of auditor within seven days of the date of annual general meeting.

Besides, if the company fails to appoint an auditor by special resolution under Section 224A, it shall be deemed that the auditor had not been appointed by the company in an annual general meeting. The Central Government in such circumstances may appoint a person to act as the auditor of that company.

(C) *Auditor of a Government Company* shall be appointed or reappointed by the Central Government on the advice of the Comptroller and Auditor General of India. [Section 619 (2)].

Q.8.4 What are the (a) rights and powers, & (b) duties of an Auditor ?

Ans. : (a) *The rights and powers* of a statutory auditor as provided for in the Companies Act, 1956 may be summarized as follows :-

1. A right to receive intimation from the company in respect of his appointment or reappointment as an auditor.

2. A right of access at all times to the books of accounts and vouchers of the company, whether kept at the head office of the company or elsewhere.

3. A right to require and receive from the officers of the company such information and explanations as he may think necessary for the successful performance of his duties as an auditor of a company.

4. A right to visit branch offices and factories of a company, and to receive proper return therefrom as may be necessary for the conduct of his audit.

5. A right to receive such accounting records, financial statements and other books and papers as would be necessary for audit.

6. A right to seek and enjoy assistance and facilities from the company so that he can successfully complete his audit.

7. A right to receive remuneration from the company for his function as an auditor.

8. A right of representation against a special notice of the company appointing another person as auditor.

9. A right to receive notice and to attend the general meeting of the company.

10. A right to be indemnified if he acted honestly or if the court's judgement is in his favour.

11. A right to have technical and legal advice whenever necessary in connection with his work of audit.

12. A right to sign the audit report and the balance sheet and the profit & loss account including the documents annexed.

(b) *Duties* : The provisions of the Companies Act, the Companies (Auditor's Report) order of 2003, the Chartered Accountants Act and Regulations, and the different laws that are applicable on a particular company or companies govern the duties of a statutory auditor. The duties may be described as follows :-

1. He should submit his Audit Report to the members of the company on the company's balance sheet and profit & loss account and on every other documents annexed - which are laid before the company in its general meeting [Section 227(3)].

2. He should clearly state in his report, under Section 227(3), that :-

   (a) he has obtained all the information and explanations relating to the accounts which to the best of his knowledge and belief were necessary for the purposes of the audit.

   (b) proper accounting records as required by law have been kept by the company.

   (c) proper returns adequate for the purpose of his audit have been received from the branches not visited by him.

   (d) the books and records kept by the company give the information in the manner required by the Companies Act, and

   (e) in his opinion the company's accounting records have been properly kept so as to give a true and fair view of the state of affairs of the company as at the end of the financial year (in case of balance sheet) and of the profit or loss for its financial year (in case of Profit & Loss Account.)

3. He should also qualify his report to the extent it differs, where he is not satisfied with any of the provisions stated above : [Section 227 (4)].

4. He should assist the Government in the latter's investigation process being launched for the purpose of examining the affairs of the company.

5. He should include in his report a statement on such matters as specified under Section 227(1A) of the Companies Act.

6. He should give a statement on certain matters as specified in the Companies (Auditor's Report) order of 2003 [under Sec. 227(4A)].

7. He should keep records of various errors of omissions and commissions done by the client staff.

8. He should give necessary advice to the company about the irregularities in the maintenance and recording of accounts books and statements.

9. He should understand and appraise the company's policies and procedures and systems adopted for the purpose of controlling wastages and inefficiencies.

10. He should see and ensure what other exceptional duties are cast upon him by the Articles of the company.

11. He should owe his duty of care primarily to the company, act honestly and sincerely and maintain the secrecy and confidentiality of his client.

12. Lastly, he has a continuing duty to maintain his professional knowledge and skill at a level conducive to act as an auditor competently.

Q.8.5 : Indicate the nature and type of duties cast upon the statutory auditor under the following sections of the Companies Act, 1956 : 227(1A), 227(2), 227(3), 227(4), 227(4A), 229, 56, 165 and 58A.

Ans. : (1) *Under Section 227(1A)* : It is the statutory auditor's duty to enquire into -

"(a) Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the company and its members;

(b) Whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company;

(c) Where the company is not an investment company within the meaning of Section 372 or a banking company, whether so much of the assets of the company as consist of shares, debentures, and other securities have been sold at a price less than at which they were purchased by the company;

(d) Whether the loans and advances made by the company have been shown as deposits;

(e) Whether personal expenses have been charged to revenue account;

(f) Where it is stated in the books and papers of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular, and not misleading."

On enquiry into the above cases, it is the statutory auditor's duty to report only when there is an unfavourable reply. This duty on the part of the auditor is designed to curb specific malpractices that are generally committed by the persons at the helm of affairs of a company.

(2) See : Question 8.4. (b) (1) answer.

(3) See : Question 8.4. (b) (2) answer.

(4) See : Question 8.4. (b) (3) answer.

(5) *Under Section 227(4A)* : It is the statutory auditor's duty to submit a report describing the position as favourable or otherwise in respect of the matters specified in the Companies (Auditor's Report) order of 2003.

[Note : For details of Specific matters, see Chapter 13.]

(6) *Under Section 229* : It is the statutory auditor's duty to sign the audit report, and to sign or authenticate any other document of the company required by law to be signed or authenticated by the auditor.

(7) *Under Section 56 :* It is the statutory auditor's duty to certify :

(a) the statement of profits and losses for the last five years showing the rate of dividends paid each year, (b) the statement of assets and liabilities of the company, (c) the provisions and adjustments made or to be made, and (d) the similar information about the subsidiaries, if any, which are stated and set out in the prospectus issued by a company.

(8) *Under Section 165 :* It is the statutory auditor's duty to certify as to the accuracy of the statutory report relating to : (a) the allotment of the shares by a company, (b) the cash receipts against such shares, and (c) the receipts and payments account upto the date within seven days of the date of report.

(9) *Under Section 58A :* It is the statutory auditor's duty to :

(a) inquire whether the company has furnished the necessary statement regarding the acceptance of public deposits, (b) ascertain whether the company has accepted such deposits, and (c) check whether the company has complied with the RBI's directives and the rules framed under this section in this regard.

Q.8.6. : The auditor is a watch-dog, but not a blood-hound. Discuss how far this statement finds its relevance in relation to the functional responsibility of a Statutory Auditor.

Ans. : The expression that an auditor is a watch-dog and not a blood-hound was made in the course of judgement in a leading case: the Kingston Cotton Mills Company Ltd. (1896). A misfeasance action was initiated by the liquidator against the company auditor to recover the amounts due for dividends which, it was alleged, were paid by the company out of profit improperly inflated by the over-valuation of closing stock and non-allowance for depreciation in the value of Mill Site and Machinery. It was alleged that the auditor was negligent in his duties as he relied upon the stock sheet prepared by the manager who for a number of years deliberately exaggerated the stock and thus over-valued the stock with a motive to get higher commission on the inflated profit. So a suit was brought against the auditor for the alleged negligence in verifying the correctness of the stock certificate. It was held that the auditor, in the absence of suspicious circumstances, was not guilty of negligence on the ground that he relied upon the certificate made by a trusted official. "It is not the auditor's duty to take stock." He does not guarantee the discovery of all fraud". 'An auditor is not bound to be a detective, to approach his work with suspicion or with a foregone conclusion that there is something wrong." He must not be made liable for not tracking out ingenious and carefully laid schemes of fraud, when those frauds are undetected for years by the directors', and cannot be held responsible for non-detection by the exercise of his reasonable care and skill.

Coming to the role of an auditor analogous to the role of a watch-dog, it can be stated that the duty of an auditor is to bark on the sight of irregularities while checking books of accounts. So it is his duty to warn the management about the possible danger. An watch-dog is not supposed to protect the assets of his master. His effort is to see whether his master is informed or warned about the possible danger. Similarly it is really very difficult on the part of an auditor to protect the interest of the company which may be lost due to weakness in the internal control system. It is the duty of the company management to take remedial measures for the protection of the property, following the remarks of the auditor as to the accounting discrepancies and defects in internal accounting control system. Coming to the role that the auditor is not a blood-hound, he would be 'justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion he should probe into the bottom, but in the absence of anything of that kind, he is only bound to be reasonably cautious and careful'.

He must be honest, sincere and methodical in his approach to detect errors and fraud. If, after his completion of audit, a fraud is discovered it does not necessarily mean that the auditor has been negligent or incompetent. He does not guarantee that no fraud exists. The auditor is not expected to be unnecessarily spiteful towards people who may or may not be responsible for any act of manipulation or fraud. He is expected to conduct his duty in consonance with the professional standards coupled with due care and skill.

The auditor is primarily responsible to make such examination of the books and records of the company as would enable him to certify that the accounting records kept by the company give a 'true and fair view' of the state of affairs of the business.

Again, in the light of another leading case : International Laboratories Ltd., (1933), the auditor (simply as a watch-dog) will not have performed the functions of his office, if, after one howl, he retreats under the bark or if he confines his protest to a fellow (watch-dog)". In this regard, the directive of the Company Law Board (1962) states that "it was the auditor's duty to comment on all such material violations of law and / or sound accounting practices as might reasonably be expected to affect directly or indirectly the fortunes of the company's accounts."

Q.8.7. : Discuss the status of a Statutory Auditor.

Ans. : The status of a statutory auditor may be best explained in the context of his role as such from the meaning of the word 'status' which is 'the position belonging to a person' (auditor). His status may be discussed under the following heads : (a) An agent, (b) An officer and (c) A servant of the company.

(a) *As an "Agent"*

If the basis of appointment of the statutory auditor is the criterion to establish relationship then the first auditor is to be considered as the representative of the Board of Directors of a company and also of the Central Government. But in actual practice, the appointment of the auditor by the Board of Directors and its approval by the Central Government is just a question of formalities and to keep the process of business going. In other cases, the auditor is appointed or reappointed by the shareholders in a general meeting and thus, is the representative of the shareholders. It is, therefore, apparent that he is an agent of the shareholders. Similar view is also expressed in "Spackman Vs. Evans' case, which runs : "The auditors may be the agents of the shareholders, so far as it relates to the audit of the accounts. For the purpose of the audit, the auditors will bind the shareholders."

According to the Law of Contract, "an agent is a person employed to do any act for another or to represent another in dealings with third person". The auditor, in this sense, may be considered as an agent of the Board of Directors or shareholders of a company. In another section, the Law of Contract provides that an agent has to render proper accounts to his principal 'on demand'. In actual practice, the auditor does not receive any allowance or goods for which he will have to render proper accounts. It is the primary duty of an auditor, whether demanded or not, to report to the shareholders regarding the financial affairs of the company.

According to the Law of Agency, "he who does through another does by himself, an idea may emanate that the act of an agent is the act of the principal. But this does not hold good in case of the duties of a statutory auditor. Let us assume that the auditor in collusion with the company management distorts the financial statements; this act by any stretch of imagination should not be treated as the act of the principals (the Board of Directors). Again the same law provides 'the knowledge of the agent is 'the knowledge of the principal'. This maxim also does not find its application in the case of an auditor, who in actual practice does not disclose the material facts viz. status of business, future trend of the business, image of the business, other than the financial accounts and statistics which even some of the directors or shareholders of the company find it difficult to study between the lines. Thus from the point of view of Law of Agency, it can be stated that the auditor cannot be the agent of the company management.

If the term 'agent' is meant to denote merely a 'person' or 'one who represents a person or persons', then the auditor may be categorised as agent.

(b) *As an 'Officer'*

It is really very difficult to state whether the auditor of a company is an officer or not. The legal decisions over the issue whether the financial auditor is to be considered as an officer of the company or not are not clear and they are conflicting each other on either basis - defacto or dejure. On this basis, it may be thought that the auditor is not an officer of a company. Further the law does not specifically classify him as an officer of the company as has been found in the case of other officers, like Directors, Secretaries, etc. According to Section (30)(c) of the Companies Act, an auditor is considered as officer only for some purposes and not for all purposes. Again, the present Act does not clearly state whether the casual auditor employed by the company is to be considered an officer for specific purposes. In one leading legal decision Findley Vs. Maddell (1910), it was decided that casual auditor and a person to whom the work of preparing books of accounts has been handed over is not an officer of the company, whereas another leading case Connell Vs. Himalaya Bank (1895) considers auditor as an officer of the company only when he is appointed in general meeting. Section 5 of the Companies Act defines 'Officer in default' as any officer of the company who is knowingly of default, failure, non-compliance, refusal or who wilfully authorises or permits such default, etc. It is yet to be decided without dispute whether the auditor would come within this definition.

(c) *As a 'Servant'*

It is sometimes stated that the auditor is a servant of the company as he is paid for. An auditor, who is a representative of the shareholders or the Board of Directors, can never be a servant of the company. The criterion to judge a particular person as a servant because he is paid for the job would bring some confusion. A lawyer cannot be considered the servant of his client because he charges fees as his remuneration. The physicians are paid for their job or service. Are they servants of the patient ? In one leading case London and General Bank Ltd., (1895) it was decided that 'He (auditor) is not the servant of the Directors, and thus, the auditor should not be considered a servant of the company and of the directors. The relationship between the statutory auditor and the company is that of an independent professional man and a client.

Q.8.8. : On what grounds a Statutory Auditor ceases to be an auditor of a company ?

Ans. : An auditor shall cease to be the statutory auditor of a company on any one of the following grounds :

1. On the expiry of the term of appointment,
2. On his death,
3. On his desire to retire signified in writing, and
4. On his becoming subject to any of the nature of disqualifications.

Note : Brief mention is necessary as to the nature of disqualifications. See Question No. 8.2.

Q.8.9. : Discuss how a Statutory auditor can be removed before the expiry of his term in the light of the provisions and restrictions contained in the Companies Act and the Chartered Accountants Act.

Ans. : The matter of removal of an Auditor may be governed by the Companies Act, 1956 and the Chartered Accountants Act, 1949.

Removal of Statutory Auditor

Governed by the provisions of Companies Act.	Governed by restrictions imposed by Chartered Accountants Act.

(a) Companies Act : According to sections 224 and 225, once a chartered accountant in practice has been appointed as a statutory first auditor by the Board of Directors of a company he cannot be removed before the expiry of his term unless a due notice is served on him and unless the previous approval of the Central Government in that behalf is obtained. It should be noted in this context that a special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than the auditor appointed previously. On receipt of such a resolution, the company must forthwith send a copy thereof to the existing auditor. The special resolution regarding the removal of the auditor cannot be brought to the effective implementation if such notice has not been served. The existing auditor, on receipt of the notice for his proposed removal, may submit his representation within a reasonable time with a request to circulate the same to the members of the company. The representation may be considered by the Board of Directors, and if found necessary, the auditor may be asked to appear before the Board for his clarification. The auditor's rights to make a representation, get it circulated among shareholders, and of being orally heard at an annual general meeting are enjoined in Section 225 of the Act. As soon as the existing auditor is removed, a new auditor should be appointed by the Board within seven days from the date of removal of the auditor.

(b) Chartered Accountants Act : An auditor may be removed from his office before the expiry of his term, if he is found guilty or deemed to be guilty of 'professional misconduct' in relation to chartered accountants in practice requiring the action by the High Court and 'professional misconduct, in relation to members of the Institute generally requiring actions by the High Court. Some of he main clauses which constitute professional misconduct on the part of a statutory auditor are cited below :

(1) If a chartered accountant in practice accepts the position as an auditor of a company which was previously held by another chartered accountant, without first communicating with him in writing.

(2) If a chartered accountant in practice engages in any business other than the profession of accountancy unless permitted by the council of the institute so to engage.

(3) If a chartered accountant is grossly negligent in the conduct of his professional duties.

(4) If a chartered accountant fails to report a material mis-statement known to him to appear in a financial statement with which he is concerned in a professional capacity.

(5) If a chartered accountant expresses his opinion on financial statements of any business or any enterprise in which he, his firm or a partner in his firm has a substantial interest unless he discloses the interest also in his report, and

(6) If a chartered accountant contravenes any of the provisions of the Act and regulations made thereunder.

Q.8.10. : Directors of a Limited Company desire to appoint as auditor a person other than the retiring auditor. What are the legal necessities to be observed before making such appointment ?

Ans. : The following legal necessities should be observed by the Directors of a Limited Company before appointing as auditor a person other than the retiring auditor :

1. The directors should ascertain and ensure that the retiring auditor is not qualified for reappointment, or that he has given the company a notice in writing of his unwillingness to be reappointed, or that a resolution has been passed at an annual general meeting of the company to the effect of appointing somebody instead of the retiring auditor or expressed provision for not reappointing the retiring auditor.

2. The directors should note that special notice is required for a resolution at an annual general meeting appointing as auditor a person other than auditor appointed previously.

3. The company shall forthwith send a copy of the special notice to the retiring auditor.

4. The company, on receipt of written representation (if any) from the retiring auditor against such special notice, should circulate such representation to the members.

5. If a copy of the representation is sent to the shareholders either because this was received too late or because of the default of the company, the contents of the representation should be read out at the meeting at the request of the retiring auditor, and the retiring auditor should be allowed to hear orally.

6. The copy of the representation is not needed to be sent out or read out at the meeting if, on the application either of the company or any other person who claims to have been aggrieved, the court is satisfied that the right is being abused to secure needless publicity for defamatory matter.

7. Where a new auditor is appointed in place of the retiring auditor, the company within seven days of the meeting should inform the new auditor about his appointment.

Q.8.11. : Briefly discuss the various liabilities of a Statutory Auditor of a company.

Ans. : The liability of a statutory auditor may be charted as under :

- Nature of Liability
  - Contractual
  - Statutory
    - Criminal
    - Civil
      - Arising from negligence
      - Arising from misfeasance

1. **Contractual liability** - The Statutory Auditor is liable for nonfulfillment of the terms and conditions of an agreement between him and the company who appoints him. He may be held responsible under the Contract Act 'in failing to perform the duties' as laid down in agreement. In the absence of any written agreement or contract, he is expected to perform a complete audit. He may conduct partial audit at his own risk. Even if he does not issue an audit certificate, it does not relieve him from incurring liability. He is also liable for breach of fiduciary relationship by disclosing confidential matters.

2. **Criminal liability** - Indian Penal Code imposes a criminal liability on the auditor. The I.P.C. states that whosoever issues or signs any certificate required by law to be given or signed or relating to any fact which such certificate is by law admissible in evidence, knowing or believing that such certificate is false in any material point, shall be punishable in the same manner as if he gives a false evidence'.

The Statutory Auditor's criminal liability may be of three categories :

(a) *Falsification of books* (Sec 539 of Companies Act.) : He shall be punishable with imprisonment for a term which may extend to seven years; and shall also be liable to a fine if, with the intent to defraud or deceive any person, the auditor :-

(1) destroys, mutilates, alters, falsifies, or secrets or is privy to the destruction, mutilation, alteration, falsification or secreting of any books, papers or securities; and

(2) makes or is privy to the making of any false or fraudulent entry in any register, books of account or document belonging to the company.

(b) *Giving False Statement* (Sec. 628 of Companies Act) : If in any return, report, certificate or other document, he makes a statement :-

(1) which is false in any material fact knowing it to be a material and

(2) which omits any material fact knowing it to be a material, he shall be punishable with imprisonment for a term which may extend to two years and shall also be liable to a fine.

(c) *Giving False Evidence :* The auditor who intentionally gives false evidence :-

(1) upon any examination, upon oath or solemn affirmation; or

(2) in any affidavit, deposition or solemn affirmation in or about the winding up of any company, shall be punishable with imprisonment for a term which may extend to seven years and shall also be liable to a fine.

3. **Liability arising from negligence** - The auditor may be held liable for the damages if he fails to perform his duties with reasonable skill and care, i.e., arising out of his negligence. He is liable to make good the loss or damage resulting from negligence on his part to detect defalcations or discover errors which may have caused loss to the company.

4. **Liability arising from misfeasance** - The auditor may be held liable for breach of trust or responsibility and for wilful misconduct and default, depending on the circumstances of each case.

5. **Liability to the professional body** - The auditor may be held liable for his professional misconduct if he violates the professional code of

conduct as instituted by the Chartered Accountants Act, 1949. He is liable if he acts as an auditor without holding a valid certificate of practice from the Institute.

6. Liability to third parties - There are several conflicting judgements over the auditor's liability to third parties, i.e., the persons other than the client (e.g. investors, creditors, bankers, tax departments, etc.). However, in the context of Indian legislation, the auditor can be held liable for damages if he has authorised the issue of such a prospectus which contains misleading information. Generally, the persons other than the client rely on the audited financial statements for various purposes (such as sanction of loan, purchase of shares or debentures, etc.), and so it appears that the auditor may be held liable to all parties in general who are interested in the affairs of the business.

Q.8.12. : Discuss the civil and criminal liabilities of an auditor under the Companies Act mentioning at least two case laws.

Ans. : Civil Liabilities of an auditor : These are contained in the following sections of the Companies Act :

(1) Sec. 227 - The auditor is held liable for 'negligence' or 'misfeasance' if he does not perform his duties and fails to state categorically in his report certain facts either in the affirmative or in negative terms. For this non-compliance, he is punishable with fine which may extend to Rs. 1,000.

(2) Sec. 229 - The auditor is held liable for 'negligence' if the audit report is not signed by him, or by a partner of the firm if the appointment is in the name of the firm. For this non-compliance, he is punishable with fine which may extend to Rs. 1000 provided the default is wilful.

(3) Sec. 57, 58, 59, 62 - The auditor is held liable for 'misstatements in prospectus' or for untrue statements made in the prospectus to pay compensation to every person who has subscribed for any shares or debentures on good faith on the basis of the auditor's authenticated prospectus.

(4) Sec. 70 - The auditor is held liable for 'untrue elements' in the Statement in lieu of Prospectus, if he has authorised the delivery of this instrument for registration. He is punishable with imprisonment upto two years or with fine upto Rs. 5,000 or with both for this act of negligence or misfeasance.

The auditor is, however, not liable under Secs. 57, 58, 59, 62 or 70 if he proves that : (a) the Statement was immaterial or (b) the Statement was issued without his knowledge or consent and was withdrawn forthwith giving reasonable public notice; or (c) he withdrew his consent in writing before delivery of the prospectus for registration; or (d) he had reasonable ground to believe, and did, up to the time of the delivery for registration of the prospectus (or Statement in lieu of prospectus), believe that the statement was true.

(5) Sec. 477 - In the case of a company being wound up by the court, the auditor is liable to be examined and to return the company books or documents in his possession to the court. If he does not comply with this requirement, he is liable to be arrested and prosecuted.

(6) Sec. 543 - In the course of the winding up of a company, if it appears that the auditor has been guilty of misfeasance or breach of trust in relation to a company, he may be held liable (as an officer of the company) to make good all losses sustained by the company on account of his negligence of duty or breach of trust, if 'misfeasance' proceedings are initiated against him within the prescribed time.

(7) Sec. 545 - An auditor being an officer of the company can be prosecuted by the liquidator during the course of winding up for delinquency.

Criminal Liabilities of an auditor : The following Sections of the Companies Act deal with this class of liabilities :

(1) Sec. 63 - An auditor is liable for punishment if he has authorised the issue of a prospectus which contains false statements. He is liable to imprisonment upto two years or a fine upto to Rs. 5000 or both.

(2) Sec. 233 - The auditor concerned, and the person other than the auditor who signs the audit report or signs or authenticates the document of the company, otherwise than in conformity with the requirements of Sections 227 and 229, are punishable with fine up to Rs. 1000 provided that the default is wilful.

(3) Sec. 68 - Any person (including an auditor) who either by knowingly or recklessly making any false statement or promise or forecast or by any dishonest concealment of material facts induces another person to enter into any agreement for acquiring / disposing of / subscribing for shares or debentures is liable to be punished with imprisonment up to 5 years or with fine upto Rs. 10,000 or both.

(4) Sec. 539 - See. 8.11. - 2(a)

(5) Sec. 628 - See. 8.11. - 2(b)

(6) Sec. 240 - An auditor is liable to be punished with imprisonment up to six months or with fine upto Rs. 2000 or with both, if he does not render necessary assistance to the inspector appointed by the Central Government to investigate the affairs of the company.

Q.8.13. : State the circumstances in which an auditor may be held liable as an 'officer' of a company under the companies Act.

Ans. : The relevant Sections of the Companies Act, which contain the circumstances holding the auditor liable as an "Officer" of a company, are as follows :-

1. Sec. 477 - The Court's power to summon an officer of the Company or a person suspected of having a property of the company in the winding up.

2. Sec. 478 - The Court's power to order public examination of an officer or a person guilty of fraud in the management of a company.

3. Sec. 539 - An officer or a person found guilty for the manipulation / falsification of the books and accounts.

4. Sec. 543 - The Court's power to the assessment of damages against the delinquent officers.

5. Sec. 545 - The Court's power to prosecute delinquent officers and members.

6. Sec. 621 - An offence committed by an officer and complained of by the Registrar or a shareholder or any person authorised by the Central Government.

7. Sec. 625 - The payment of compensation in case of frivolous or, vexatious prosecution.

8. Sec. 633 - The Court's power to grant relief in proceedings for negligence, misfeasance, default, etc.

APPENDIX TO CHAPTER 8

Some important audit case laws relating to the liabilities of a statutory auditor.

1. *Derry Vs. Peck* (1889) ; It was held that the auditor is liable in tort to third parties, if the undermentioned points are proved by the plaintiffs : (a) the auditor's statement was untrue in fact; (b) the auditor failed to exercise reasonable skill and care to ascertain the truth (a part of his duty) knowing that the statement was untrue; (c) the auditor's statement was intended that the plaintiff should act on it with sound belief; and (d) the plaintiff suffered damages by relying on the auditor's statement.

2. *Fairdeal Corporation Vs. Gopalakrishnan* ; It was decided that an auditor remains liable to carry out his audit function with reasonable skill and care, even if his appointment is honorary. Duty of care and diligence is important for an auditor though there is no remuneration for him.

3. *Ultramares Corporation Vs. Touche, Niven & Co., (1923) :* The auditors knew that creditors of certain type would use the balance sheet, but they were not aware of the specific creditors. The creditor-banker lent the firm about $ 165,000, based on the audited balance sheet which showed the assets at $ 2,50,000 and the net worth at $1,00,000. In reality, the company net worth was 'Nil' and most of the overstatement was due to a large block of fictitious accounts receivable. The auditors confined their scrutiny to the evidence created and/ or held by the client, such as sales invoices and did not ask for direct confirmation of accounts balance from the customers. When the overstatement was discovered, the banker (third party creditor) sued the auditors for both negligence and fraud.

The judge, in the original trial, disallowed the charge of negligence as there was a lack of contractual relationship between the auditor and the third party creditor. He also disallowed the charge of fraud.

The judge, in the appeals trial, upheld the negligence charge and ordered - "If liability for negligence exists, the failure to detect a theft or forgery beneath the cover of deceptive entries may expose accountants to liability in an indeterminate amount for an indeterminate time to an indeterminate class." On the charge of fraud, the judge opined that the negligence might be so serious as to constitute a form of fraud. This case ultimately ended indecisively, but the following auditing implications were established :

(i) An auditor is liable to the client and known third parties for 'ordinary negligence' and to unknown third parties for 'gross negligence'.

(ii) The person, not parties to the original contract, cannot ordinarily recover damages in respect of an auditor's negligence.

4. *Le Lievere and Dennes Vs. Gould* (1893) : The decision was - "The question of liability for negligence cannot arise at all until it is established that the man who has been negligent owed some duty to the person who seeks to make him liable for his negligence. What duty is there when there is no relation between the parties by contract ? A man is entitled to be as negligent, as he pleases towards the whole world if he owes no duty to them. "Thus, it appears that the auditor, in the absence of fraud, does not incur liability to third parties who suffered damages for the former's negligence.

5. The *Kingston Cotton Mills Co. Ltd. (1896) :* [See Ques. 8.8.]

6. *Candler Vs. Crane, Christmas & CO. (1951) :* In this case Mr. Candler, the plaintiff, claimed that he suffered a loss of investment in shares of the company as he relied on the 'draft accounts'- which, without any change, was certified by the auditors. He, therefore, sued the auditors for compensation against damages sustained. Mr. Justice Denning gave a verdict that the auditors were not liable to the third parties in absence of any contractual relationship between them. It is interesting to note that this judgement was however, overriden by the House of Lords in 1964 in their decisions in another landmark case, Hedley Byrne & Co. Ltd. Vs. Heller & Partners Ltd.

7. *Hedly Byrne & Co. Ltd. Vs. Heller & Partners Ltd. (1964) :* The brief outline of the case is that the advertising agents (the plaintiffs) entered into a contract with their party and made a reference to the merchant bankers (the defendants) for obtaining information as to the financial position of the party who also happened to be the client of the merchant bankers. The bankers furnished the information without assuming any responsibility. The plaintiffs suffered a loss due to inaccurate and misleading information furnished by the bankers, and so, filed a damage suit for negligence in the Court. It was held by the House of Lords that :

(i) there existed a general relationship as banker and customer, not as Solicitor and client ;

(ii) the bankers disclaimed liability under reference in clearly expressed words to the customer; and

(iii) the bankers should, therefore, be exonerated from their liability for damages arising out of negligence.

In course of the judgement Lord Morris remarked : "If some one possessed of special skill undertakes, quite irrespective of contract, to apply that skill for the assistance of another person who relies on such skill a duty of care will arise".

The noticeable feature of this legal decision and its practical application in auditing scene is that the Institute of Chartered Accountants in England and Wales came out with the following two statements concerning the auditor's liability to third parties :

(1) Statement no. V.8. : Accountants Liability to Third parties - The Hedly Byrne Decision.

(a) The extent to which an auditor accepts responsibility should be made clear beyond the scope of misunderstanding;

(b) Where an auditor specifically restricts the scope of his report or expresses appropriate reservations in a note attached to and referred to in the financial statements he has prepared or the report which he has made thereon, this can constitute a disclaimer which will be effective against any action for negligence brought against him by third parties;

(d) Where an individual shareholder uses the audited annual accounts for investment decisions no action would lie against the auditor as the accounts are not normally prepared for this purpose;

(d) Where the audited accounts would be used for tax assessment purposes by the Revenue Department, no action would lie in case of reliance upon accounts negligently prepared since in fact the failure to recover tax is attributable to the death or insolvency or decamping of the taxpayer, not to the negligence of the auditor;

(e) The third parties entitled to recover damages will be limited to those who by reason of accountants' negligence in preparing reports, accounts, or financial statements on which the third parties place reliance suffer financial loss in circumstances where the accountants knew or ought to have known that the reports, accounts, and the financial statements in question were being prepared for the purpose specifically or transaction which gave rise to the loss and that they would be shown to and relied on by third parties in that particular connection.

(2) Statement no. V.18. : Professional Liability of Accountants and Auditors.

(i) *Liability to Clients :* Action for negligence can be -

(a) in contract, by persons to whom the accountant owes a contractual duty of care ;

(b) in tort, by persons with whom the accountant is not in a contractual relationship but to whom the accountant owes a duty in accordance with the Hedley Byrne decision.

The opinions expressed or the advice given by an auditor will not be liable to action for negligence merely because, in the light of later events, they prove to have been mistaken.

(ii) *Liability to third parties :* Such liability is signified where no direct contractual liability exists. The accountant, under the **Hedly Byrne Doctrine,** may incur liability in the following occasions :-

(a) Preparing financial statements or reports for a client when it is known or expected that they are intended to be shown to and relied upon by a third party, even if the identity of the third party is not disclosed ;

(b) Giving reference regarding a client's credit-worthiness ;

(c) Allowing the use of the auditor's name indiscriminately ;

(d) Accepting the work which is beyond the professional competence, or not obtaining the specialist advice where the report may have to include opinions of a nature outside the field of the auditor's professional work.

8. *London and General Bank (1895) :* The brief outline of the case was that the bank advanced considerable amounts to its customers on loan and current accounts although the securities held were insufficient. The bank credited its profit and loss account with interest on such advances pending actual realisation and did not provide for bad debts either. As a result, the accounts had shown unrealised profits. Consequently, dividends were paid out of capital (not out of realised profits) in pursuance of a resolution of the shareholders based upon the directors' recommendation and upon balance sheet certified by the auditor. The auditor, in his report to the shareholders, merely stated that the value of the assets as shown by the balance sheet was dependent upon realisation without any comment as to the insufficiency of security. Subsequently, the auditor was held guilty of misfeasance and was ordered to pay the Official Receiver the dividends plus interests thereon.

Lord justice Lindley, in the course of his judgement, made the following remarks which have a direct bearing to the auditors' responsibilities :

(1) It is no part of an auditor's duty to give advice either to directors or shareholders as what they ought to do. He has nothing to do with the prudence or imprudence of making loans with or without security. It is nothing to him whether the business of a company is being conducted prudently or imprudently, profitably or unprofitably. It is nothing to him whether dividends are properly or improperly declared provided he discharges his own duty to the shareholders.

(2) It is the auditor's duty to ascertain and state the true financial position of the company, at the time of audit, by actually examining the books of the company. He does not discharge his duty without inquiry and without taking any trouble to see that the books of the company themselves show the company's true position. He must take reasonable care to ascertain. Unless he does this, his duty will be worse than a farce.

(3) An auditor is not bound to do more than exercise reasonable care and skill in making inquiries and investigation. He is not an insurer and does not guarantee that the books do correctly show the true position of the company's affairs or that the balance sheet is accurate according the books of the company. He must be honest. He must not certify what he does not believe to be true. He must take reasonable care and skill before he believes that what he certifies is true.

(4) An auditor need not be unnecessarily suspicious where there is nothing to excite suspicions. Where there is nothing to excite suspicion, very little inquiry will be reasonable and sufficient. When suspicion is aroused, more care is obviously necessary. But still an auditor is not bound to exercise more than reasonable care and skill even in a case of suspicion, and he is perfectly justified in acting on the opinion of an expert where special knowledge is required.

(5) The duty of an auditor is to convey information and not means of information. Information and means of information are not equivalent terms. A person whose duty is to convey information to others does not discharge that duty by simply giving them so much information as is calculated to induce them, or some of them, to ask for more. An auditor who adopts such a course does so at his peril, and runs a very serious risk of being held judicially to have failed to discharge his duty.

(6) The duty of an auditor is to convey in direct and express terms to the members any information which he thought proper to be communicated. It is not his duty to consider what is good or what is bad policy. He has to examine facts and see that the members have his opinion as to the balance sheet showing the state of affairs of the company.

Summary : An auditor was guilty of misfeasance as he gave only the 'means of information' and not the 'information' to the shareholders in respect of the untrue and incorrect sate of affairs of the company.

9. *City Equitable Fire Insurance Co. Ltd. (1924)*:

This is a case in which the directors and auditors of the company were sued by the Official Receiver (as liquidator) for damages arising out of negligence and breach of duty. The charges were that –

(a) The debts due to the company from Ellis and Co. (the stockbrokers of the company) and its General Manager were misdescribed and shown under wrong account head, viz Loans at call or short notice, and the part of Ellis & Co.'s debt was wrongly included under 'Cash at Bank and in hand, and the auditor did not disclose these debts to the shareholders.

(b) Larger sums were due from Ellis & Co. at the date of each balance sheet than was so included – which the auditor failed to disclose.

(c) The existence of a large number of the company's securities, which were in Ellis & Co's custody and had been pledged by that firm to its customers (i.e. third parties), was not brought to light and reported by the auditors to the shareholders.

According to Mr. Justice Romer (in Chancery Division) :

It was held in respect of the first charge that (i) it was no part of the auditor's duty to bring to the notice of the directors and shareholders about the misdescription of the debts; (ii) such misdescription did not involve any damage to the company; (iii) the auditor need not specifically draw the attention of the shareholders of loans given to the brokers or others; and (iv) there was nothing to arise in the auditor's mind any doubt as to the goodness of the debt.

As regards the second and third charges, the Court held that the transactions involved 'window dressing' operations effected by "a pretended purchase of treasure bonds just before the balance sheet date, followed by a pretended sale just after that date" by Ellis & Co. The company, in this way, materially reduced the debt due from Ellis & Co. and correspondingly increased the gilt-edged Securities in the balance sheet. The Court held that the auditors were not guilty of negligence for not inspecting the securities as such fraud might not have been detected in view of their actual knowledge of the state of affairs at the time of each audit.

As regards the third charge, the court held that : (i) the auditors should have asked for the Securities instead of accepting the certificate of the Company's stockbrokers; (ii) the fraud must have been detected had the auditors asked for the securities – which could not have been produced by Ellis & Co.- as the same were charged to brokers against the loan by them to Ellis & Co. ; and (iii) the auditors on this ground are guilty of negligence. But the Court could not pass a decree for damages as the Company's Articles of Association provided for a protection to the auditors.

According to the Master of the Rolls (Appeal Case) :

The decision of Mr. Justice Romer was appealed against by the Official Receiver in the Court of Appeal. This Appeal was dismissed by the Court with cost. The Master of the Rolls, in the course of the judgement, said that "the auditor must take a certificate from a person who is in the habit of dealing with, and holding Securities and who he, on reasonable grounds, rightly believes to be, in the exercise of the best judgement, a trustworthy person to give such a certificate."

Summary :

(1) An auditor is liable where assets are misdescribed in the balance sheet if the Company incurs damage as a result of such misdescription.

(2) An auditor is liable if he does not inspect the securities which are in the hands of third party in whose custody such assets are not ordinarily kept.

(3) An auditor is liable for misfeasance if he does not verify investments and accepts the certificate of a stockbroker instead.

(4) An auditor is liable only when he accepts the certificate for investments from persons who are not expected to hold other's securities and are not trustworthy, irrespective of their status as bankers or stockbrokers.

10. *The Westminister Road Construction Co. Ltd. (1932)* :

This case is also known as *Smith Vs. Offer and Others.*

The facts of the case were that : (1) the profit of the Company was inflated by (a) understating the company's liabilities by suppression of purchase invoices and (b) overstating the value of work-in-progress; (2) the dividend was paid out of such inflated profit which resulted in payment of dividend out of capital; (3) the auditors also acted as accountants to the company; (4) the company went into liquidation; and (5) the Official liquidator brought on action against the directors and auditors of the Company alleging that they have failed to perform their duties and were, therefore, guilty of misfeasance.

Mr. Justice Bennett, in the course of his judgement, remarked the following –

(1) "An auditor did not discharge his duty if he merely saw that the balance sheet accurately represented what was shown by the books on the material date.

(2) "His duty with regard to the ascertainment of unrecorded liabilities must be determined by the nature of the business carried on.

(3) "If the auditor found that a company in the course of its business was incurring liabilities of a particular kind, and that the creditors sent in their invoices after an interval, and that the liabilities of the kind in question must have been incurred during the accountancy period under audit, and that when he was making his audit a sufficient time had not elapsed for the invoices relating to such liabilities to have been received and recorded in the Company's books, it became his duty to make specific inquiries as to the existence of such liabilities and so, before he signed a certificate as to the accuracy of the balance sheet, to go through the invoice files of the company in order to see that no invoices relating to liabilities had not been omitted."

(4) "With regard to the Over-Valuation of Work-in-progress, it was the duty of the auditor to check the figures at which work-in-progress was brought into the balance sheet. He had also to satisfy himself that all liabilities incurred by the Company in connection with the work so valued had been brought into account."

Summary : (1) An auditor is guilty of misfeasance if he fails to detect the omission of liabilities from the balance sheet even when such omission is apparent. (2) An auditor is guilty of negligence if he fails to detect the over-valuation of work-in-progress when ample materials as evidence are available for testing the accuracy of the figures given to him.

11. *London Oil Storage Co. Vs. Seear, Hasluck and Co. (1904)* :

The facts of the case were that : (1) The clerk of the audit firm compared the petty cash book with the accounts and did not verify the balance of actual cash in hand; (2) the petty-cashier misappropriated the differential amount between the actual cash that should have been and the physical cash balance in hand; and (3) the company brought an action against the auditors for damages on the ground that the fraud could have been detected by the auditors had they verified the petty cash in hand.

The auditors denied the charge for negligence and put forth an argument that the alleged loss was the result of negligence on the part of the Company directors in entrusting so much money to the cashier and in not checking the petty cash from time to time.

The judge decided the case as follows :

(1) The directors of the company were guilty of gross negligence and were a contributory to the cause of the loss.

(2) The auditors commited a breach of duty by not verifying the petty cash in hand and hence were liable to pay damages of a nominal amount.

Summary : It is the auditor's duty to take appropriate steps for verification as to the existence of assets shown in the balance sheet. He remains liable for damages if he omits to verify the existence of assets.

12. *Irish Woollen Co. Vs. Tyson and others (1900)* :

The fact of the case was that the dividends were paid out of fake profit arrived at by the manipulation and falsification of the accounts of the Company with respect to the vital aspects, such as : Over-valuation of the Stocks and book debts, and under-valuation of trade liabilities by suppressing the purchase invoices and carrying them to the next period while including the goods in the Stock of the current period. The company also alleged that the auditor entrusted the major work to his assistant who did not exercise reasonable skill and care to the audit. As a result, the frauds of the aforesaid nature could not be detected during audit.

The judgement ultimately stated that –

(1) The auditor's duty was not to take stock unless there was something to arouse his suspicion as was held in the case of Kingston Cotton Mills.

(2) The auditor was not supposed to do everything himself and could get the work done by his assistant.

(3) If the auditor has called for the creditors' statement of accounts upon which the payment was ordered and compared them with the ledger, he would have detected the suppression and carrying over to invoices.

(4) The auditor was liable for any damage that the Company sustained from the understatement of liabilities in the balance sheet.

Summary and Comments :

(1) The auditor is liable for damages by reason of falsification in the accounts which might have been detected by the exercise of reasonable care and skill.

(2) The plea that an auditor is not a stock-takér or valuer, or that he must rely upon the trusted official regarding the list of bad or doubtful debts does not hold good now a days in view of the exacting standard of audit work expected of an auditor.

13. *Leeds Estate Building and Investment Co. Ltd. Vs. Shepherd (1887)* :

The brief facts of the case are as follows :

(i) The Company's Articles of Association provided for payment of bonuses to the directors in proportion to the dividends paid but such payments were to be paid only out of profits.

(ii) The Company's Articles further provided that : (a) the directors should cause true accounts to be maintained and statement of income and expenditure and balance sheet to be placed once a year before the company; (b) the directors were authorised to declare dividend out of profits; and (c) the auditors should state whether balance sheet exhibited a true and fair view of the state of affairs of the business. (iii) The Company made no profits during the whole period of its operation except in one year – the fact of which was discovered only during the course of liquidation proceedings. It was further. established that the balance sheet was entirely false by including fictitious items and designed to show fictitious profit with a view declaring dividends by the manager and that the same was certified by the auditor. (iv) The Company directors pleaded ignorance as to the fact that dividends had been paid out of capital as they relied upon the auditor. (v) The auditor put forth his argument that he was unaware of the articles and that the action was time-barred. (vi) The liquidator argued that the auditor was negligent in his duties as he did not comply with the provisions laid down in the articles and as he certified a false balance sheet.

Mr. Justice Sterling, in his judgment remarked :

(1) It was the duty of the auditor not to confine himself merely to the task of ascertaining the arithmetical accuracy of the balance sheet, but to see that it was true and accurate representation of the company's affairs. It was no excuse that the auditor had not seen the Articles when he knew of their existence.

(2) The directors were bound to make good the losses arising out of the payment of dividend out of Capital and to the like amount the auditor and manager were for damages caused to the business.

Summary : An auditor, who fails to inquire into the substantial accuracy of the balance sheet and who fails to conclude that the transactions are *ultra vires* the company's Articles, is negligent in the performance of his duties and therefore liable for damages.

14. *Wilde and others Vs. Cape and Dalgleish (1897) :*

The brief fact of the case was that the cashier of the plaintiffs defalcated certain amount which the auditor failed to detect as he had not checked the pass book. The plaintiffs brought action against the auditor for breach of duty and negligence and also claimed damages. The auditor argued that the preparation of the profit and loss account and the balance sheet was the Contract and not anything else. The Judge held that the auditor was guilty of negligence for not performing his duties with reasonable skill and care.

Summary : An auditor is liable to pay damages for loss to his client in the event of nonfulfilment of the contract.

15. Arther E. Green & Co. Vs. The Central Advance and Discount Corporation Ltd. (1920)

The brief facts of the case are as follows :-

(i) The auditors sued the Corporation to recover the audit fees and the Corporation made a counter-suit claiming damages from the auditors for breach of duty and negligence.

(ii) The defendant contended that the auditors did not report about the insufficient provision for bad and doubtful debts which resulted in inflated profits and more commission paid to the manager. Further, the auditors failed to highlight that some of the debts were time-barred.

(iii) The auditors argued that "in a money lending business it did not matter how old the debts were, because in the long run people would come back and pay in order to be able to obtain further advances." The Judge decided that the auditors were guilty of negligence in their duties for :

(a) not reporting the insufficiency of the provision for bad and doubtful debts to the shareholders; and

(b) accepting the incomplete schedule of bad debts given by the directors.

Summary : The auditor is guilty of negligence of his duty if he fails to perform statutory duties in communicating the true position of accounts to the shareholders although such communication is made to the directors.

16. Republic of Bolvia Exploration Syndicate Ltd. (1913) :

The facts of the case are as follows :

(i) The directors of the company made certain payments, such as (a) Commission for placing shares (not to a director) and (b) Costs and also a share of profit to a Solicitor-Director.

(ii) One of the Company directors did not account for the balance that he received from one of the Company's suppliers.

(iii)The articles of the Company did not contain any provision authorising such payments, and therefore the Companies Act was applicable.

(iv)The Liquidator of the Company brought an action against the auditors alleging that the auditors were negligent as they certified the payments which were *ultra vires.*

Although all these payments were *ultra vires,* the Court was not convinced that the Company suffered damages due to the auditors' default for not pointing out this fact in the report. The Court dismissed the case against the auditors without costs in consideration of the existence of special circumstances.

Summary : The auditor is *prima facie* liable for *ultra vires* payments but the extent of his liability for not detecting such payments depends on the existence of special circumstances.

17. *Union Bank of Allahabad (1925)*

The facts of the case are as follows :

(i) The auditor blindly signed the false Balance Sheet having been influenced by the dishonest manager and the secretary of the bank.

(ii) The auditor confessed that - he would have discovered the criticality of the affairs of the bank and fraud connected with the depositors and creditors, had he examined the books and asked for an explanation. But he never asked a question and certified the accounts.

(iii)The directors trusted the dishonest manager for years and also the auditor's report and declared dividends.

(iv)The Bank, thereafter, went into liquidation.

Mr. Justice Wallis, in his judgment, remarked the following :-

(1) "Unless the auditors are to be held strictly to their legal liability, the object of legislature in requiring a certificate from them is absolutely defeated. He was utterly reckless and indifferent in his conduct as an auditor. He was trusted to discharge his duty."

(2) "An auditor is not merely an arithmetical machine to check the figures in the books. He should have satisfied himself not only that the accounts were correct but that the books represented the true state of affairs of the Bank."

Summary : An auditor is liable to be guilty of misfeasance for signing the balance sheet blindly and has to suffer the consequences if such balance sheet is found subsequently to be incorrect.

18. *Superintendent and Remembrancer of Legal Affairs, Bengal Vs. Akhil Bandhu Guha and others (1936) :*

The facts of the case are as follows :

(1) The managing directors of Dhakeswari Cotton Mills Ltd. were also the managing directors of a newly formed company named East Bengal Jute and Cotton Mills Ltd.

(2) The amount against the item 'Deposit by others' shown in the balance sheet of the first Company was actually arrived at by deducting the loan amount advanced to the other new company. This loan was never separately shown in the balance sheet.

(3) The amount against the item 'advances to Contractors and Others' included the loans to the managing directors but such loans were not specifically disclosed in the balance sheet.

(4) The auditors certified the balance sheet as having been properly drawn up, and the majority of the directors adopted the balance sheet.

(5) One of the shareholders brought a criminal suit against the managing directors under Section 282 of the Companies Act 1913 (now Section 628 of Companies Act 1956 which states - Any person who makes a false statement in any returns, balance sheet, etc. is liable to be imprisoned upto two years and fined.) before the Magistrate.

(6) The Magistrate convicted all the directors and sentenced them with fine and imprisonment. But the respondents appealed before the District Judge who reversed the judgement stating that the criminal intention of the directors was not proved.

(7) The Govt. made an appeal in the court against the District Judge's Order.

(8) The Court, in its judgment upheld the Magistrate's order and held that the directors and the auditors were guilty of criminal liability.

In the course of his judgment, Mr Justice Cunliffe remarked the following :

(1) "A balance sheet need not be, in fact it must not be a mere inventory. It is supposed to be a pictorial representation of the trading position of the Company, easily appreciated not by ignorant people but by persons who are reasonably able to understand commercial conditions."

(2) "A loan and a deposit ; being obviously items differing completely in principle from the balance sheet point of view, ought to appear on different sides, one as an asset and the other as a liability and that the act of consolidating the two and presenting them as one item in the balance sheet was a striking case of non-disclosure amounting to suppression of truth."

19. *Armitage Vs. Brewer and Knott (1932) :*

The facts of the case are as follows :

(1) The plaintiff appointed the auditors to have protection against the petty frauds that were suspected to be perpetrated by the book-keeper.

(2) There was no system of internal check. The book-keeper had complete charge of the books of account including the preparation of wages sheets and payments therefor.

(3) It was found that the book-keeper manipulated the wages sheets and embezzled money; but the auditors did not give due importance to the matter so as to bring it to the notice of the principal.

(4) As a result, the plaintiff claimed damages against the auditors for their failure to detect frauds.

Mr. Justice Talbot observed that (i) the audits differed greatly as to scope and special instruction and (ii) the fraud must have been detected by a thorough examination of the wages sheets by the auditors. It was held that the auditors were guilty of negligence as they failed to detect frauds for which they were informed.

SHORT ANSWER QUESTIONS.

Q.1. : What is 'misfeasance'? Cite an example when an auditor may be guilty of misfeasance.

A.1. : 'Misfeasance' means breach of duty imposed by law.

Section, 227(3) of Companies Act imposed a duty on the auditor to state categorically in his report certain facts in the affirmative or negative terms. If these are not complied with, the auditor is guilty of misfeasance and is liable to fine upto Rs. 1000/-

Q.2. : Give examples of Criminal liability of an auditor under the Companies Act.

A.2. : (i) Wilfully making a false statement either in the balance sheet or in any other documents (e.g., Certificate, prospectus, etc.).

(ii) Destruction, mutilation, alteration or falsification of any voucher, paper, books, etc. with intent to defraud or deceive any person.

Q.3. : State three conditions that must be proved before the auditor is held liable for negligence.

A.3. : These are : (i) that the auditor was negligent; (ii) that as a result of his negligence the client suffered a loss; and (iii) that the loss was suffered by person to whom the auditor owed a duty.

Q.4. : State the three conditions that must be proved to hold an auditor criminally liable.

A.4. : These are (i) that the statement by the auditor was false in material facts; (ii) that he wilfully made such a false statement; and (iii) that the statement complained of has been made in any return, report, balance-sheet, certificate, etc. under the Companies Act.

Q.5. : "An auditor has no liability for negligence in the conduct of an honorary audit." Discuss.

A.5. : See : Serial no. 2 of Appendix of this Chapter.

Q.6. : Distinguish between the Civil and Criminal liability of an auditor.

A.6. : Civil liability of an auditor arises out of negligence in the performance of his duties and the auditor may be sued in a civil court for damages caused therefor; whereas Criminal liability arises out of an act constituting a crime on the part of an auditor.

Q.7. : Name the important Case laws in connection with the civil liability of an auditor.

A.7. :

Case laws	***Decision***
(1) London Oil Storage Co. Vs. Seear, Hasluck & Co.	By omitting to verify cash in hand, the auditor committed a breach of duty and failed to discover the fraud. Hence, he was liable to pay damages.
(2) Leeds Estate Building Society *Vs.* Shephered.	By omitting to examine the Articles of the company, the auditor was negligent in his duties to discover that the dividends were paid out of capital and was liable to pay damage.
(3)Irish Woollen Co. *Vs.* Tyson and Others.	By not obtaining the Statement of account from the creditors, the auditor neglected his duties, failed to discover falsification and manipulation of accounts and hence was asked to pay damages.

Other case laws are :

Arther E. Green & Co. *Vs.* Central Advance and Discount Corpn. Ltd ; London & General Bank; Westminister Road Construction Co. Ltd.; Union Bank of Allahabad etc.

CHAPTER 9

AUDIT OF LIMITED COMPANIES

Learning Objectives : *After reading and carefully studying this chapter, the student should :*

- Know about the significant provision of Indian company law in relation to which auditor's responsibilities arise.

Q. 9.1 : Indicate the important points to be considered if you are appointed (a) as the first auditor, (b) as the auditor in place of the retiring auditor, and (c) as the auditor through an order of the Government.

Ans. : (a) *As the First Auditor* : The following points are necessarily to be considered —

1. To see that the appointment has been duly confirmed by the Board of Directors at the company meeting held within one month of the date of incorporation of the company ;
2. To check up that the letter of auditor's appointment along with a copy of the board's resolution have been sent to the auditor ;
3. To verify that the audit assignment is within the terms of Section 224 of the Companies Act ;
4. To ensure that the acceptance of audit work is informed to the Registrar of Companies within one month of the receipt of appointment.

(b) *As an Auditor in place of Retiring Auditor* :

1. To ensure that the formalities of the Company Law in this regard are really complied with ;
2. To clearly communicate the Retiring Auditor in writing about the appointment before acceptance so that he is not held guilty of professional misconduct ;
3. To scruitnise the minutes of the Board meeting or general meeting about the appointment and the remuneration determined, before the confirmation as to acceptance is sent to the Registrar of Companies.

(c) *As an Auditor under the Government's Order* :

1. To go through the terms and conditions of the order received directly from the Government, and to see the original order copy received by the company in this respect ;
2. To confirm his acceptance in writing to the Central Government.

Q. 9.2 : State what basic steps should be taken before the commencement of an audit of a company.

Ans. : Before commencement of the audit work on the books of accounts of a company, the auditor should :

1. Verify the validity and legality of his appointment in terms of provisions under Section 224 (as the first auditor) or Section 225 (as auditor replacing the retiring auditor) or of the Central Government's order ;
2. Obtain confirmation as to the fixation of remuneration by the appropriate authority of the company and under the company law ;
3. Obtain and study the following books, documents and statutory registers for a knowledge about the company and its nature of business and activities :

Memorandum of Association

Articles of Association

Prospectus or Statement in lieu of prospectus

Certificate of Incorporation

Certificate to commence business

Previous Years' Audited accounts & Audit Report.

Preliminary Contracts & Agreements,

e.g., Vendors' Contract,
Underwriters' Contract,

Fixed Assets' purchases contracts,

Collaboration agreements, Agreements with promoters, etc.

Statutory Books of Accounts and Registers, such as :

Account books relating to :

Sales and purchases, assets and liabilities, money received and expended.

Registers of :

Investments, Deposits, Charges, Members, Debenture-holders, Directors, Contracts, Loans, Directors' shareholdings.

Index of Members.

Minute Books :

Shareholders and Directors

Lists of : Managerial personnel including

Accounts department — their powers and duties, records kept by them.

Q. 9.3 : While conducting the audit of a company, how will you check : (a) Share Capital, (b) Shares issued at a discount, (c) Shares issued at a premium, (d) Forfeited Shares, (e) Redemption of Redeemable Preference Shares, (f) Underwriting Commission on Shares, (g) Bonus Shares, (h) Issue of Debentures, (i) Reissue of Redeemed Debenture, (j) Share Certificates, (k) Share Warrants.

Ans. : (a) *Share Capital* : The audit of this item arises when a company : (1) Issues share capital for its formation ; (2) Increases its paid-up capital ; (3) Introduces fresh shares ; and (4) Increases its authorised capital.

The audit examination involves the fundamental steps as follows :

1. Examining the original certificate of the Controller of Capital Issues (which is necessary when the capital is more than Rs. 25 lakhs) and the fact of its permission indicated in the prospectus.
2. Ascertaining the authorised capital and the issued capital from the Memorandum and Articles of Association of the Company.
3. Checking the documents such as : Application for shares, Share application book, Stock exchange's letter about the mode of allotment, Allotment letter, Share allotment book, Regret letter, Director's Minute Book (for resolution regarding 'calls'), Letters for calls, Call register, Refund of application money received in excess, Cash and Bank Statements (for receipts of application, allotment and calls money and for refunds), and the Cash Book.
4. Appraising the internal accounting controls relating to the various capital receipts.
5. Examining the extent of compliance with provisions of the Companies Act regarding : prohibition of allotment unless minimum subscription is received (Sec. 69), prohibition of allotment in certain cases unless a statement in lieu of prospectus is delivered to the Registrar (Sec. 70), and restriction on application and allotment of shares (Sec. 72).
6. Verifying the Ledger accounts entries and comparing the balance with the number of shares allotted.
7. Confirming, after inquiry, that the amounts in respect of shares allotted have been received by the company (Sec. 227).

(b) *Shares issued at a discount* : Since the provisions contained in Section 79 of the Companies Act regulate the issue of such shares, the audit steps should be :

1. To see that such issue is authorised by a resolution passed in a general meeting and sanctioned by the Company Law Board ;
2. To check the rate of discount specified in the resolution (the maximum discount rate being 10 percent), and to verify the permission of the Central Government in case a rate higher than 10 percent is allowed ;

3. To examine that at least one year has, at the date of the issue, elapsed since the date on which the company was entitled to commence business ;

4. To verify that such shares are issued within 2 months after the date on which the issue is sanctioned by the Company Law Board, or within such extended time as allowed by the Company Law Board ;

5. To examine the Articles of Association regarding the authorisation to issue such shares, and also the prospectus regarding the disclosures thereof ; and

6. To check up that the 'discount on issue of Shares' is invariably shown in the asset side of the balance sheet under the head 'Miscellaneous expenditure' until it is written off.

(c) *Shares issued at premium* : Section 78 of the Companies Act deals with the issue of such shares. Here, the word 'premium' represents the differential amount in excess between the price issued in the market and the face value of shares. The suggested audit steps are :

1. Examining the compliance of the provisions of Section 78 by a company with respect to : (i) whether for cash or otherwise, a sum equal to the aggregate amount or value of the premiums on the shares has actually been transferred to an account called 'Share Premium Account'; (ii) Share premium amount has not been mixed up with the Share capital ; (iii) Share Premium Account has been used (when actually used) for no other purposes but for the purposes of : (a) paying up unissued shares to be issued to the members as fully paid up bonus shares, (b) writing off the preliminary expenses, (c) writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures ; or (d) providing for the premium payable on the redemption of any redeemable preference shares or of any debentures.

2. Verifying the memorandum and articles of association and the Board's minute book to confirm authorisation for issue of such shares.

3. Inspecting the prospectus in order to confirm the rate of premium and the amount to be received.

4. Confirming that the share premium amount actually appears in the liabilities side of the balance sheet under the head 'Reserves and Surplus'.

5. Examining the accounting entries to confirm the utilisation of premium as stated under 1 (iii) above.

(d) *Forfeited Shares* : The suggested audit steps are :

1. Verifying the Articles of Association as to the provisions in this regard, and in absence, examining as to whether forfeiture of shares was done strictly in accordance with the regulations 29 to 35 of Table A of the Companies Act.

2. Checking as to whether a proper notice was given to a member who is in default in payment.

3. Examining : Directors' Minute Book for a resolution passed in forfeiting the shares, and the adjustment entries made in the books of account after such forfeiture, and also the entries in the Register of Members.

4. Confirming, where forfeited shares are reissued, that : (i) there is board's resolution for the reissue, (ii) the balance of the Forfeited Account after reissue (reissue may be at the original face value or lower) is indicated under the head 'Capital Reserve', (iii) the premiums received on the original issue of shares remain in the Share Premium Account and the premiums on the forfeited shares had not been transferred to the Forfeited Shares Account.

5. Ascertaining as to whether the credit balance of the forfeited shares has been utilised to write off discount on issue if shares and debentures, or preliminary expenses (fictitious assets).

(e) *Redemption of Redeemable Preference Shares* : Section 80 of the Companies Act governs the issue and redemption of redeemable preference shares. Therefore, it is the duty of the auditor to see that these provisions are fully complied with by a company.

The suggested audit steps are :

1. Verifying from the Articles of Association that the company is authorised to issue such shares for redemption.

2. Examining the fulfilment of the following conditions to the effect that :

(i) the shares have been redeemed only when they are fully paid up ;

(ii) the shares have been redeemed out of the profits of the company which would otherwise be available for dividend, or out of the proceeds of the fresh issue of shares made for the purposes of redemption ;

(iii) the premium, if any, payable on redemption has been provided for out of the company's profits or Share Premium Account, before the shares are redeemed ;

(iv) a sum equal to the nominal amount of the shares redeemed has been transferred to a reserve fund called 'Capital Redemption Reserve Account', when shares are redeemed out of the profits ;

(v) the Capital Redemption Reserve Account, where utilised, has been utilised in paying up unissued shares to be issued to the members of the company as fully paid bonus shares ;

(vi) the Registrar of Companies has been notified within one month of the redemption of shares; and

(vii) the redeemable preference shares have actually been specified in the balance sheet.

3. Verifying that an amount equal to the shares redeemed has actually been invested, and the interest on such investment has been properly accounted for.

4. Examining the Articles of Association and the Minute Book and the usual procedures for audit of fresh issue, when shares are redeemed out of profits.

(f) *Underwriting Commission on Shares and Brokerage* : Section 76 of the Companies Act contains the provisions for regulating the underwriting commission. In this regard, the auditor's duties are to :

1. Ensure the fulfilment of the statutory conditions, such as : (i) the payment of commission is authorised by the Articles of Association ; (ii) the commission does not exceed 5% of the price of the shares issued or the rate or amount indicated in the Articles, whichever is less ; (iii) the commission on debentures issued is $2^1/_2$%; (iv) the rate and/or amount is disclosed in the prospectus ; and (v) the filing of the prospectus with the Registrar of Companies is accompanied by the agreements made with each underwriter.
2. Vouch the receipts of the underwriters and the calculations for payments of such commission, in addition to the examination of the approvals by the company directors in the board meeting.
3. Verify the agreement with underwriters in case of issue of shares in lieu of commission.
4. Check up that such commission has been separately shown on the asset side of the balance sheet under the head 'Miscellaneous Expenditure' until it is written off.

• *Brokerage on Shares* : Statutory restrictions under Sec. 76 do not apply for this item. Therefore, the suggested audit steps are to :

1. Refer the Board's Minute Book regarding the approval of this arrangement.
2. Refer the Articles of Association authorising such payment.
3. Verify the disclosure in the prospectus.
4. Vouch the receipts and the calculations of such brokerage paid to each broker.
5. See that this brokerage on shares has been shown separately on the asset side of the balance sheet under the head 'Miscellaneous Expenditure' until it is written off.

(g) *Bonus Shares* : Article 96 of Table A of Schedule 1 of the Companies Act deals with the issue of bonus shares. On the recommendation of the board, the company may in general meeting resolve and convert into capital any sum standing to the credit of the company's reserve accounts, or to the credit of the Profit and Loss Account, or otherwise available for distribution. It may also reserve and distribute such surplus not in cash but in unissued shares, fully or partly paid, to the existing shareholders by way of dividend. The bonus shares are issued to all shareholders in proportion to their holding.

The suggested audit steps are to :

1. Verify from the Articles and Memorandum of Association that : (a) the company is authorised to capitalise reserves and profits for issuing such shares; and (b) the total of subscribed and paid-up capital is within the authorised capital.
2. Refer to the resolution for such issues passed by the directors in their board meeting and also

to the resolution passed by the shareholders approving the board's resolution.

3. Ensure that each of the conditions contained in the Government's guideline in this respect has been duly complied with.

4. Check up the relevant matters, like (i) receipt of government's sanction, (ii) accounting records for capitalisation of reserves and profits, (iii) entries in the Register of Members, (iv) inclusion of bonus shares value in the paid-up capital, and (v) the details of disclosure, such as the source (capitalisation of profits or reserves, share premium account) from which the bonus shares are issued and the accounting thereof under the Head 'Share Capital' on the liabilities side of the balance sheet of a company.

(h) *Issue of Debentures:* Debenture is an acknowledgement of debt which is given by a company under its common seal. It is, therefore, a part of loan capital. It can be issued at par, at a discount, at a premium, and the modus operandi of its issues are similar to the issue of shares. The power to issue debentures vests, under Section 292(1) of the Companies Act, with the board of directors of a company, and the permission of the Controller of Capital Issues is necessary before issue. For auditing this item, the suggested steps are to :

1. Refer the Articles of Association to find out whether the company is authorised to borrow through debentures, the Memorandum of Association to justify the company's powers, and the resolutions passed by the board of directors and the shareholders prior to obtaining the permission of the Controller of Capital Issues.
2. Inspect the prospectus or a statement in lieu of prospectus for the contractual terms of allotment.
3. Ensure that the total borrowings including debentures do not cross the limits prescribed under Sec. 123(1)(d) or the limits determined by the shareholders.
4. Verify the Register of Charges if a charge is created on the debentures.
5. Examine and checkup : the books of accounts relating to receipts of application money, excess amounts refund, payments of interest or provisions thereof, the trust agreement, etc.
6. See that the interest on debentures is charged to the Profit & loss Account, and that the unclaimed interest is shown in the balance sheet.
7. Scrutinise finally to ensure that interests are paid to the debenture-holdings even if no profit is earned by a Company.

(i) *Reissue of Redeemed Debentures :* Section 121 of the Companies Act deals with this item. In absence of any specified provisions contained in the articles or in the conditions of issue of debentures, the company shall have the right to keep the debentures alive even after the redemption of debentures issued previously for the purpose of re-issue. However, the audit examination generally follows the undernoted steps :

1. Refer the Articles and Memorandum of Association to ascertain whether the company is empowered to re-issue.
2. Check up the Minute Books to find out whether the company has passed any resolution for such re-issue.
3. Verify the original debentures, and their terms and conditions of issue to make sure that the reissue of redeemed debentures is permissible.
4. Examine the Register of Debenture-holders and the books of account to ascertain that (i) necessary entries have been made, and (ii) the stamp duty has been paid on the re-issued debentures.

(j) *Share Certificate :* The audit of this item involves two major steps as follows :

1. Examining the fulfilment of the conditions embodied in Section 113 of the Companies Act to the effect that a company has, within three months after the allotment of any of its shares or debentures or debenture stock and within two months after the application for registration of the transfer of any such shares, etc., completed and delivered the certificates of all shares, debentures, and debenture stocks, unless the conditions attached to these shares etc. provide otherwise.
2. Comparing the entries in the Register of Members with the information contained in the counterfoils of the share certificates.

(k) *Share Warrant :* Sections 114 and 115 of the Companies Act deal with this item. The suggested audit steps are to :

1. Refer the Articles of Association to ascertain the basis of Share Warrants issue,
2. Examine the Register of Members to find out that the names of members who are in receipt of share warrants have been struck off.
3. Examine the compliance, by a company, with the conditions enumerated in Section 114 and 115.

[**Sec. 114(1) :** A public company limited by shares, if so authorised by its articles, may with the previous approval of the Central Government, with respect to any fully paid-up shares, issue under its common seal a warrant stating that the bearer of the warrant is entitled to the shares therein specified, and may provide by coupons or otherwise, for the payment of the future dividends on the shares specified in the warrant.

Sec. 114(3) : A share warrant shall entitle the bearer thereof to the shares therein specified and the shares may be transferred by delivery of the warrant.

Sec. 115(1) : On the issue of a share warrant, the company shall strike out of its register of members of the name of the member then entered therein as holding the shares specified in the warrant as if he has ceased to be a member and shall enter in that register the following particulars, namely :

(a) the fact of the issue of the warrant ; (b) a statement of the shares specified in the warrant, distinguishing each share by its member ; and (c) the date of the issue of the warrant.]

Q. 9.4 : State the legal provisions regarding the redemption of Redeemable Preference Shares.

See : 9.3 (e). (Serial no.2).

Q. 9.5 : When is the audit of Share Capital of a company necessary? State them.

See : Ans. to Q. 9.3 (a) — first paragraph only.

Q. 9.6 : What is the meaning of the word 'Premium' for shares issued at a premium ?

See : Ans. to Q. 9.3 (c) — first paragraph only.

Q. 9.7 : What are Bonus Shares ? Can they be issued in lieu of dividend ?

See : Ans. to Q. 9.3 (g). The issue of bonus shares in lieu of dividend is not admissible in terms of the Capital Issues (Control) Act.

Q. 9.8 : What is a 'Debenture'? Who is authorised to issue debenture ? Whose permission is necessary for issue of debentures ?

See. Ans. to Q. 9.3 (h) — first paragraph only.

Q. 9.9 : List out the essential auditing steps with respect to : (A) Share Transfer, (B) Alteration of Share Capital, (C) Reduction of Share Capital (D) Loan from Bank, and (E) Deposit from Public, relating to a company.

Ans. (A) *Share Transfer :* While the audit of the accounts of a company is statutory, the audit of shares transfer is not statutory; it is optional. The essential auditing steps are to :

1. Refer the Articles of Association to ascertain the procedures followed to transfer shares ;
2. Refer the statutory provisions (Sec. 108A) of the Companies Act and inquire about the applicability of the restrictions to the company where such audit is undertaken ;
3. Evaluate the systems of internal accounting and administrative controls to decide the extent of checks, and then to verify :
   (a) Whether the transfer forms are duly stamped and completed,
   (b) Whether the transfer forms bear the signatures of the genuine transferrors,
   (c) Whether due intimation was given to the transferrors including joint shareholders and any objection received against share transfer,
   (d) Whether the transfer fees have been received and recorded in the cash book by reference to the duplicate copies of the receipt book,
   (e) Whether the shares to be transferred are on lien or mortgaged and if so, whether a notice given to the mortgagees, etc.

4. Ascertain whether the transfer/transmission of shares is on account of death or bankruptcy of member, and in that case, it is necessary to examine :
   (a) the Articles of Association for compliance with the regulations,
   (b) The succession certificate, or the will, or the power of attorney, and/or the certificate issued by the Controller of Estate Duty (to confirm the estate duty payment), and
   (c) The executor's application that the shares may be issued.
5. Verify the books and records, such as : (a) Directors' Minute Book (for approval of transfers), (b) Share transfer registers, and (c) Register of Members.

As this audit is separately taken up, it is the responsibility of the auditor to issue a report, after the completion of the audit, to the management of the company highlighting the cases of errors and frauds and irregularities, if any.

(B) *Alteration of Share Capital :* Sections 94 and 95 of the Companies Act deal with this item. Thus, the auditing steps should be to :

1. Refer the Articles of Association for authorisation regarding the alteration of share capital;
2. Refer the Memorandum of Association as to the fulfilment of the conditions as per Section 94, such as :
   (a) increase of share capital amount by new shares issue,
   (b) consolidation and division of share capital into share of large amount,
   (c) conversion of fully paid shares into stock and reconversion of that stock into fully paid shares of any denomination,
   (d) subdivision or substitution of shares into shares of smaller amount so that the proportion between the amount paid and the amount unpaid (if any) on each reduced share remains the same as before,
   (e) cancellation of the unissued shares for diminishing the share capital amount.
   (f) that a resolution has been passed in the general meeting for giving effect to the above alterations ;
3. Ensure that a notice giving effect to conditions listed at 2 above has been submitted to the Registrar of Companies by the company within 30 days ;
4. Refer the Directors' minute book and Shareholders' minute book for share capital alteration, and verify the matters, e.g., entries in the register of members, amount of share capital, cancellation of share certificate with the counterfoils of the new certificates issued.

(C) *Reduction of Share Capital :* Sections 100, 101 and 103 of the Companies Act deal with this item. The auditing steps, therefore, should be to :

1. Refer the Articles of Association for authorisation regarding reduction of share capital ;
2. Refer the special resolution with respect to : reduction of liability on any of he shares in respect of share capital which is lost or is unrepresented by available assets, and/or paying off any paid-up share capital which is in excess of the wants of the company ;
3. Refer the documents, such as : the court's confirmation order, the scheme of reduction as per the minutes, and the certificate of the Register of Companies ;
4. Verify : (a) the Register of members for the changes made, (b) the entries in the books of account including the cash book and Bank pass book ; (c) the cancellation of old certificates, (d) the issue of new certificates, (e) the extent of participation of the creditors and fixed interest bearing securityholders in the scheme, and (f) the accounting of fresh issue of shares for unpaid call on equity share capital.

(D) *Loan from Bank :* The essential audit steps should be to :

1. Refer the Articles and Memorandum of Association of the company for authorisation to make such loans ;
2. Refer the Director's minute book approving the resolution to make loans ;

3. Refer the agreement clauses of loans and verify the pertinent matters, e.g., interest on loan, nature and kind of securities lodged, repayment terms, etc.; and
4. Ensure that this item appears on the liabilities side of the balance sheet.

(E) *Deposit from Public :* The essential audit steps should be to :

1. Refer the Articles and Memorandum of Association for authorisation to accept such deposits ;
2. Ensure that the company has complied with the conditions enumerated in the rules relating to acceptances of Deposits from public, etc. ;
3. Examine : Statement of receipts from the public as 'fixed deposits' forwarded to the Reserve Bank of India, rate of interest, amount of appreciation, the limit to which the deposit is sanctioned, etc.

Q. 9.10 : (A) What is Capital Reserve ? How is it created ? (B) How does it differ from a Revenue Reserve ? (C) Why is a Revenue Reserve created ? (D) What are the duties of an auditor in relation to Capital Reserve and Revenue Reserve ? (E) Give three examples of Capital Reserve and Revenue Reserve.

Ans. : (A) *Capital Reserve :* This refers to a reserve created out of the profits of capital nature. The company law has not specifically defined this term, but state that it should not include any amount regarded as free for distribution through the Profit and Loss Account among the shareholders.

• *How created :* Capital Reserve is created by transferring the amounts from one or all the following sources to this account : (a) profits prior to the incorporation of a company ; (b) profits on the redemption of debentures at a discount ; (c) premium receipts on the issue of shares and debentures ; (d) credit balance against Forfeited Shares Account after re-issue of such forfeited shares ; (e) differential amount when the value of the net assets acquired on purchase of a business exceeds the original purchase price ; (f) profits on the sale of fixed assets ; (g) profits earmarked for non-distribution among shareholders in terms of a provision in the Articles of Association ; (h) appreciation amount as a result of revaluation of assets ; and (i) certain capital gains earned but not distributed.

(B) *Differences :*

Revenue Reserve	Capital Reserve
1. It is an appropriation of the annual profit of a company.	1. It is created out of the capital profits of a company.
2. It is a non-committed reserve, i.e., not created to meet any specific liability.	2. It is more or less a committed reserve, i.e., created to meet a specific liability.
3. It is also known as a general reserve.	3. It is sometimes referred to as capital profit.
4. In the year of loss, no amount can be transferred to this.	4. It is unrelated to any loss of the company.
5. Debit balance of Profit and Loss Account is shown as an adjustment against the balance in this reserve.	5. It does not require any such adjustment.
6. It is used to meet the business activities and any unforseen contingency.	6. It is used to write off intangible assets, and for issue of bonus shares as per the Articles of Association.
7. The provisions of the Companies (Transfer of Profits to Reserves) Rules, 1975 apply.	7. Part-III of Schedule VI of the Act restricts inclusion of any amount regarded as free for distribution through the Profit & Loss Account.

(C) *Why a Revenue Reserve :* It is created to : (1) meet any unknown contingency ; (2) strengthen financial solvency ; (3) provide additional working capital ; and (4) pay dividends in the years of inadequate profit.

(D) *Auditor's duties :*

In relation to a **Capital Reserve**, the auditor should (1) Review the Articles of Association for the relevant clause and the purposes for which utilisation of this reserve are admissible ; (2) Verify the transfers of all (completeness test) capital profits ; (3) Review the Director's minute book for transfer and utilisation of capital profits, including investments, if any ; (4) Examine the balance sheet for separate disclosure of this reserve including the additions and withdrawals ; and (5) Ensure the fulfilment of the conditions as to the distribution as dividends among the shareholders, such as Board's resolution recommending the dividend, Articles permitting the distribution and existence of realisable surplus after an appropriate revaluation of all the fixed assets.

In relation to the **Revenue Reserve,** the auditor should (1) Review the Articles of Association for the relevant clauses which authorise creation of this reserve ; (2) Review the Directors' Minute Book for the amount set aside for the various reserves and for authorisation of withdrawals ; (3) Examine the mode of creation of this reserve out of the profits, and other reserves such as development rebate reserve, investment allowance, etc., which are charged against the profit ; (4) Verify the adequacy of this reserve under the Companies (Transfers of Profits to Reserves) Rules, 1975, in case of recommendation of dividend by the directors ; and (5) Ensure appropriate disclosures in the company's annual accounts.

(E) *Examples :*

Capital Reserve : Share Premium Account, Capital Redemption Reserve, Development Rebate Reserve, Fixed Assets Revaluation Reserve, etc.

Revenue Reserve : General Reserve, Dividend Equalisation Reserve, Deferred Taxation Reserve, Contingencies Reserve, Staff Gratuity Reserve, etc.

Q. 9.11 : (A) What is a Secret Reserve ? How and why is it created ? (B) Can a public limited company create secret reserve now ? Quote legal decisions, if any, and give reasons for your answer. (C) Explain the position of an auditor in this regard.

Ans. : (A) *Secret Reserve :* It refers to a reserve which is not disclosed in the balance sheet. According to E.L. Kohler (in his 'Dictionary for Accounts), a secret reserve represents "the amount by which the net worth has been deliberately understated a hidden reserve." "Such a condition exists where they are omitted or where liabilities are overstated. The term does not represent any account actually bearing that name."

• *How created :* A variety of methods are usually adopted, such as : (1) Overvaluation of liabilities ; (2) Undervaluation of assets like investments, stocks, WIP, etc. ; (3) Excess provision of depreciation, doubtful debts, discount on debtors ; (4) Fictitious liabilities ; (5) Capital expenditure treated as revenue expenditure ; (6) Deferred revenue expenditure charged in the current year, etc.

• *Why created :* The important reasons are to : (1) pay lower rates of taxes ; (2) declare lower dividends ; (3) Conceal abnormal profits ; (4) meet losses owing to bad debts ; (5) keep the confidentiality of the earning capacity ; (6) equalise the dividends in the years of inadequate profits thereby maintaining the corporate image before the investors and public.

(B) With the introduction of the Companies Act, 1956, a public limited company is not allowed to create a secret reserve. The creation of a secret reserve will amount to a contravention of the company law, as the balance sheet will not reflect the true and fair view of the state of affairs of the company and the Profit and Loss Account will not show the true and fair view of the profit or loss for the year.

• *Legal decisions :*

1. In **Shamdasani *vs.* Poch Khandelwala,** it was held that if a part of secret reserve was utilised to meet bad and doubtful debts it must be revalued in the balance sheet of a company. It must not be concealed in any way.

2. In **Rex Vs. Kylsant & other,** it was observed that a secret reserve was an intolerable abuse as it may lead to cover up the management's negligence and irregularities and inefficiencies. It is almost a breach of faith if a large portion of the company's assets is left in the secret disposition of the managing authority to whom

the investors and shareholders entrust their moneys faithfully.

3. In **Royal Mail** case, the auditor was warned to report the fact of utilising the secret reserve for the payment of dividends in the years of losses.

(C) *Auditor's position :* The auditor should always endeavour to unearth a secret reserve (if any), as because he remains responsible to submit a report as to : whether the balance sheet gives a true and fair view of the state of affairs of a company, and whether Profit and Loss Account shows the true and fair view of the profit or loss for the financial year. Thus, he should :

1. Review critically the reserve clauses in the Articles of Association ;
2. Examine thoroughly the books of accounts and records to see that the bad debts written off have been disclosed in the annual accounts ;
3. Check up the valuation of the closing stocks, work-in-progress, and assets, and the correctness of the values of liabilities ;
4. Guard against the inclusion of contingent liabilities as current liabilities ;
5. Study and evaluate the internal accounts and administrative controls established and operated in the company ;
6. Examine whether there has been any change in the method of accounting or the basis of valuation of the stocks, and also recompute the information to ascertain its impact on the profit for the year.

Q. 9.12 : What is 'Contingent Liability' ? Give five examples of different types of such liabilities and show, how they should appear in a company's balance sheet.

What would be your duty as an auditor in connection with these liabilities ?

Ans. : *Contingent Liabilities :* It is a liability which depends on the happening of an event. This liability may become due as and when the event takes place, otherwise not. So, it is a possible liability.

• *Examples are :* (1) Claims against the company not acknowledged as debts ; (2) Uncalled liability on partly paid shares ; (3) Arrears of fixed cumulative dividends ; (4) Estimated amount of contracts yet to be executed on capital amount and not provided for, i.e., commitments for capital expenditure ; (5) Any other amount for which a company is liable, e.g., bills discounted not yet due.

• *Disclosure practices :* Such liabilities must be referred to on the balance sheet of a company by means of footnotes as illustrated below :

1. In respect of labour awards against the company which is not admitted as a liability, Rs. 2,80,500.
2. On foreign bills rediscounted, Rs. 4,50,000.
3. Sales tax on certain inter-state sales, the extent of which cannot be ascertained and which is not acknowledged as a debt.
4. On account of guarantee of Rs. 1,15,00,000 given by the company in respect of bank advances to a subsidiary, the amount due under this arrangement being Rs. 50,00,000.

• *Auditor's duty :* He should ensure that the details including the estimated amounts of each type of such liability are adequately disclosed. He should verify the estimates of each item with reference to available evidential matters and documents and obtain a certificate from the management of the company. He should also see that these liabilities are categorised into two main groups, *i.e.,* liabilities provided for in the balance sheet, and liabilities not provided for in the balance sheet but shown as a 'footnote' as required under Part I of Schedule VI of the Companies Act. 1956.

Short Answer Questions :

Q. 1. State with reasons whether the following items are : provisions, capital reserves or revenue reserves :

(a) Amount retained to provide for loss that may arise out of the doubtful debts.

(b) Amount set aside to provide for the increased cost of replacement of fixed assets.

(c) Surplus arising on a professional revaluation of fixed assets.

(d) Amount transferred from Profit and Loss Account equal to the reduction in taxation on account of accelerated depreciation allowances.

(e) Amount set aside from profits towards a special publicity campaign to commence in the following year.

(f) Amount set aside to provide for the repayment of debentures.

(g) Estimated cost of maintaining, for the remaining period of guarantee, machines sold during the year.

A. 1.

Item	Category	Reasons
(a)	Provision	For diminution in the value of book debts.
	Reserve	To strengthen the financial position.
(b)	Revenue reserve	Created to retain profit.
(c)	Capital Reserve	Not free for distribution as dividends.
(d)	Revenue Reserve	A taxation equalisation reserve, created to spread the relief from taxation over years.
(e)	Revenue Reserve	No liability in respect of the campaign has yet arisen.
(f)	Revenue Reserve	To improve financial position.
(g)	Provision	Retained for a known liability.

Q. 2. Write short notes on : (a) Dividend equalisation reserve, (b) Deferred taxation reserve.

A. 2. (a) This reserve is created to maintain a uniform rate of dividend by a prudent company whose profits fluctuate from year to year. In years of sufficient profits, transfers are made to this reserve a portion of which is drawn in years of inadequate profits. Additions to and withdrawals from this reserve must find their disclosure in the annual accounts, and the auditor should examine the Director's Minute Book for the same. This reserve appears as a separate item in the balance sheet under the head 'Reserves and Surplus'

(b) This reserve, as a measure of prudent financial policy, is created out of profits with a view to equalising the tax burden from year to year. When a company undertakes large scale plant renovation programme, full development rebate and larger depreciation allowance are admissible in respect of new plant. This reduces the tax burden. But with the passage of time, the assets become old and the depreciation allowances based on written-down-values become lower, and as a result the incidence of tax increases. This reserve, in the circumstances, seeks to even out the burden of taxation at future years.

Q. 3. (a) What do you mean by 'Capitalisation of Reserves'? (b) State its advantages (i) for the company and (ii) for the shareholders.

A. 3. (a) See : Q 9.9 (A).

(b) (i) Advantages for the company are :

(1) It strengthens the financial position of the company.

(2) It may be invested either in the business itself or outside the business in easily realisable securities.

(3) It can be used to meet capital losses, such as for writing off intangible assets e.g., goodwill, preliminary expenses, cost of the issue of debentures, etc.

(ii) Advantages for the shareholders are :

(1) It may be utilised in the issue of bonus shares subject to the Articles of Association of the company.

(2) It can be used in providing for the premium payable on the redemption of redeemable preference shares or debentures.

(3) It can be employed in paying up unissued shares of the company to be issued to

the members of the company as fully paid bonus shares.

Q. 4 : What is a 'Branch Office' of a company for the purpose of the Companies Act, 1956 ?

A. 4. : It means any establishment described as a branch by the company, or any establishment carrying on either the same or substantially the same activity carried on by the company's head office, or any establishment engaged in production/processing/ manufacture but does not include any establishment specified in any order under Section 8 of the Act.

Q. 5. Distinguish between : 'Contingent liabilities provided for' and 'Contingent liabilities not provided for' with instances.

A. 5. 'Contingent liabilities provided for' refer to those that are considered to be necessarily provided for in accordance with the legal requirements ; for instance, certain claims against the company which will have to be paid at a later date although not decided on the balance sheet date.

'Contingent liabilities not provided for' refer to those that may or may not arise and may or may not be payable by the company ; for instance, a liability on bills discounted. In case of a bill having been dishonoured at the due date the company being the previous endorser will be liable to the endorsee. In other words, this liability will arise only when the bill is dishonoured. Thus, one is not definite whether such contingency will arise or not. That is why, provision is not made for such a contingent liability. Such liabilities are incorporated as a footnote in the balance sheet.

Q. 6. What are the duties of the auditor of a Holding Company with regard to the Subsidiary Companies ?

A. 6. The duties of the auditor of a holding company with regard to the subsidiary companies are : (1) Verification of the inter-company transactions, e.g., purchase and sale of raw-materials, finished goods, assets, etc. (2) Examination of the statement of accounts of the subsidiaries ; (3) Review of the qualifications made in the audit report of the subsidiaries ; (4) Review of the classification and valuation of the assets and liabilities if a consolidated Profit and Loss Account and Balance Sheet have been prepared ; (5) Examination as to the provision for losses made in the holding company's accounts if any subsidiary has suffered a loss ; (b) Reviews as to the segregation of investment and share particulars of the subsidiaries in the balance sheet of the holding company.

Q. 7. List the documents in respect of the Subsidiary Companies which must be attached to the Balance Sheet of the Holding Company as per the Companies Act.

A. 7. These are : (i) Copies of the balance sheet, Profit and Loss Account, report of the directors, auditor's report ; (ii) Statement of holding company's interest in subsidiaries ; (iii) Statement of profits and losses of the subsidiaries ; (iv) Statement showing the changes as to : (a) fixed assets, (b) investments ; (c) money lent, and (d) money borrowed for any purpose other than that of meeting current liabilities in respect of subsidiaries.

Q. 8. Distinguish between : Purchased Goodwill and Created Goodwill.

A. 8. Goodwill is called 'purchased' when the purchase price for acquiring a running business is more than the value of the net assets (i.e., Total assets less total liabilities) acquired. This extra amount is debited to goodwill account.

On the other hand, in 'Created Goodwill' (sometimes called 'Deferred Goodwill') the expenditure on research or experiments which enables the company to have a monopoly business is debited to goodwill account.

While 'purchased' goodwill is usually written off out of abnormal profits or capital profit, 'created' goodwill should be written off within a reasonable time.

Q. 9. Distinguish between : (a) Reserve which is a charge against profits, (b) Reserve which is an appropriation of profits.

A. 9. 'Reserve which is a charge against profit' is created by debiting Profit and Loss Account so as to make provisions for Bad and Doubtful Debts, Depreciation, etc.

'Reserve which is an appropriation of profits' is created by debiting P & L Appropriation Account so as to make provision for Redemption of Debentures, Dividend Equalisation Fund, etc.

• *Main distinctions :*

(a)	(b)
1. It is shown on the Assets side of the balance sheet — as a deduction from the concerned asset.	1. It is shown on the liabilities side of the balance sheet.
2. It is compulsory.	2. It is discretionary.
3. It is independent of the company's profit or loss. It has to be created even if there is a loss.	3. It depends upon the company's profit.It need not be created if there is a loss.

Q. 10. What do you mean by 'Redeemable Preference Shares ?

A.10. A Company limited by shares, when authorised by its Articles of Association, may issue preference shares which are liable to be redeemed. The particulars in respect of (i) amount, (ii) terms of redemption, and (iii) earliest date of redemption are required to be disclosed in the balance sheet.

Q. 11. State the statutory condition for the issue of bonus shares.

A. 11. The issue of bonus shares should be made out of free reserves created out of the genuine profits or Share Premium Account.

Q. 12. State the conditions when the issue of bonus shares is not permitted.

A. 12. The issue of bonus shares shall not be permitted : (i) unless the existing partly paid shares are fully paid-up, and (ii) if the company has defaulted in making payments of statutory dues of he employees towards contribution to provident fund, gratuity and bonus, etc.

Q. 13. How are the contingent liabilities categorised according to Part I of Schedule VI of the Companies Act ? or, How will you disclose the contingent liability in the balance sheet of a company ?

A. 13. Contingent liabilities are categorised into two main groups : (1) Liabilities provided for in the balance sheet, e.g., liabilities for a suit filed against the company even though its amount is uncertain [These are normally included under — Current Liabilities and Provisions] and (2) Liabilities not provided for in the balance sheet but are shown as a 'footnote' to the balance sheet, e.g., arrears of fixed accumulated dividends, etc.

Q. 14. What will be the effect in the event of maturity of contingent liability ?

A. 14. A contingent liability, on its maturity, may result in either the acquisition of corresponding asset or a loss to the business. Examples — goods purchased under an agreement may result in their acquisition ; speculative transactions in the Stock Exchange may incur a loss.

Q. 15. What is 'Revaluation of Fixed Assets' ?

A. 15. The expression implies restatement of the book values of fixed assets on the basis of technical appraisal usually made by independent professionals such as engineers, valuers, architects, etc. Such revaluation takes into account the factors like possibility of obsolence, technical estimates of future working life, etc.

CHAPTER 10

ASSETS AND LIABILITIES : VERIFICATION AND VALUATION

Learning Objectives : *After reading and carefully studying this chapter, the student should :*

- Know about the verification procedures of various account items.
- Appreciate that an auditor is not a valuer though he is intimately concerned with values.

Q. 10.1 : (A) What is meant by verification of assets and liabilities ? (B) What is the object of such a verification ? (C) How far is an auditor responsible for verification of assets appearing in the balance sheet ?

Ans : (A) *Meaning :* The verification of assets and liabilities involves the consideration of the following points :

1. That each asset/liability is correctly stated in the balance sheet.

2. That each asset/liability is correctly valued according to the generally accepted valuation principles.

3. That the assets actually exist on the date of balance sheet, and are the property of the company.

4. That the assets are free from any charge except that disclosed on the balance sheet.

5. That no liabilities on the date of balance sheet have been omitted.

(B) The verification of assets and liabilities achieves **two main objects :**

1. Propriety of transactions recorded.

2. Expressing an opinion on the financial statements, i.e., whether the balance sheet reflects a true and fair view of the state of affairs of the company.

(C) Auditor's responsibility :

[**Note :** The student is advised to mark the wording of the question. The words 'how far' expect him to deal with the 'extent of auditor's responsibility, not the detailed audit steps.]

An auditor does not discharge his duties completely when he has simply vouched the entries appearing in the various books of account relating to an asset item. To clarify, vouching confirms the purchase of an asset on a particular date but cannot, on that score, enable the auditor to be satisfied that the state of affairs remained unchanged on the date of subsequent balance sheet. In the meantime, the value or ownership or existence of such item may have changed. It is, therefore, absolutely necessary for the auditor to verify the assets appearing in the balance sheet by inspection, certificates from authorised responsible parties (e.g., bankers, creditors, etc.) or by other available documentary evidence.

Numerous Court decisions (illustrated below) hold the view that the auditor is liable for inadequate verification of assets.

1. London Oil Storage Company Ltd. *vs.* Seear Hasluck & Co. (1904)	1. Failure to verify the existence of petty cash in hand.
2. Irish Woollen Co. *vs.* Tyson & Others (1900).	2. Failure to detect the carryforward of invoices due to not checking the creditors' statement with purchase ledger balances.
3. London & General Bank Ltd. (1895)	3. Failure to disclose the material fact with respect to the value of assets.

4. The Westminister Road Construction & Engg. Co. Ltd., (1932)	4. Failure to check the figures at which Work-in-Progress was valued and shown.

Q.10.2 : What matters should be inquired into while verifying the assets of a concern ?

Or,

On what matters does verification of assets emphasize even after vouching of assets ?

See : Q. 10. 1 (A).

Q.10.3 : What matters should be inquired into while verifying the liabilities of a concern ?

See : Q. 10. 1 (A).

Q.10.4 : As the auditor of a company, to what extent can you rely on the certificates given by (a) the company management, (b) the company's internal auditor with respect to the verification of assets and liabilities ?

Ans : (a) *Certificates given by management :* The auditor can rely to a certain extent on such certificates as collateral evidence with respect to the verification of assets and liabilities depending on circumstances during audit. If he is satisfied that there are no irregularities after having checked the accounts of debtors, relevant items and the stock statements, he can place his reliance on the certificates issued by the management regarding the provision of doubtful debts, outstanding income and expenditure, and the stock in hand.

(b) *Internal auditor's certificate :* Large companies are usually found to have their own internal audit department carrying out continuous audit throughout the year. The statutory auditor can rely on the reports and certificates of the internal auditor after having fully satisfied himself that the internal audit was effective with respect to the verification of assets and liabilities and the pertinent points dealt with.

Q.10.5 : As an auditor of a company, how would you verify : (a) Copyright, (b) Royalty, (c) Travelling expenses, (d) Loans on Mortgage, (e) Bank Overdraft, (f) Loan to a director, (g) Investment in Shares, (h) Plant and Machinery, (i) Secured Loans, (j) Investment in debentures, (k) Preliminary Expenses, (l) Leasehold mining rights, (m) Railway siding, (n) Advances for value to be received, (o) Compensation for loss of office paid to directors of a company absorbed by another, (p) Premium paid for lease, (q) Discount on issue of debenture stock, (r) Rebate on capital purchase due to earlier payment, (s) Cost of old factory pulled down preparatory to building a new one, (t) Trade marks and patent rights, (u) Goodwill, (v) Loose Tools, (w) Technical 'know- how' payments, (x) Motor Vehicles, (y) Imported Plant and Machinery and (z) Fixed Assets. [C.U. B.Com (Hons), C.A. (Inter)] — different years.)

Ans : (a) *Copyright :* It refers to the rights of either the publisher or the author for publication or reproduction of a book written by an author. Such rights depend on the terms and conditions contained in the agreement between the author and the publisher. In order to verify this item, the auditor should (1) examine the original contract to know the terms including the rate of royalty, (2) ascertain the right possessed by whom, (3) vouch the actual payments as royalties or the actual purchase consideration paid to the author, (4) review the life-span and value of the copyright for writing off the value, and (5) confirm about the disclosure in the balance sheet.

(b) *Royalty :* A term which is used to mean a payment for the right to use certain classes of property belonging to others, such as the rights to extract minerals from mines or to manufacture articles from patents or to publish and sell copyright books. The auditor's verification procedures should include (1) review of the agreement, (2) examination of the Deed for the lease or patent or copyright, (3) checking of the rate and amount of royalty paid or received and of the recording of transactions.

(c) *Travelling expenses :* These are usually reimbursed to the staff and employees undertaking official tours. The auditor in this respect should

(1) examine the tour programme and its approval by the controlling officer in respect of touring personnel (e.g., salesmen, site inspecting staff, etc.), (2) verify the Travelling Allowance claim bills, (3) check the rates of allowances admissible, vouchers attached with the claim bill, mode of travel and the journey distance, and (4) review the bills remaining outstanding at the year end.

(d) *Loans on Mortgage :* The auditor should examine and verify (1) the mortgage deed to ascertain the name of the mortgagor, the property mortgaged, the amount of loan, the rate of interest, and other terms and conditions ; (2) the coverage of risks to property by proper insurance ; (3) the realisable value of the property ; (4) the existence of any charge on the property ; (5) the extent of receipts against the loan ; (6) the certificate from the mortgagee to find out the outstanding amount, if any.

(e) *Bank Overdraft :* The auditor should (1) review the director's minute book authorising such overdraft ; (2) ascertain from the bank as regards amount, nature of security, and other terms ; (3) check up the accrued interest thereon ; and (4) ensure the disclosures to the extent that the overdraft is exhibited under 'secured loans' or 'unsecured loans' (as the case may be) and the interest under 'current liabilities' on the balance sheet.

(f) *Loan to a director :* The auditor should (1) examine the applicability of the provisions of Sections 227(4A) and 295 of the Companies Act and verify as to their compliance by a company granting such loan ; (2) inspect the directors' minute book for sanction of such loan ; (3) check up the book debts relating to directors so as to ascertain if they are in the nature of loans ; and (4) ensure the disclosure of this loan as a separate item in the balance sheet.

(g) *Investment in Shares :* The auditor should (1) inspect the share certificates and cross check with the register of investments ; (2) confirm about the actual holding of all shares in the company's own name (except in the case of shares in a wholly-owned subsidiary company in which case a few shares may be held in the name of nominees) ; (3) see the letters of trust given by nominees ; (4) check up the entries regarding particulars of shares held in other names made in a register meant for this ; (5) review the compliance of the requirements of the company law with respect to such investments in a company belonging to the same group ; (6) verify the value of quoted shares with the market quotations on the balance sheet date ; (7) ensure proper disclosure, on the balance sheet, of all particulars of such investments, and (8) inspect the register of inter-company investments.

(h) *Plant and Machinery :* The auditor should (1) inspect directors' minute book authorising capital expenditure on this account ; (2) examine the cost details when such plant is erected by the company's own men, or the invoices for the purchases and the bills for erection by outsiders ; (3) check up the profit or loss on the sale of any plant and its accounting treatment ; (4) scan the plant register and physically inspect some of the major plants by a visit to the works ; (5) obtain from the company management certificate about the verifications of all items as required under Companies (Auditor's Report) order of 2003; (6) check the adequacy of the amount of depreciation ; and (7) finally ensure appropriate disclosure of all information in the balance sheet as required by the company law.

(i) *Secured Loans :* The auditor should (1) refer the Articles/Memorandum of Association and the Directors' minute book to ascertain the borrowing powers of the company; (2) check up the clauses of the agreement or arrangement made with the bank or other financial institutions and the nature of securities and interest rates ; (3) obtain confirmations from the lending institutions about the amount of loan, year end balance, interest dues, and the securities lodged ; (4) verify whether such loans are guaranteed by any director ; (5) examine, in the case of loans obtained against debentures, the following : (i) Trust deed, (ii) Sanction from Controller of Capital Issues, and (iii) Register of Charges, if there is any charge.

(j) *Investments in debentures :* [See Answar (g) before, Use the word 'debentures' in place of the word 'shares'.]

(k) *Preliminary Expenses :* The auditor should : (i) Identify the expenses incidental to the Articles, Memorandum, Prospectus and preliminary contracts (i.e., costs of stamp duty, registration, company's seal, printing documents, legal charges, etc.)

and capitalisation thereof ; (ii) Vouch by reference to the documentary evidences, such as bills, receipts, agreements, etc.; (iii) Compare the actual expenses with the estimates specified in the prospectus ; (iv) Verify as to whether these expenses have been written off from the future profits, etc.

(l) *Leasehold mining rights :* The duties of the auditor should be to (1) examine critically the terms and conditions of the lease agreements with particular emphasis on matters, such as the period covered by the rights, rate of royalty, minimum rent, recovery terms for short-workings, etc ; and (2) verify the mode of capitalisation and of the accounting treatments.

(m) *Railway siding :* This is owned usually by the large organisations through an agreement with the Department of Railways. The auditor, in order to certify this item, should (1) examine the terms and conditions of the agreement with respect to the rent and other maintenance charges payable to the railway authorities; and (2) verify the appropriateness of the scheme of capitalisation and depreciation.

(n) *Advances for value to be received :* They usually refer to the items included under 'prepaid expenses', such as rent, rates, taxes, insurance, royalty, etc. In these cases, the auditor should (1) examine the terms contained in the original documents and agreemens, if any; (2) verify the relevant receipts and payment vouchers ; and (3) make sure that a separate schedule of such advances is made, i.e., not clubbed with other loans or advances paid to staff or suppliers, etc.

(o) *Compensation to a director :* The auditor should (i) examine the compliance with the provisions under Section 318 of the Companies Act ; and (ii) verify the accounting treatment as to whether it has been debited to the current year's Profit and Loss Account.

(p) *Premium paid for lease :* The auditor, in order to verify this item, should (i) refer to the terms of lease agreement ; (ii) verify the rate and amount paid, and (iii) check up as to whether it has been treated as capital or deferred revenue expenditure and charged off over the period of lease for which the benefit was derived.

(q) *Discount on issue of debenture stock :* The auditor should verify as to (1) whether a sinking fund has been created for a period equal to the life-span of this stock, (2) whether the discount is written off periodically, (3) whether the directors' minute book authorises this action.

(r) *Rebate on capital purchase due to earlier payment :* The auditor's duty should be to verify as to how such rebates are computed and allocated to the relevant purchases and the accounting adjustments.

(s) *Cost of old factory pulled down, etc. :* The auditor should verify : (i) the cost of demolition ; (ii) the amount realised, if any ; (iii) the accounting treatments ; and (iv) the corresponding payment vouchers and miscellaneous receipts.

(t) *Trade marks and patent rights :* The auditor should (1) inspect the certificates issued by the registering authorities ; (2) examine the terms and conditions attached to the rights when such rights (including trade marks rights) are obtained by purchase from others ; and (3) verify the transfer deeds or assignment deeds.

For trade marks, the verification should cover the aspects of the cost of registration or assignment and the mode of capitalisation.

For patent rights, the verification should extend to the original cost, rate and amount of depreciation, and the accounting treatment.

(u) *Goodwill :* It refers to the additional value attached to a prosperous firm because of certain attributes not possessed by other firms to the same degree. It is defined as "the current value of expected future income in excess of a normal return on the investment in net tangible assets" (by E.L.Kohler). However, the auditor should verify this item with reference to (1) the partnership agreement that determines the value of goodwill ; (2) the basis of its creation and/or writing-off ; (4) the disclosure practices in the accounts ; and (5) the different methods of calculating goodwill.

For writing off goodwill the auditor should pay particular attention as to the method adopted. Goodwill may be written off either out of current year's profits or out of reserves. Whatever be the basis, the auditor should ensure that the basis is followed consistently and also properly disclosed in the Profit and Loss Account and the balance sheet.

(v) *Loose Tools :* They usually refer to small tools, dies, moulds, etc. having relatively a short span of life. The auditor should examine the aspects of (1) inventory taking ; (2) stock records ; (3) the original acquisition costs or the costs of making, if own-made ; (4) the charging of tools-costs to production ; (5) the method of revaluation, if any ; and (6) the scheme of depreciation charged or the write-off in the accounts.

(w) *Technical 'know-how' or technical aid payments :* The expression is generally associated with certain services obtained from outside agencies, usually foreign collaborations. However, these payments depend upon the contractual agreements between two parties, 'aid' giver and 'aid' receiver. Such agreements may be for technical design, drawings, installation, erection, manufacturing process, etc. However, the auditor should (1) examine the director's minute book for authorisation ; (2) refer the agreement deed for the rate and amount of payment and the basis ; (3) check the classes of payment, *viz.* royalty, patents, etc.; and the mode of payment ; and (5) ensure the consistency of accounting treatment as to revenue and/or capital expenditure. The auditor should keep in mind the concept of propriety audit while verifying this item.

(x) *Motor vehicles :* In order to verify this asset, the auditor should (1) examine the documens, such as registration books, insurance policies, road licences, and the original purchase receipts ; (2) inspect physically ; (3) verify the Assets Register for the necessary entries relating to the year of acquisition, rate and amount of depreciation, and the realised value when sold out ; and (4) ensure disclosure under an appropriate head in the balance sheet.

In case of any vehicles bought under the hire-purchase agreement, the auditor should ascertain the terms and conditions for this and check up the payments towards instalments, interests, and the scheme of capitalisation necessary under the law.

(y) *Imported plant and machinery :* The auditor should (1) refer the directors' minute book for resolution authorising this purchase ; (2) refer the Reserve Bank of India's permission and the import licence ; (3) examine the agreement with the supplier in a foreign country with respect to the terms of payment and interest rates and the deferred payment basis ; (4) verify the vouchers relating to the purchase, customs duty, clearing and shipping charges, insurance premia, etc ; and (5) check the entries made in the Assets Register.

(z) *Fixed Assets :* The auditor should (1) refer the director's minute book for sanction of capital purchases ; (2) vouch the suppliers' bills and receipts for details ; (3) examine the Assets Register for all assets bought, hired, transferred (from one location to another), sold, scrapped or destroyed during the year and the adjusted written-down values after depreciation ; (4) note down the basis of depreciation charged and its consistency, and of any change in the basis and its impact on profit or loss and its disclosure ; (5) obtain a certificate from the management to the effect that (i) the fixed assets shown in the balance sheet were in existence on the date, (ii) the assets were free from encumbrances, and (iii) the amount of depreciation provided for in the year is adequate but not excessive.

It is, however, to be noted that the verification of different types of assets requires different steps but the above steps apply to all fixed assets.

Q.10.6 : How would you verify the following items included in the 'stock-in-trade' appearing in the balance sheet ?

(a) Goods sent out on consignment.

(b) Goods sent out on sale or return.

(c) Goods sold on hire-purchase.

Ans. : The verification steps should cover the following aspects :

(a) (i) Ascertaining the basis of valuation ;

(ii) If the valuation is at cost, confirming that such cost includes all expenses incurred thereon by the consignor and the consignee, and that the market value is not below cost ;

(iii) Checking the stock certificate received from the consignee by reference to the entries in the 'consignment outward account' the proforma prices being reduced at cost.

(b) (i) If such sales are treated as ordinary sales, examining whether necessary adjustments have been made in respect of goods not approved and still in the hands of the customers [Sales Account (debit) and Customers Account (credit)] ; and (ii) Examining further that the unapproved goods with customers are valued at lower of cost or market price.

(c) (i) Verifying the stock of such goods ; and (ii) Making sure that the proportionate estimated profit included in the outstanding instalments is deducted to arrive at the cost of such goods.

Q.10.7: State the audit procedure your will adopt to verify the 'stock-in-trade' of a manufacturing organisation.

[C.A. Inter.]

Ans : The various components of stock-in-trade are : Finished goods, Work-in-progress, Raw materials, and Stores, etc. In all these areas, the auditor's general considerations should be to obtain reliable information with respect to (i) physical existence, (ii) ownership, (iii) quantities in physical terms, (iv) pricing, and (v) arithmetical accuracy. However, the audit examination should be adopted on the following lines :

1. Where stock records are maintained :

(a) applying test checks to ensure proper maintenance ;

(b) comparing quantities as per stock sheets with those of the balances in the stock records ;

(c) checking consistency in their valuation ;

(d) comparing 'gross profit on turnover' (%) with that of previous years, including the explanations for material variations, if any ; and

(e) ensuring separate disclosure of the value of the various components of stock-in-trade in the balance sheet.

2. Where stock records are not maintained :

(a) Inquiring into the system of stock-taking and stock sheets preparation by reference to counts, pricing, extensions and totals ;

(b) inquiring into the system of internal accounting and administrative controls and evaluating its adequacy ;

(c) verifying the stock movements (i.e., receipts, issues, etc.) during the count, the listing of items in the stock sheets ;

(d) determining the obsolete, slow-moving, non-moving, and damaged items and ascertaining their treatment in accounts ;

(e) ensuring that the stock sheets include the goods sent on consignment but not yet sold, and do not include any goods (i) held on consignment, (ii) sold but not despatched, and (iii) received but not purchased ;

(f) examining that the quantities and corresponding values have neither been over-stated nor under-stated, and that the valuation has been done as per the company's policy in accordance with the generally accepted accounting principles ;

(g) testing the appropriateness of allocation of costs of materials and labour, and of the proportion of overhead charges (if any) relating to the goods-in-process ;

(h) comparing 'gross profit on turnover' (%) with that of previous years and ascertaining the reasons for material variations ;

(i) obtaining a certificate from the management to the effect that the stock sheets are accurate, and confirming that the stock sheets have been signed by a partner or director or a responsible officer, and

(j) finally ensuring that the various components of stock have been separately disclosed in the balance sheet with their mode of valuation.

Q.10.8 : While examining the balance sheet of a company you find that the fixed assets at the close of the year have increased by 50% as compared to the previous year. What are the possible reasons for this increase and what corresponding change would you expect to find in the other items in the balance sheet ? [C.A. Inter.]

Ans :

Possible reasons for increase	Corresponding change in other items in balance sheet
1. Additions by purchase and/or construction.	1. (a) Reduction in cash balance. (b) Increase in current liabilities.
2. Receipts as a gift or donation.	2. Credit to the Capital Reserve Account for an estimated value.
3. Revaluation of any or all of the assets.	3. (a) Credit to the Capital Reserve Account, or (b) Increase in the Subscribed Capital through issue of fully paid bonus.

Q.10.9 : Enumerate the procedure for the verification of the debtors' balances of a limited company. [C. A. Inter.]

Ans : For the purpose of verification of the debtors' balances of a limited company, the audior should :

1. Examine these balances with the schedule of debtors ;

2. Review the letters of confirmation which have been obtained from the debtors ;

3. Verify the schedule of debtors, in order to check the provision for doubtful debts, with the cash book of the next period with a view to marking as good all debts which have been paid in full since the close of the year.

4. Check the ledger accounts, with regard to the remaining debts, with particular emphasis as to :

(i) the age of the debt,

(ii) the payments being made on account and the increase in balance,

(iii) the cheques or bills that have been dishonoured, and

(iv) the adverse comments, such as payment stopped, suit filed, etc., which may appear in the accounts ;

5. Inquire into each doubtful debt from the management, and see the Board's resolution for bad debts written off and for debts considered doubtful ;

6. Note that the Sundry debtors due do not include any loan or advance ;

7. Ensure that (i) all statutory information * relating to Sundry debtors has been accurately disclosed in the balance sheet, (ii) the provision is not in excess of the amount of doubtful debts, and (iii) the excess provision (if any) is treated as a reserve for doubtful debts and shown under 'Reserves and Surplus' on the balance sheet.

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* The Schedule VI of the Companies Act 1956 requires that the following information in respect of debtors should be disclosed in the annual accounts of a company.

1. In regard to Sundry debtors particulars to be given separately of :

(a) Debts considered good and in respect of which the company is fully secured ;

(b) Debts considered good for which the company holds no security other than the debtors personal security ; and

(c) Debts considered doubtful or bad.

2. (a) Debtors outstanding for a period exceeding six months.

(b) Other debts less provision.

3. Debts due by directors or other officers of the company or any of them either severally of jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member to be separately stated.

4. Debtors due from other companies under the same management within the meaning sub-section IB of Section 370 to be disclosed with the names of the companies.

5. The maximum amount due by directors or other officers of the company at any time during the year to be shown by way of a note.

Q.10.10 : How would you verify the following Assets in the Balance Sheet of a company :

(a) Loans against the security of land and property.

(b) Loans against the security of Stocks and Shares.

(c) Loans against the security of goods.

(d) Loans against the personal security of the borrower.

(e) Loans against the security of insurance policies.

Ans : The usual verification steps are as follows :

(a) *Loans against security of landed property :*

(1) Examining the documents like : Memorandum and Articles which empower the company to lend money, security papers, mortgage deeds, title deeds of properties, insurance policies, etc.

(2) Vouching the date and amount of loan, the rate of interest, and the date on which due.

(3) Examining the valuer's certificate for sufficiency or otherwise of the securities held.

(4) In case of land and property having been mortgaged, seeing that

(i) the mortgage has been properly executed.

(ii) the mortgager is empowered to do so.

(iii) the mortgage is registered with the Registrar of Companies in the case of a company.

(iv) the first mortgagee is aware of the second mortgagee (if any) and the title deeds are with the first mortgagee.

(5) Scanning the loan accounts in the ledger and obtaining confirmation from the borrowers as to the loan amounts on the date of balance sheet.

(b) *Loans against security of stocks and shares :*

(1) Obtaining the list of stocks and shares held as securities and ascertaining that these are transferred in the client's name.

(2) Examining the status of shares as fully or partly paid as because the transferee will have to pay the uncalled amount whenever the company makes a call.

(3) Checking the valuation of securities held to ascertain its sufficiency or otherwise against the amount of loan.

(4) Examining the terms of agreements, *viz.*, rate and amount of interest payable by the borrower, etc.

(5) Verifying whether such securities have been lodged with the bank for safe custody and obtaining a certificate from the bank.

(6) Confirming from the borrowers as to the loan amounts on the date of the balance sheet.

(c) *Loans against security of goods :*

(1) Examining the documents like :

(i) Godown-keeper's receipt/Warehouse receipt/Dock warrant against which a loan has been advanced.

(ii) Railway receipt/Bill of Lading/Letters of Hypothecation/Insurance policy/Invoice on the basis of which a loan has been advanced for the goods-in-transit.

(iii) Inspection Reports to ascertain the quantity of goods which have been held as securities.

(2) Ensuring that the above documents have been duly endorsed in favour of the client.

(3) Ascertaining the value of the goods from the invoices, market quotations, etc., in order to determine the value of securities.

(4) Confirming/inspecting the turnover of the stock, where the goods are of perishable mature.

(d) *Loans against personal security of the borrower :*

(1) Making an inquiry as to the financial solvency of the surety, if any.

(2) Examining the validity periods of the Securities e.g., promissory notes.

(3) Ensuring that the terms, on which a loan has been advanced, have not been changed during the repayment period of the loan.

(4) Vouching of repayments and enquiry as to steps for recovery.

(e) *Loans against Insurance policy :*

(1) Examining whether the insurance policies :

(i) are running policies ;

(ii) have been assigned in favour of the client , and

(iii) so assigned have been notified to the insurance company.

(2) Seeing that the amount of loan advanced is within the surrender value of such policies.

(3) Checking the premiums paid by the borrower by reference to the last receipts.

(4) Ascertaining whether the client has paid any premiums to prevent the policies lapsing and whether amounts so paid have been debited to the concerned loan Account of the borrower.

Q.10.11 : How would you verify the following liabilities :

(a) Debentures, (b) Secured Loan, (c) Unsecured Loan, (d) Liabilities for expenses.

Ans : (a) *Debentures :* The verification steps are :

(1) to examine the Memorandum and Articles so as to ascertain the borrowing powers of the company.

(2) to check the Debenture Trust Deed — its terms and conditions, and the securities offered.

(3) to confirm, wherever necessary, that the permission of the Controller of Capital Issues has been obtained.

(4) to see that — (i) cash has been received, if debentures are issued at cash, and (ii) entries have been made in the books of account, if debentures are issued at a premium.

(b) *Secured Loan :* The verification procedures are :

(1) to examine : the borrowing powers of the company, the Board's resolution, the agreement or arrangement with the bank or financial institutions, the securities offered, the interests payable, and any charge created and registered.

(2) to check up the fluctuations in the exchange rates in case of loans in foreign currencies with a view to ensuring adequate disclosure of the company's liabilities at the end of the year.

(3) to obtain confirmations about the balances of each loan from the bank or financial institutions in order to see their appropriate disclosures in the balance sheet.

(c) *Unsecured Loan :* The usual verification steps are :

(1) to refer the Memorandum and the Articles of the company so as to examine the specific powers of borrowing.

(2) to examine the Board's resolutions and the resolutions in the general meeting passed by the shareholders with a view to ascertaining the limits of borrowings by the company and by the directors.

(3) to ensure whether the borrowing limits as laid down in Section 58A of the Companies Act have been complied with.

(4) to check in particular — (i) the receipts of loan with the cash book and bank statement ; (ii) the directors' approval to such borrowings ; and (iii) whether any of the directors has guaranteed the loans.

(d) *Liabilities for expenses :* The verification steps for audit should be :

(1) to scrutinise all payment vouchers (cheque or cash) for at least the first two months of the next year in order to distinguish as to (i) which expenses relate to the period under audit and (ii) which do not relate to the period under audit.

(2) to obtain a list from the management showing the liabilities for expenses that are provided for and also to verify them with reference to relevant vouchers.

Q.10.12 : (A) Examine the factors that effect the valuation of Goodwill.

(B) State and explain in brief the methods of valuing Goodwill.

Ans : (A) *Factors Affecting Goodwill Valuation :* These are mainly :

1. **Profitability** : One who pays for goodwill looks to the future profits. The future profits which depend on a variety of factors (such as, nature of business, location, patents and trade marks protection, favourable markets, efficient management, etc.) influence the value of goodwill ;

2. **General Reputation** : The image of a corporation and the superiority of products or services and the continuing researches for new products and new markets have an edge over other firms belonging to the same industry ;

3. **Yield** : A comparatively higher yield expected by investors in the industry to which a firm belongs attaches importance to the valuation of goodwill.

(B) *Methods of Valuing Goodwill :* Basically, there are two methods : (i) Simple profit method, and (ii) Super profit method.

(i) **Simple profit method** : It involves the valuation of goodwill on the basis of a certain number of years' purchase of the average profits of the past few years. Here, the average profits are subjected to the following adjustments :

(a) Expenses and losses unlikely to occur in the future are added back to profits ;

(b) Expenses and losses expected to be borne in the future are deducted from profits ;

(c) Profits likely to come in the future are added ; and

(d) Profits unlikely to recur are deducted.

(ii) **Super profit method** : Super profit represents the difference between the future maintainable profits of a firm and the normal profits for that firm. Here, the normal profit is ascertained in the light of normal rate of earning and the capital employed in the business. Thus, this method requires information regarding (a) the normal rate of return for the representative firms in the industry, and (b) the fair value of capital employed.

• *Terms explained :*

1. 'Normal rate of earning' is that rate which investors in general expect on their investments in the particular type of industry.

2. 'Capital employed' represents the aggregate of share capital and reserves less the amount of non-trading assets (such as, investments). This may also be determined by adding up the present value of trading assets and deducting all liabilities.

3. 'Future maintainable profits' is determined on the basis of past records after taking into consideration the objective factors like (a) past average taxed earnings, (b) projected future taxed profits, and (c) adjustments of preferred rights and of subjective evaluation of other factors, like government policy, economy conditions, management's capabilities, etc.

For the valuation of goodwill under super profit scheme, there are four methods as under :

1. **'Purchase of super profit' method** : The formula is, Goodwill = Super profit x No. of years. Here, the number of years varies from firm to firm even in the same industry and is determined with reference to the probability of a business having the same rate of earnings.

2. **Sliding-scale valuation of super profit :** Prof. A.E. Cutforth advocates that it is generally difficult to maintain the higher super profit in the future years and so super profit should be divided into 2 or 3 divisions, each division being multiplied by a different number of years' purchase in descending order from the first division.

3. **Annuity Method :** The formula is :

Goodwill = Super profit x Annuity of Re. 1 at the normal rate of return for a stated number of years.

Here, goodwill is the discounted value of the total amount calculated as per the purchase method.

4. **Capitalisation method :** The formula is :

Goodwill = (Estimated annual profit / Normal rate of return) x 100. This method is criticised on the ground that it puts a large value on goodwill. It can, however, assist in proper valuation when the future maintainable profit is lower than the normal profit.

Q.10.13 : (A) State the circumstances that necessitate the valuation of shares of a company. (B) State the factors affecting such valuation. (C) Explain the methods used for share valuation.

Ans. : (A) *Circumstances* : These may be for :

1. Assessments under the Estate duty, Wealth tax or Gift tax Acts.
2. Formulating the schemes of amalgamation, absorption, etc.
3. Conversion of shares from one category to another ; say, preference to equity.
4. Purchase of shares by company employees when they can hold shares upto their period of employment.
5. Purchase of a block of shares in another company.
6. Acquisition of internal control under a scheme of reconstruction.

The valuation of shares of a company by a valuer arises primarily when (i) shares are unquoted, (ii) shares relate to a private limited company, (iii) shares in large blocks are under transfer, and (iv) the courts direct, the law requires, and the articles of association provide to this effect.

(B) *Factors affecting valuation* : There are basically two factors :

(1) Assets employed, and (2) Earning capacity. Either of the factors or both affect share valuation in the following cases :

(a) Assets form the basis for a company destined to be liquidated.

(b) Earning capacity constitutes the basis for the valuation of the professional firms of auditors, architects and engineers.

(c) Assets and earning capacity both are considered for a going-concern business.

(C) *Valuation methods* : There are three principal methods : (1) Yield on shares, (2) Assets valuation, and (3) An average of (1) and (2).

1. **Yield on Shares :** The shares are valued on the basis of earnings per share multiplied by the Price Earnings Ratio (which is 100%/normal rate of return). The formula is as under :

$$\frac{\text{Profit after tax and preference dividend}}{\text{No. of equity shares}} \times \text{PER.}$$

2. **Assets Valuation :** This method basically involves the determination of Net Assets attributable to the ordinary shareholders. Such 'Net assets', thus, comprise the capital, reserves and profit attributable to the ordinary shareholders. The formula is as under :

$$\frac{\text{Net Assets}}{\text{No. of Ordinary Shares}} = \frac{\text{Total Assets} - (\text{Creditors} + \text{Debentures} + \text{Preference Shares})}{\text{No. Ordinary shares}}$$

3. **Average Method :** It is a formula to bring the parties to an agreement as it takes care of both the factors. This method, however, finds favour with the government for valuing shares of investment companies for wealth tax purposes.

Q. 10. 14 : Explain the different methods of valuation of (A) Current Assets, and (B) Fixed assets.

Ans : (A) *Current Assets valuation :*

Items of current assets	Methods of valuation
1. Interest accrued on Investments.	1. Computation by reference to the date of acquisition/purchase of investments, accounting date, etc.
2. Stores and Spare Parts 3. Stock-in-Trade	2 & 3. First-in, first-out, Last-in, first-out, Average (simple or weighted), Base Stock, Standard Cost, Adjusted selling price. [Refer to any text book on 'Costing' for details.]
4. Loose Tools	4. Cost of purchase or replacement cost.
5. Work-in-Progress	5. First-in, first-out, Average Price, Standard Cost. In process industries, equivalent production in terms of completed units for opening or closing WIP is ascertained and valued by either of the methods above.
6. Sundry Debtors	6. Realisable amount by collection in the ordinary course of business less provisions for doubtful debts and discounts allowable.

7. Cash and Bank Balances	7. Book balances or realisable value. Balances held in foreign countries should be converted at the official exchange rates.
8. Marketable Securities	8. At cost, at market price, at lower of cost or market price.

(B) *Fixed Assets* : These are valued at (i) historical cost, (ii) replacement cost, and (iii) liquidation values. The first two methods are applied for a going-concern enterprise, whereas the last method is applicable to a concern where earnings are non-existent.

Q.10.15 : How should the investments held by a company be valued for the purposes of its balance sheet ? Discuss.

Ans : The investments held by a company may be in various forms. Generally, such investments include (1) Trust securities ; (2) Govt. securities ; (3) Shares, debentures, or bonds ; (4) Immovable properties ; and (5) Capital in partnership firms, etc.

For the purpose of the balance sheet of a limited company, Schedule VI Part I of the Companies Act, 1956 enjoins that the auditor should ascertain the aggregate amount of the company's quoted investments, and market value. The aggregate amount of unquoted investments should also be disclosed.

Thus, the basic requirements are :

1. To ascertain that the investments are valued in accordance with the generally accepted accounting principles ;
2. To ensure that the valuation is consistent ;
3. To see that the investments are appropriately classified and stated in the balance sheet of a company.

Investments, which are acquired and held for earning income (e.g., securities, shares or debentures, partnership capital, etc.), should be stated in the balance sheet 'at cost' inclusive of cost of brokerage and other expenses, without any regard to their market values. But a provision may be necessary if the market values are lower than the cost. Where the company is in receipt of bonus shares against its investment in shares of other companies, no value is needed to be placed on the bonus shares but only the number of shares held are to be increased.

In case of any immovable property held as investment but not used for the company's business, normal depreciation should be provided with a view to showing the true and fair view of the profit or loss.

In case of quoted shares and debentures, the current market prices can be found out from the economic journals, news papers, and the stock exchanges. If at the balance sheet date, their market prices are abnormaily below the amount shown in the books, a provision should be made for such material diminution in value.

Q.10.16 : "An auditor is not a valuer though he is intimately connected with values." — Discuss.

Ans. : *The expressions* : "An auditor is not a valuer" and "It is no part of an auditor's duty to take stock. ....In the case of a cotton mill he must rely on some skilled person for the materials necessary to enable him to enter the stock-in-trade at its proper value in the balance sheet" were made by the Court in the course of a judgement in a leading case : The Kingston Cotton Mills Co. Ltd., (1896). A misfeasance action was taken by the liquidator against the company auditor to recover the amounts due for dividends which, it was alleged, were paid by the company out of inflated profits arising from over-valuation of closing stock and non-allowance for depreciation in the value of Mill plant and machinery. It was alleged that the auditor was negligent in his duties as he relied upon the stock made out by the manager who intentionally exaggerated the stock and thereby over-valued the stock with an ulterior motive of earning higher commission on the inflated profit. Although the Court observed in this case : 'the auditors do not guarantee discovery of all fraud', it also remarked that the auditor's duty was to ascertain and certify the true financial position of the company and that in the discharge of his duty he was bound to exercise reasonable amount of care and skill in verifying the values of assets and liabilities, at which these were stated in the balance sheet.

Again, in Barchris Construction Case the focus of the trial was on the overstatement of earnings and of the current ratio. The alleged overstatement of earnings was due to recording the gain on a sale-leaseback as current revenue rather than its amortisation over the life of the lease. The alleged overstatement of current ratio was due to inclusion of an accounts receivable item from the consolidated summary and the commission of a liability. The Court held that the registration statement contained false statement of material facts and that an overstatement of current ratio (15 per cent) was highly material. In retrospect, it can thus be implied the Barchris decision was critical about the auditor's role in the over-valuation of earnings and the current ratio.

Similarly, The Westminister Road Construction Case held the company auditor responsible for his failure to ascertain true valuation of the work-in-progress even when sufficient evidential matter was available.

The above case laws together with the following provisions and recommendations demonstrate the fact that the auditor, though not a valuer, is definitely concerned with values :

1. The mode of valuation of the stocks of raw materials, stores and spares, stock-in-trade and the work-in-progress should be properly stated [Part I of Schedule VI of the Companies Act, 1956].

2. If loans and advances, and current assets do not have any value on realisation in the ordinary course of the business at least equal to the amount at which they are stated, the fact should be stated [Footnote 'm' ibid].

3. The values of the opening and closing stocks of the goods produced, and of the work-in-progress at the commencement or end of the accounting period should be stated. The Profit and Loss Account should also state the amount, if materials, by which any items shown therein are affected by any change in basis of accounting (i.e., valuation) [Part II of Schedule VI of the Companies Act].

4. Provision for diminution in value should not exceed the amount required to reduce cost to market value at the date of the balance sheet in the case of investments which are current assets or to long-term value in the case of investments which are fixed assets [I.C.A. of England & Wales on : Treatment of investment in the balance sheet].

5. The historical cost of manufactured inventories should include a systematic allocation of production overhead [Statement on Valuation and Presentation of Inventories in the context of the Historical Cost System — International Accounting Standards Committee].

6. The auditor should also obtain from the management a certificate concerning the existence title, and value of inventories, and the details of charges, if any, created on them [I.C.A. of India in the Statement of Auditing Practices, 1977].

Q.10.17 : Under the existing law an auditor of a company can neither justify over-valuation nor under-valuation of the assets of the company ? — Discuss.

Ans : The Companies Act, 1956 requires a statutory auditor to report :

(1) That the balance sheet and the Profit and Loss Account are in agreement with the books of account ; and

(2) That the accounts give the information as required and give a true and fair view of (a) the state of affairs of the company in the case of balance sheet, and (b) the profit or loss of the company for the year in the case of the Profit and Loss Account.

Thus, we find that the valuation of different types of assets shown in the financial statements should be 'true and fair'. That means, the accounts shown against the assets should neither be over-stated nor under-stated in order to exhibit a true and fair view of the financial position at the end of the relevant year.

For the term 'value', we may attach different meanings, e.g., cost (of acquisition), market value (price), liquidation value (price obtained by forced sale), replacement value, realisable value, quoted value, assessed value, etc. The pertinent question, therefore, arises as to which of these different types of 'value' should be accepted by an auditor for the financial statements.

As discussed earlier, the financial statements — in order to be accepted as reliable, relevant, consistent, accurate and free from bias-must meet the requirements of law in all respects including the application of methods and procedures. The Company Law relating to the accounts and audit, for the purpose of their fair presentation, necessitates that the various assets and liabilities should be meaningfully grouped and classified and their amounts be stated so as to reflect the recorded facts. Under the existing provisions, the law requires (examples given below) that :

(i) The fixed assets should be stated at cost less depreciation.

(ii) The amount added or deducted, in case of revaluation of assets, should be shown for a period of five years.

(iii) The trade investmens being fixed assets should be shown at cost and the fluctuations in their values be ignored. But in case of substantial diminution in value, it should be disclosed. This is necessary as because the balance sheet will cease to be 'true and fair' if otherwise stated.

(iv) The current assets should not be shown at more than realisable amounts and the fictitious assets should be shown separately.

(v) The closing stock of stores and spares, stock-in-trade and work-in-progress should be separately classified with the mode of valuation being stated.

Q.10.18 : Write short notes on : (i) Intangible Assets, (ii) Fictitious Assets, (iii) Contingent Assets, (iv) Outstanding Liabilities, (v) Unpaid Expenses, (vi) Wasting Assets, (vii) Floating Assets, (viii) Unrealisable Assets, and (ix) Outstanding Assets.

Ans : (i) *Intangible Assets* : They refer to those assets which have no physical existence and which cannot be seen or touched. Goodwill, patents, trade marks, copyrights, tenancy rights, etc. are the examples of intangible assets. The auditing aspects usually covered are : basis of valuation, fair presentation in the balance sheet, adequacy of amortization scheme, consistency in recordings, disclosure practices and their adequacy etc. The values of these assets are limited by rights and benefits available to the owners.

(ii) *Fictitious Assets* : They refer to these expenses which are treated as assets till they are fully written off from the future profits as per the company law provisions. Preliminary expenses, share issue expenses, discount on the issue of shares, deferred revenue expenditure (e.g., expenses on advertising a new product), etc. are the examples. The total expenses incurred on such assets are required to be shown in the balance sheet till they are fully written off. The auditing procedures differ according to the nature and type of expenses.

(iii) *Contingent Assets* : They refer to the possible future claims or services arising from the business performances preceeding to the balance sheet date. The examples are : (1) An option to apply for shares in another company on favourable terms, (2) Uncalled share capital of an undertaking, (3) Refund of Octroi paid for goods which have been sent out later on, etc. The Companies Act does not require these assets to be disclosed for the sake of the principle of conservatism. It is argued by some experts that the prosperity of a company is not depicted in tangible terms as these assets are not shown whereas the contingent liabilities are provided in the company's balance sheet.

(iv) *Outstanding Liabilities* : They refer to those liabilities which have remained unpaid on the date of the balance sheet ; e.g., unearned income and unpaid expenses. Unearned income refers here to the income received in advance which is due to be earned in the next year or years. The auditing steps in this case are to examine the relevant vouchers from the perspectives of determining how much amount to be credited to the current year's P & L A/c and how much to be carried forward which will be earned during the next year.

(v) *Unpaid Expenses* : Expenses, such as rent, rates, taxes, salaries and wages, audit fees etc. which are incurred during the year but whose payments will be made in the next year are called unpaid expenses. The auditing procedures in this regard include examination of vouchers, invoices, receipts, etc. with a view to ascertaining those expenses which ought to have been debited to the current year's P & L A/c.

(vi) *Wasting Assets :* Natural resources, such as those from mines, quarries, timber tracts, or oil wells, are wasting assets in the sense that they are moving toward exhaustion or extinction as they are being physically removed from the property and becoming the product to be sold. Normally, these are valued at original cost less depletion according to estimated exhaustion of such assets.

(vii) *Floating Assets :* They refer to those assets which are acquired for resale or manufactured for sale or converting them into cash. The examples of these type of assets are : stock, book debts, bills receivable, semi-finished goods, etc. They are valued at cost (original or historical) or market price whichever is lower for disclosure in the balance sheet. The auditing procedures differ according to the asset item in particular.

(viii) *Unrealisable Assets :* These refer to those assets as items of expenditure of capital nature, such as preliminary expenses and pre-acquisition losses, discount and commission on the issue of shares and debentures, etc., which are not realisable but have to be fully written off to the Profit and Loss Account within a few years after the commencement of commercial production. Till then, these assets should be shown in the Balance Sheet of a company.

(ix) *Outstanding Assets :* These are sometimes called intangible assets. The examples are : income receivable, prepaid expenses, deferred revenue expenditure. The procedures of audit vary with each of these assets as their accounting treatments are different.

Short Answer Questions :

Q. 1. What do you mean by : (i) Verification, (ii) Valuation.

A. 1. (i) *Verification :* The process of substantiation involved in proving by customary audit procedure that a statement, account or item is accurate and properly stated or is within premissible or reasonable limit.

It involves proving authenticity of the recorded amount of asset and liabilities (balances). It requires two stages : transaction testing, and balance testing, or a combination thereof. For example, sales ledger balances are verified by checking the transactions that give rise to balances (transaction testing); similarly balances are checked by external confirmations as independent sources of evidence (balance testing).

(ii) *Valuation or Allocation :* Whether asset, liability, revenue and expense components are included in the financial statements at appropriate amounts.

It is not simply a determination of the values of assets appearing in the balance sheet. It is the critical examination of these values on the basis of generally accepted accounting principles. The basis of valuation differs according to the different classes of assets and according to the purposes for which they are held. Different meanings are attached to this term. For example, acquisition value (cost), market value (price), liquidation value (price obtained by forced sale), replacement value, realisation value, quoted value, assessed value, etc. The pertinent question is, which of these values should be accepted by the auditor for the financial statements.

Q. 2. 'Verification forms an important part of the whole system of audit' — Discuss.

A. 2. The essential elements of the whole system of audit work are to ensure that :

(i) All transactions that have been recorded have actually occurred ;

(ii) All transactions that occurred have actually been recorded ;

(iii) All assets of an organisation are actually owned by it ;

(iv) All liabilities of an organisation are actually owed ;

(v) All amounts that have been recorded in the books and accounts are reasonably accurate ;

(vi) Business and economic circumstances in which an organisation operates are fairly reflected in the financial statements ;

(vii) Amounts are recorded in the accounting period to which they actually relate ; and

(viii) All information that is relevant has been properly included.

Based on the appraisal of the above criteria, the auditor concludes as to whether or not the financial statements exhibit a true and fair view of the state of affairs of the business. This appraisal is done through the procedures of verification, such as examination, inspection, confirmation, review, recomputation, and comparison. That is why, the concept of verification assumes a greater implication in the auditing techniques. With the adequacy of the steps in verification, the auditor can curb the tendency to inflate or deflate profits by unscrupulous management.

Q. 3. State five classification of 'Assets' with examples.

A.3. (i) Fixed Assets — Buildings, Plant and Machinery.

(ii) Current or Floating Assets — Cash, Stock, Book debts.

(iii) Fictitious Assets — Preliminary expenses, Debit balance of P & L Account.

(iv) Intangible Assets — Goodwill, Trade marks, Patents.

(v) Wasting Assets — Coal and Oil mines.

Q. 4. Distinguish between : Verification of assets and Valuation of assets.

A. 4. Major distinctions are : (1) Verification of assets consists of obtaining confirmation of one or more factors of cost, authorisation, valuation, existence, benefit, ownership, and presentation. But valuation of assets is concerned with an inquiry into 'value' only ; (2) The former is a comprehensive concept and includes the 'values' at which the assets appear in the books of account, whereas the latter is a part of the former ; (3) While the former serves to guard against the improper valuation, the latter affords a basis for the auditor to satisfy himself that the values against the assets are based on generally accepted accounting principles.

Q.5. Define the terms : (a) Assets, and (b) Liabilities.

A.5. (a) Assets are any claims to service in money or any claims to service having a value in money which are legally or equitably secured to some person or set of persons at any particular moment.

(b) Liabilities, in a broader sense, imply sources of assets or claims in assets. Liabilities, in a narrower sense, imply creditors' claim in, or source of, assets.

Q. 6. Give examples of 'Assets' subject to :

(a) depreciation, (b) depletion, (c) neither depreciation or depletion.

A. 6. (a) Buildings, plants, equipments, etc.

(b) Mines, Oil wells, Collieries, etc.

(c) Land.

Q. 7. 'Liabilities are of two types', Name and distinguish between them.

A. 7. Fixed liabilities and Current liabilities : Fixed liabilities are those which are payable after a long term. Current liabilities are those which are payable by current assets within the operating cycle of the business.

Q. 8. Classify assets as 'claim of services'.

A. 8. Assets as 'claims to services' can be classified into two heads as under :

(1) Contractual (*in personam)*

(a) to human services (e.g., prepaid expenses),

(b) to goods (Debtors for goods).

(c) to money (Debtors for money).

(2) Non-Contractual (*in rem*)

(a) Tangible assets, like land, buildings, etc.

(b) Intangible assets, like goodwill, preliminary expenses, deferred expenses, etc.

Q.9. Distinguish 'liabilities' under the Proprietory theory and under the Entity theory.

A. 9. Under the Proprietory theory, liabilities mean proprietors' indebtedness to creditors. Under the Entity theory, liabilities mean promises for or negative claims to services of the business held out in favour of both creditors and proprietors.

Q. 10. Explain the terms : (a) Book value, (b) Market value, (c) Acquisition value, (d) Liquidation value, (e) Replacement

value, (f) Realisable value, (g) Quoted value, (h) Assessed value, (i) Appraisal value.

A. 10. (a) 'Book value' signifies the amount at which an item is stated in accordance with the accounting principles related to the item.

(b) 'Market value' signifies the amount that an asset will fetch when it is sold in the open market.

(c) 'Acquisition value' signifies the amount (i.e., price) which is paid for the purchase or acquisition of an item of a business.

(d) 'Liquidation value' signifies the amount which is obtained by a forced sale under certain circumstances irrespective of the market conditions.

(e) 'Replacement value' signifies the amount which would be incurred if an item has to be purchased at the current market price and not the amount at which it was actually purchased earlier.

(f) 'Realisable value' signifies the amount which is obtained through the normal sale of an item (obsolete or in use).

(g) 'Quoted value' signifies the amount (i.e., price) which is quoted in the Stock Exchange in the case of shares and securities.

(h) 'Assessed value' signifies the amount which is relevant for tax purposes only.

(i) 'Appraisal value' signifies the amount which is determined by an independent appraiser (who may be an engineer, valuer, officer of a company or the Govt.) for special purposes, such as business takeover, insurance coverage, tax assessment, etc.

Q. 11. Point out the components of 'Stock-in-trade'.

A. 11. The components of stock-in-trade are : finished goods, work-in-progress, raw materials, stores ; etc.

Q. 12. What is Goodwill ?

A. 12. Goodwill refers to the additional value attached to a prosperous firm because of certain attributes not possessed by other firms to the same degree.

CHAPTER 11

DIVIDENDS AND DIVISIBLE PROFITS—FINANCIAL, LEGAL AND POLICY CONSIDERATIONS

Learning Objectives : *After reading and carefully studying this chapter, the student should :*

- Be familiar with the consideration relating to the dividend.
- Understand the auditing responsibilities that arise from the provisions of company legislation in India.

Q.11.1 : (A) Define and explain the term 'Divisible Profits'. (B) Discuss the same with reference to : (1) Section 205 of the Companies Act, 1956, (2) Income Tax Act, and (3) The decided cases.

Ans. : (A) *Divisible Profits :*

These refer to that portion of profits (i.e., the excess of income over expenditure including provision for taxes and depreciation) which are available for distribution as dividend to the shareholders of the company. But this does not mean that any profit will be distributed if available. The available profit should be such that is legally distributable in accordance with the provisions contained in (i) the Companies Act, 1956, (ii) the Income Tax Act, 1961, and (iii) the Articles of Association of the Company. In this context, a relevant question arises as to whether capital profits (which are not earned during the normal business operations but arise on the revaluation or sale of assets or on the re-issue of forfeited shares, etc.) are to be considered as available for distribution as dividends. Under normal circumstances, these profits should not be distributed. But these are distributable only on the conditions that (a) such distribution is authorised by the Articles of Association, (b) such surplus is actually realised in cash or remains after a proper valuation of all assets, and (c) the capial losses are made good.

To quote from the well-known case law [Bueons Airs Great Southern Railway Co. *vs.* Preston (1947)], the divisible profits of the company mean "profits available for recommendation and distribution as dividends after setting aside to reserve or after carrying forward such amounts as the directors deem fit. Even the whole of the profit for the year can be carried forward."

(B) *Discussions :*

(1) **Section 205 of the Companies Act 1956.** The term 'divisible profits' has not been defined in this legislation. The above section provides for certain conditions that must be fulfilled before the profits are distributed as dividends. The important provisions are :

1. No dividend should be declared or paid by a company for any financial year except : (i) out of the profits of the company for that year arrived at after providing for depreciation as per Section 205 (2), or (ii) out of the profits of the company for any previous 'financial year or years arrived at after providing for depreciation as per Section 205(2) and remaining undistributed, or (iii) out of both, or (iv) out of moneys provided by the Central Government for the payment of dividends in pursuance of a guarantee given by that government.

2. If the company has not provided for depreciation for any previous financial year or years, it should provide for such depreciation out of the profits for that year or years before declaring or paying dividend.

3. If the company has incurred any loss in any financial year or years, then the amount of the loss or an amount equal to the amount provided for depreciation for the year or years whichever is less should be set-off against the profits of the company for the year for which dividend is proposed to be declared or paid, or against the profits of the company for any previous financial year or years,

arrived at in both cases after providing for depreciation as per Section 205 (2) or against both.

4. The Central Government may, in the interest of the public, allow any company to declare or pay dividend for any financial year without providing for depreciation.

The provisions 2 to 4 are necessarily to be followed as per the Companies (Amendment) Act, 1960. The Companies (Amendment) Act, 1974 also enjoins a provision that a company should provide reserve not exceeding 10% of its profits before the dividends are declared.

(2) **Income Tax Act.** Section 109 of this Act provides for declaration of a statutory percentage of distributable income as under in respect of the following classes of companies :

45% in the case of a consultancy service company.

90% in the case of an investment company.

60% in the case of other companies.

It also states that the company must have to pay additional income tax if such statutory distribution is not made.

(3) **Legal Decisions.** It is interesting to note that the decided legal cases in India and abroad provide ample guidance for determining the quantum of divisible profits in addition to the provisions of Section 205 of the Companies Act which contain the detailed scheme of working out the amount of 'divisible profits'. The management of the company and the auditors should consider these legal decisions as sources of guidance to arrive at the divisible profits while recommending or computing dividend. In this context, we may cite briefly the following case laws :

1. Lubbock. *vs.* British Bank of South America Ltd. (1892) :

The directors of the company treated the profit arising from the sale of a business as a profit available for distribution as dividend. A shareholder objected to this on the ground that this profit was a capital profit as it was realised on the sale of a part of the business. The court observed that the profits was on capital and, therefore, not a part of the capital itself, and held that it should be available for dividend if the Articles of Association so provide.

2. Foster. *vs.* The New Trinidad Asphalte Co. Ltd., (1901) :

The Company took over the assets of another company along with promisory notes which were regarded as of 'no value' at the time of take over. But at a later date the company realised the full debt with interest and credited the profit and loss account with the amount. The company directors also proposed to distribute the same as dividend. But a shareholder went to the court on the ground that these notes were not initially recorded in the books and the realisation on them was totally unexpected. The court also regarded this profit on realisation as capital profit. Justice Byrne observed "....The amount of debt is distinct item of the property purchased which has since been realised by the payment. .....The amount is prima facie capital. .....It is clear that an appreciation in the total value of the capital assets, if duly realised by sale of some portion of such assets, may in a proper case be treated as available for purposes of dividend. Accretions to capital may be realised and turned into money which may be divided among the shareholders. ....The question of what profit is available for dividend depends upon the result of the whole accounts fairly taken for that year, capital as well as profit and loss, and although dividend may be paid out of earned profits in proper cases, and although there has been a depreciation of capital, I do not think that a realised accretion to the estimated value of one item of capital assets can be deemed to be profit divisible amongst the shareholders without reference to the result of the whole accounts fairly taken.".

3. Drown *vs.* Gaumont-British Picture Corpn. Ltd., (1937) :

It was held that the receipts of premiums on the issue of shares could be distributed as dividend provided that the Articles of Association of the company allow such action. But in India, this decision does not hold good as the company has to transfer such premiums to the Share Premium Account in accordance with the company law.

4. Verner *vs.* General and Commercial Investment Trust Ltd., (1894) :

The main question before the court was "whether a limited company which has lost a part of its capital can lawfully declare or pay a dividend without first making good the capital which has been lost". It was held that (i) there was nothing in the Memorandum and the Articles of the compny necessitating the lost capital to be made good before the declaration of dividend; (ii) there was no payment of dividend out of capital; and (iii) there was no insolvency. The case, thus, concludes that a company can distribute dividends out of the current year's profit even without making good the part of lost capital if the Articles of Association permit. However this legal decision is inapplicable in India in view of Section 205 of the Companies Act, 1956.

Q.11.2 : The Directors of a public limited company desire to distribute dividend out of profits realised as stated below. Comment on the legality of such distribution. (a) Share premium; (b) Sale of company's fixed assets; (c) Capital Redemption Reserve; (d) Forfeiture and Re-issue of shares; (e) Development Rebate Reserve; (f) Fixed Assets Revaluation Reserve; (g) Tax Exempt Profits Reserve; and (h) Sales Promotion Reserve.

Ans. : (a) In accordance with the company law, a company has to transfer share premiums to Share Premium Account. The receipts of premiums, thus, cannot be distributed as dividend.

(b) Profit on the sale of company's assets is not earned during normal business operations. Hence, it is capital profit. This is available for distribution as dividend subject to the conditions that : (i) Such distribution is authorised by the Articles of Association, and (ii) Such surplus in actually realised in cash. This profit is on capital and not a part of capital, as decided in Lubbock. *vs*. British Bank of South America (1892).

(c) *Capital Redemption Reserve* : This represents an amount transferred from profits available for dividend, equal to the nominal amount of any redeemable preference shares otherwise than out of the proceeds of a fresh issue of shares. Under Section 80 of the Companies Act, it can only be applied in paying up unissued shares of the company to be issued to the members as fully paid bonus shares. This Section further stipulates that a reduction of this reserve can be made only in the manner in which the share capital of a company can be reduced. Thus, under the company law, this reserve is not available for distribution as dividend.

(d) *Forfeiture and Re-issue of shares* : Where forfeited shares are re-issued, the amount realised in excess of the nominal value of the shares is transferred to the Capital Reserve, and the premiums received on the original issue of shares remain in the Share Premium Account. Under regulations 29 to 35 of Table A of the Companies Act, 1956 the amount received on the forfeited shares is credited to the Forfeited Shares Account and shown in the Balance Sheet under: Share Capital. This amount on credit can be applied to write off : (i) discount on the re-issue of shares, or (ii) fictitious assets like preliminary expenses. Thus, this amount is not distributable as dividend.

(e) *Development Rebate Reserve* : This Reserve is created by a corresponding debit to the Profit and Loss Account of the relevant previous year with a view to utilising the same for the purposes of a company's business for a specified number of years (usually ten years as per the present provisions in the company law). This reserve, thus, cannot be utilised for payment of dividend for atleast eight years.

(f) *Fixed Assets Revaluation Reserve* : This Reserve is created by writing-up the fixed assets of a company as a result of revaluation. According to the present company legislation, the unrealised appreciation in the values of fixed assets is not available for dividend distribution.

(g) *Tax Exempt Profits Reserve* : This represents those profits of an industrial company which are exempt from tax under section 84 of the Income Tax Act 1961. This is a Revenue Reserve and not a Capital Reserve. It can, therefore, be distributed as dividend.

(h) *Sales Promotion Reserve* : It is an amount set aside for sales promotion purposes of a company, and therefore, a revenue reserve. The whole or a part of the amount, if unutilised, can be distributed as dividend.

Q.11.3 : Can dividends be declared without taking into account past losses ? Cite a decided case law.

Or, Can a company declare dividends out of current year's profits without

writting off previous year's accumulated losses ?

Ans. : According to Schedule VI of the Companies Act, 1956, any debit balance in the Profit and Loss Account is to be set off against the revenue reserves of a company. This means that the loss of any financial year must be made good out of past undistributed profits. In the absence of past undistributed profits held in the form of revenue reserve, the question arises whether losses brought forward from previous years should be covered before any dividend can be declared from the current year's profits. The answer is that there is no legal obligation for a company to make good a debit balance on its Profit and Loss Account resulting from the past losses before distributing current profits, but so much of the loss sustained by a company in one or more financial years, as is attributable to the amount of provision made for depreciation, must be set off against the current profits of a company before a dividend can be declared.

In a case law : Ammonia Soda Co. Ltd. *vs.* Chamberlin, it was held that it was not in all cases necessary to make good a debit balance in the Profit and Loss Account before distributing dividend out of current profits. Such payment of dividend is not necessarily a payment of capital. However, circumstances leading to debit balance in P & L A/c must be studied.

Q.11.4 : A company cannot pay dividend out of capital. Why is this ?

Ans. : The payment of dividend out of capital means the payments of dividend out of the assets acquired with the paid-up capital of the company. Section 205 of the Companies Act, 1956 expressly provides that no dividend may be paid except out of the profits of the company or out the funds provided for the purpose by the Central or State Governments. A dividend is a share of the profits of a company. The company law prohibits the payments of dividend out of capital for the following reasons :

1. The share capital as mentioned in the Memorandum of Association of a company is a fund meant for payment to the creditors in the event of the company being wound up. This means that the capital is liable to be spent in carrying on the business of a company and not for giving it back to the members or shareholders.

2. The payment of dividend out of capital amounts to a reduction of share capital on a voluntary basis without the leave of the court and without any sanction under any law in force including the company law.

3. The payment of dividend out of capital affects the value of the assets of a company, thereby having a serious effect on the securities offered against the secured loans. Thus, the liquidity position of a company is affected.

Q.11.5 : State the various methods of depreciation that a company may adopt to comply with the provisions of Section 205 of the Companies Act, 1956 (the charge of depreciation before declaring a dividend).

Ans. : For the purpose of ascertaining the quantum of divisible profits, the following approved methods of depreciation may be adopted by a company to comply with the provisions of Section 205 of the Companies Act, 1956 :

1. In the case of assets for which depreciation is allowable under the Income Tax Act, depreciation may be provided for by any of the following methods :

(a) The written-down value method as adopted for income tax purposes. Normal depreciation including any extra shift allowance is to be provided for.

(b) The straight-line method by which 95% of the cost of an asset is equally written off each year during a specified period. [The expression 'specified period' means the number of years during which at least 95% of the cost of an asset would be provided for by way of depreciation if depreciation were calculated according to the written-down value method.]

(c) Any other method approved by the Central Government, which has the effect of writing off by way of depreciation at least 95% of the cost of an asset during the specified period.

Where any of the three methods is adopted, if an asset is sold, discarded, demolished or destroyed for any reason before depreciation of such asset has been provided for in full, the excess of its written-down value over its sales proceeds or its scrap value must be written off in the financial year in which it is sold, discarded, demolished or destroyed.

2. As regards any other depreciable assets for which depreciation is not allowable under the Income Tax Act, depreciation must be provided for by such method as may be approved by the Central Government by any general or special order.

Q.11.6 : (A) What do you understand by 'Interim dividend' ? How does it differ from 'Final dividend' ? (B) Enumerate the provisions regarding the declaration and payment of dividends. (C) Indicate the points that the directors of a company should necessarily consider while deciding on the 'Interim dividend'. (D) Discuss the duties of an auditor in relation to interim and final dividends.

Or, The directors of a company, of which you are the auditor, consult you as regards the payment of an 'interim dividend' on the company's shares. What information would you require and what general advice would you give to the directors ?

Ans. : (A) *Interim dividend :* It means a dividend paid to the members of a company in anticipation of the profits of a year before the accounts of the company for that year have been prepared, audited and adopted at the annual general meeting. It is declared and paid on account of the full year's dividend at any time between two annual general meetings.

Where no 'interim dividend' has been paid in any year, any further distribution to the shareholders on account of that year sanctioned at an annual general meeting on the recommendations of the directors is known as 'final dividend'.

(B) *Provisions :* The Companies Act, 1956 enjoins the following provisions regarding the declaration and payment of dividends :

1. A company may, if so authorised by its Articles, pay dividends in proportion to the amount paid up on each share, where a larger amount is paid up on some shares than on others [Section 93].

2. No dividend may be declared or paid except out of the profits of a company or out of funds provided for the purpose by the Central or a State Government [Section 205 (1)].

3. All dividends must be paid in cash [Section 205(3)].

4. A dividend must be paid only to a registered shareholder or to his order or to his bankers, or (in the case of bearer shares) to the holder of the share warrant or his bankers [Section 206].

5. Where a dividend has been declared by a company and the dividend has not been paid within 42 days from the date of its declaration, the officers of the company who are in default are punishable with imprisonment upto 7 days and also with fine [Section 207].

The Articles of Association of a company also contain some provisions relating to dividends. These are :

1. The company in a general meeting may declare dividends, but no dividend shall exceed the amount recommended by the board of directors.

2. The board of directors may from time to time pay to the members such interim dividend as it appears to be justified by the profits of the company.

3. Notice of any dividend that may have been declared shall be given to the members entitled thereto.

4. Where a dividend has been declared by a company, it becomes a liability of the company to the shareholders from the date of its declaration, but does not carry any interest against the company.

(C) *Directors' Responsibility on Interim dividend :* The Articles of Association of a company authorise its directors to declare an interim dividend. Thus, considerable responsibility rests with the directors. The following points should, therefore, be looked into by the directors in this regard :

1. Preparation of interim accounts to ascertain the adequacy of profits.

2. Proper valuation of the assets and liabilities.

3. Inquiry into the conditions of trade and prospects for the rest of the year in order to anticipate any losses and contingencies.

4. Cash flow position and the position of financial commitments in the near future.

5. The past dividend policy, i.e., the rate and amount of dividend declared in earlier years.

6. The policy of conservatism to ensure that the dividend is not declared out of capital and that the rate of interim dividend fixed is lower than the estimated rate for the whole year, because it is better to declare a higher final dividend than the interim.

(D) *Auditor's Duties :* His duties are :

1. To refer the Articles of Association of a company to ascertain whether they allow the declaration and payment of an interim dividend.

2. To check up the resolutions passed at the meetings of the Directors and Shareholders.

3. To verify the rate and amount of dividend proposed by the directors and see to the justifications against the proposals.

4. To seek confirmation on the amounts transferred to Reserve as per the Companies (Transfer of Profits to Reserves) Rules 1975.

5. To ensure that the declaration and payment of interim dividend are not out of capital and do not adversely affect the liquidity position of the company.

6. To examine whether the provisions contained in Sections 205, 205A, 205B, and 207 of the Companies Act have been duly complied with.

7. To check up the Register of Members, the Dividend List, the Dividend Warrants, the Unclaimed or unpaid amounts of dividends, the Bank Account to which the unclaimed dividend amounts were transferred and the mode of ultimate disposal of such unclaimed dividends for over three years by way of transfers to the General Revenue Account of the Central Government.

8. To refer the resolutions of the Board where a Dividend Equalisation Reserve is created.

Q.11.7 : What considerations should be borne in mind before declaring dividends ? Or, Discuss the legal view-points regarding distribution of 'Capital Profits'.

Ans. : The following considerations are necessarily to be borne in mind before declaring dividends :

1. **Past Losses :** If the company has incurred any loss in any financial year or years, then the amount of the loss or an amount equal to the amount provided for depreciation for the year or years whichever is less should be set-off against the profits of the company for the year for which dividend is proposed to be declared or paid, or against the profits of the company for any previous financial year or years, arrived at in both cases after providing for depreciation as per Section 205 (2) or against hoth.

2. **Depreciation :** If the company has not provided for depreciation for any previous financial year or years, it should provide for such depreciation out of the profits for that year or years before declaring or paying dividend.

The Central Government may, in the interest of the public, allow any company to declare or pay dividend for any financial year without providing for depreciation.

The provisions are necessarily to be followed as per the Companies (Amendment) Act, 1960. The Companies (Amendment) Act, 1974 also enjoins a provision that a company should provide reserve not exceeding 10% of its profits before the dividends are declared.

3. **Capital Profits :** Dividends can be paid only out of profits—capital profits or revenue profits. Capital profits are available for distribution as dividend subject to the conditions that : (i) such distribution is authorised by the Articles of Association, (ii) such surplus is actually realised in cash, (iii) such surplus remains after a proper valuation of all assets, (iv) such profits are not profits prior to incorporation of the company, and (v) such profits are not profits realised on redeeming company's own debentures by purchase in the market at a discount.

4. **Reserves :** (i) Profits appropriated to reserves or carried forward to next year are not available

for dividend; and (ii) An amount equal to 75% of the development rebate allowable for income tax assessment must be set aside from profits to determine the amount of divisible profits — which cannot be used for 8 years next for dividend for current year.

Q.11.8: (A) What do you understand by (i) Capital profits, and (ii) Profits prior to incorporation ? (B) Are such profits available for distribution as dividends ? Discuss them. (C) State the purposes for which 'profits prior to incorporation' can be utilised.

Ans. : (A) (i) **Capital profits** : These refer to those profits which are not earned during the normal business operations. That means, these result from other sources and are not traceable as trading profits. The examples of capital profits are :

(a) Premium received on the issue of shares or debentures.

(b) Profit earned on the sale of fixed assets.

(c) Profit earned on the redemption of debentures by purchase at a discount.

(d) Profit earned on the resale of the forfeited shares.

(e) Profit earned prior to incorporation of a company.

(ii) **Profits prior to incorporation** : These refer to the profits that might have been earned by a company during a period commencing from the date of taking over a running business to the actual date of incorporation of that company.

(B) Section 205 of the Companies Act states that a dividend should be paid out of profits without making any discrimination as to revenue profits or capital profits.

Capital profits are available for distribution as dividend subject to the conditions that : (i) such distribution is authorised by the Articles of Association, (ii) such surplus is actually realised in cash, (iii) such surplus remains after a proper valuation of all assets, (iv) such profits are not profits prior to incorporation of the company, and (v) such profits are not profits realised on redeeming company's own debentures by purchase in the market at a discount.

The case laws, *viz.* Lubbock *vs.* British Bank of South America and Foster *vs.* New Trinidad Lake Asphalte Co. Ltd. [cited under Q. 11. 1(B)(3)] corroborate the view that capital profits are available for distribution as dividends.

Profits prior to incorporation of a company are not available for distribution as dividends on the following grounds :

(a) The company had not actually come into existence before incorporation.

(b) The company cannot be assumed to have made profits before it comes into existence.

(c) The profits earned do not relate to the post-incorporation period.

(d) The shareholders do not have any right to share profits which relate to pre-incorporation period.

(e) The profits are of capital nature.

(C) The 'profits prior to incorporation' of a Company can be utilised for the following purposes :

1. To pay off the interest on the purchase consideration to the vendors (who are entitled to this from the date the business is taken over to the date when such purchase consideration is discharged).

2. To write off Goodwill.

3. To write down other fixed assets.

4. To carry forward as a capital reserve.

Q.11.9: Can a dividend be declared out of current profits without making good depreciation of fixed assets ? Discuss with reference to the legal position in India.

Ans. : Section 205 of the Companies Act, 1956. provides for certain conditions that must be fulfilled before the profits are distributed as dividends. The important provisions are :

1. No dividend should be declared or paid by a company for any financial year except : (i) out of the profits of the company for that year arrived at

after providing for depreciation as per Section 205 (2), or (ii) out of the profits of the company for any previous financial year or years arrived at after providing for depreciation as per Section 205 (2) and remaining undistributed, or (iii) out of both, or (iv) out of moneys provided by the Central Government for the payment of dividends in pursuance of a guarantee given by that government.

2. If the company has not provided for depreciation for any previous financial year or years, it should provide for such depreciation out of the profits for that year or years before declaring or paying dividend.

3. The Central Government may, in the interest of the public, allow any company to declare or pay dividend for any financial year without providing for depreciation.

The provisions are necessarily to be followed as per the Companies (Amendment) Act, 1960. The Companies (Amendment) Act, 1974 also enjoins a provision that a company should provide reserve not exceeding 10% of its profits before the dividends are declared.

Q.11.10 : While examining the Profit and Loss Account of a company, you find that the Directors propose to distribute the following items as dividends :

(A) Profit on revaluation of Freehold Premises;

(B) Profit on realisation of Debtors taken over; and

(C) Profit on sale of Bombay Branch Assets.

(D) Bounties received from the Central Govt. Would you certify the accounts as correct ?

Ans. : (A) Profit realised on revaluation of Freehold Premises is a 'Capital profit'. It is not available for distribution as a dividend unless : (i) such distribution is authorised by the Articles of Association, (ii) such asset is realised in cash, and (iii) a surplus remains after a proper valuation of all assets of the company.

(B) Profit on realisation of Debtors taken over can be distributed to the shareholders provided that a reference is made to the book value of the whole of the assets and that the Articles of Association permit such distribution.

(C) Same as at (A) above.

(D) Bounties received from the Central Government is a revenue profit. It has been earned during normal business operations, and therefore, can be distributed as a dividend.

Q.11.11: (A) What do you understand by the expression 'dividends' are paid out of capital ? (B) When will dividends be deemed to have been paid out of capital ? (C) What are the consequences if dividends are paid out of capital ?

Ans. : (A) The expression means the payment of dividend out of the assets acquired with the paid-up capital of the company. Such payment amounts to a reduction of the share capital itself on a voluntary basis as some part of the money forming the capital is returned to the shareholders. Dividend is a return on capital and not a return of capital itself. On this ground, the company law prohibits the payment of dividend out of capital.

(B) Dividends will be deemed to have been paid out of capital, if—

(i) a revenue expenditure is booked to capital with an aim at inflating the profits of a company.

(ii) a company distributes the sale proceeds of fixed assets.

(iii) a company pays dividend even in case of loss disclosed in the profit and loss account and even in absence of undistributed profits.

(C) If dividends are paid out of capital, the following consequences will result :

i) The shareholders are to repay the amounts if they have received the dividend with full knowledge of the facts.

ii) The directors shall be jointly and severally liable to repay the amounts with interest. They will not be liable for dividends wrongly paid if it is proved that they acted honestly on the bonafide valuation by the company officials.

Q.11.12 : Can a company declare dividends—

(a) Out of sale proceeds of its branch and goodwill in a foreign country.

(b) Out of the profits arising from the redemption of debentures at a discount ?

Ans. : (a) Profit on sale proceeds of a company's branch and goodwill is a capital profit, and so, it is not available for dividend distribution unless : (i) such distribution is authorised by the Articles of Association, (ii) the amount is realised in cash, and (iii) a surplus remains after proper valuation of all assets.

(b) This is a capital profit. But such profit cannot be distributed as dividend in the light of a case law : Wall *vs.* London and General Provincial Trust Co. Ltd., (1920). Justice Younger decided the case by saying— "Where the Double Account system exists, no transfer can be made from one account to another. An appreciation of capital never increases the income balance. To do this, single account must be adopted. This discount is not either net profit of the Company or net profit arising from its business and the directors are not entitled to distribute it as dividend".

Q.11.13 : A limited Company has made sufficient profits to enable it to declare a dividend, but due to a small existing bank balance the dividend cannot be paid. Your advice is sought as to how to raise the money for the purpose.

Ans. : Before an advice is given for raising the necessary funds, it would be prudent to analyse the factors that have contributed to the insufficiency of bank balance. The relevant factors may be—

1. (a) Overvaluation of stock-in-trade.

   (b) Under-valuation of liabilities.

   (c) Fictitious sales.

   (d) Inadequate provision or no provision for (i) depreciation and/or (ii) bad and doubtful debts.

2. (a) Excessive stock-in-trade.

   (b) Excessive book debts.

   (c) Excessive capital purchases for expanding the business.

If the insufficiency of bank balance is due to the factors listed under (1) above, the payment of dividend does not arise in view of untrue profits.

If the insufficiency of bank balance is due to the factors listed under (2) above, dividend should be paid. The company, in such circumstances, may adopt any or more of the following methods to raise the money :

(i) Overdraft arrangement with the Bankers.

(ii) Issue of debentures.

(iii) Issue of more shares provided that there is sufficient unissued capital.

Q.11.14 : How would you, as an auditor, vouch— (a) Dividends, and (b)Unclaimed dividends ? (b) (i) What is meant by 'unclaimed dividend'? (ii) State how it should be treated in accounts. (iii) Explain in brief the duty of an auditor in relation thereto.

Ans. : (a) Dividends : (1) Examining the Articles of Association to ascertain the class of shares having dividend rights, and the board's resolutions declaring the rate of dividend.

(2) Verifying : (i) the computations of gross and net dividends payable to each shareholders, (ii) the schedules of gross and net dividends with the dividend warrants, income tax deduction list, and the dividend account ; and (iii) the amount transferred to the Dividend account from the Bank Account.

(3) Checking the dividend account's Pass Book with the Dividend Warrants returned to ascertain the unclaimed dividends, and also the Directors' Minute Book to find out whether unclaimed dividends have been forfeited.

(4) Ensuring that : (i) the dividends on preference shares are paid after deduction of income tax; (ii) the provisions of Section 205 of the Companies Act regarding the depreciation provision, transfer to reserve, writing off of the past losses, etc., have been complied with; and (iii) the Articles of Association authorise the payment of dividend, in case of bonus shares, in the form of 'scrip'.

(b) *Unclaimed Dividends :*

When certain shareholders do not claim the dividends declared by the company, the amounts of dividends so unpaid are Unclaimed Dividends.

Vouching of this item extends to :

(1) Whether the dividends remaining unpaid for forty-two days have been transferred, within seven days after expiry of this period, to a separate bank account under 'Unpaid Dividend Account of ... Co. Ltd.'

(2) Whether the amounts are shown as liabilities in the balance sheet.

(3) Whether the amounts remaining unpaid or unclaimed after the expiry of three years from the date of such transfer have been passed on to the 'Consumer Welfare Fund' of the Central Govt., as per the provisions laid down under Section 205 B of the Companies Act, 1956 and as per the Consumer Welfare Fund Rules of 1992.

(4) Whether the company had paid the interest due on the amount of unclaimed dividend in case of its failure to transfer the amount to a separate bank account as required by law.

Q.11.15: Discuss the commercial view-points regarding distribution of 'Capital Profits'.

Ans. : Commercial view-points : The following essential points should be borne in mind before a decision is taken to distribute capital profits :

(1) Whether the working capital is sufficient to meet the commitments of the business.

(2) Whether the plans are afoot for expansion of the business for which extraneous gains through capital profits would provide additional capital.

(3) Whether there is any capital loss to the company.

(4) Whether there is a necessity to reduce or wipe off intangible assets, such as — preliminary expenses, underwriting commission, etc., for which such profits can be utilised.

Q.11.16 : State the principles (i.e., decisions) laid down in the following case laws with regard to the distribution of profits as dividend. (a) Foster *vs.* New Trinidad Asphalte Co. Ltd.; (b) Lubbock Vs. British Bank of South America; (c) Spanish prospecting Co. Ltd.; (d) Lee *vs.* Neuchatel Asphalte Co. Ltd.; (e) Ammonia Soda Co. Ltd. *vs.* Arther Chamberlin; (f) Drown *vs.* Gaumont British Picture Corpn. Ltd.; (g) Wilmer *vs.* Mc. Namara & Co. Ltd.; (h) Verner *vs.* General and Commercial Investments Ltd.; (i) Bolton *vs.* Natal Land & Colonisation Co. Ltd.; (j) Crabtree Thomas *vs.* Crabtree; (k) Staply *vs.* Read Bros. Ltd.

Ans. : (a) A realised accretion to the estimated value of one item of capital assets cannot be deemed to be profit divisible amongst the shareholders without reference to the result of the whole accounts fairly taken for that year, capital as well as profit and loss.

(b) The profit, which is on capital and not a part of the capital itself, should be available for distribution as dividend if the Articles of Association of a company so provide.

(c) The term 'Profit' implies comparison between the state of a business at two specific dates, usually separated by an interval of a year. This can only be ascertained by a comparison of the assets of the business of the two dates. Thus, the terms 'profits' and 'profits legally distributable to the shareholders' should be clearly distinguished.

(d) If a company is formed to acquire or work property of wasting nature, e.g., a mine, quarry or patent, the capital spent in acquiring the property may be regarded as sunk and gone. If a company retains assets sufficient to pay its debts, the excess of money obtained by working the property over the cost of working may be distributed among the shareholders even without making depreciation provisions on the wasting assets provided the Articles of Association do not compel it to do so.

The above principle does not hold good in India in view of the provisions in the Companies Act, 1956 which enjoins that depreciation must be provided on assets before the distribution of profits to the shareholders.

(e) A company may write up the assets of its business as a result of bonafide revaluation and may distribute current profits without making good prior losses. Further, a company in absence of any rule of law may set-off an appreciation in value of its capital assets following a bonafide revaluation against the losses of current revenue accounts and the payment of dividend in this case is deemed to be paid out of current profits.

This decision does not hold good in India. Any loss suffered in the previous year(s) must be set-off against the current year's profits in terms of Section 205 of the Companies Act, 1956.

(f) See Q. 11. 1 (B) (3)—Item No. 3.

(g) A company may declare dividends out of current profits even without making depreciation provisions on its fixed assets. However, this decision is inapplicable in India in view of Section 205 of the Companies Act, 1956.

[Facts of the case (This does not form an answer here). The company was carrying on a business of movement of mails, parcels, etc. It was providing depreciation on its assets in the past. But in one year, it declared dividends to the preference shareholders without any depreciation provisions. Mr. Wilmer and ordinary shareholders brought an action against the company in the court. The Judge observed that 'the Balance Sheet cannot be impeached simply because it does not charge anything against revenue in respect of goodwill.]

(h) See Q. 11. 1 (B) (3)—Item No. 4.

(i) A company may declare dividends out of current profits without making good previous loss of capital assets. However this decision is not applicable in India according to Section 205 of the Companies Act, 1956.

(j) Depreciation on plant and machinery must be provided before arriving at the profits if a manufacturing business is to continue for an indefinite period.

(k) A company can pay dividends out of current profits by writing up the assets again to the extent it has written down its assets excessively in the past.

Q.11.17: Is it permissible for a company after having written down in the past, some of its assets excessively out of profits, to assets excessively out of profits, to write them up again on a subsequent occasion and credit the excess to Profit and Loss Account for the purpose of dividend ? Discuss.

Ans. : This question was raised by one of the shareholders of the company before the Court in the case of Staply *vs.* Read Brothers Ltd., (1924). The arguments put forth by the company were—(i) that the goodwill had been written off in the past at a very excessive rate ; (ii) that the debit balance in the Profit and Loss Account was the result of goodwill having been excessively written off in the past ; and (iii) that the present value of goodwill was more than what was proposed to be written up.

The court upheld the procedure adopted by the company by stating that, if the goodwill were retained as an asset in the balance sheet and if the profits were carried to a 'goodwill depreciation reserve fund' instead of being used to write off the volume of goodwill, the company could distribute those profits at any time to the extent by which the amount of reserve fund exceeded the actual depreciation amount.

Thus, the surplus created as a result of the write-up of assets which was written down excessively in the past and credited to the Profit and Loss Account represents the amount withheld from being distributed and is, therefore, available for the payment of dividend to the shareholders.

Short Answer Questions :

Q. 1. Distinguish between : profits and divisible profits.

A. 1. The Company law has not defined these terms. Generally speaking, the 'profit' of a business is the excess of income over expenditure during a year. It is also the excess of the assets between the two periods. On the other hand, 'divisible profits' refer to the portion of the 'profit' which can be legally distributed as dividend to the shareholders of a company.

Q. 2. State what the shareholders can do when a declared dividend is not paid within the statutory period of days.

A. 2. After the expiry of the statutory period of 42 days, the shareholders can sue the company for not paying a declared dividend.

Q. 3. What is dividend ?

A. 3. Dividend is that part of the profit which is available for distribution to the shareholders of a company.

Q. 4. Can dividend be paid out of capital ?

A. 4. Dividend is a return on capital and not a return of capital itself. Therefore, it cannot be paid out of capital.

Q. 5. Specify the matters that are necessary for the determination of divisible profits.

A. 5. These are—provision for depreciation, capital profits, capital loss, and debit balance in P & L A/c of previous year.

Q. 6. How 'unclaimed dividend' is shown in the books of account ?

A. 6. Unclaimed dividend amount is credited to a special account under its very name and shown separately as a liability in the balance sheet.

Q. 7. What is 'Capital Loss' ?

A. 7. 'Capital loss' arises on account of two reasons, namely : loss on the sale of fixed assets, and depreciation of such assets.

CHAPTER 12

AUDIT OF DIFFERENT INSTITUTIONS

Learning Objectives : *After reading and carefully studying this chapter, the student should :*

- Understand that the patterns of audit examination depend mainly on the different systems or operations involved in organisations like bank, insurance, and educational institutions.
- Be familiar about the audit steps for verification of the items of assets and liabilities in a banking company.
- Know the salient features of an insurance business and the auditor's responsibilities connected therewith.

Q.12.1: What are the special points that you would usually take into consideration in the audit of accounts of a Bank ?

Ans. : *Bank Audit :* The auditor should take into consideration the following points in this regard :

1. The category to which a bank belongs; that is, whether nationalised or not.

2. The approval of the auditor's appointment by the Reserve Bank of India.

3. The compliance by a bank with the provisions of the Banking Regulations Act, 1949 and the Companies Act, 1956 and also of the provisions under Section 228 of the Companies Act regarding branch audit.

4. Internal accounting and administrative controls in operation relating to the receipt and payment of cash.

5. The systems and practices followed for routine transactions.

6. Inspection of the Books of Account, such as : General Ledger, Personal Ledgers (for Savings/Current) Deposit Accounts, Loans and Overdrafts, Registers (for Bills, Demand Drafts, Letters of Credit/Guarantee), Cash Book, Cheques Clearance Book, and other records connected with the banking functional activities.

7. Examination of the powers exercised by different officers.

8. Verification of the items appearing in the Balance Sheet and the Profit and Loss Account.

Q.12.2 : (A) In the case of banks only a balance sheet audit is carried out. Why is this ?

(B) How would you verify the following items appearing in the balance sheet of a bank : (1) Cash and Bank balances, (2) Deposits and other accounts, (3) Acceptances, endorsements and other obligations, (4) Borrowings from others, (5) Loans and advances, (6) Investments, (7) Bills purchased and discounted, (8) Inter-branch, Inter-company, and overseas transactions, (9) Money at call and short notice ?

Ans. : (A) *Why Balance Sheet audit :*

The Banking Company Regulation Act, 1949 provides that a banking company cannot engage in any business other than banking business. Banking business is entirely different from other business which may involve purchase and sale of traded goods or manufacture and sale of goods produced. In the latter types of business, the scope and extent of audit cover the examination of the trading or merchandising or manufacturing expenses and also of the cost of stocks in trade. These audits are altogether absent in a banking audit. In the case of banks the business involves "the accepting, for purposes of lending or investment, of deposits of money from the public repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise" and that is why a balance sheet 'audit' is done.

(B)(1) *Cash and Bank Balances.* The verification steps should be the following :

General : Review of internal checks and internal accounting and administrative controls in operation relating to the receipts and payments, rotation of 'tellers', delegation of authority and assignment of responsibilities, existence of cash-in-transit insurance policy, fidelity guarantee, deputing a responsible official (who has no connection with the cash department) for test checks every day, etc.

Cash : Joint custodian of cash by at least two responsible officers, whether the payments are made only after the cheques, demand drafts, etc., have been passed for such by a responsible official, physical verification of cash in hand on the closing day of the year on the date of audit, agreement of cash in hand with the cash balance book, inspection of foreign currency notes.

Bank Balances : Scrutiny of the reconciliation statement of balances with the Reserve Bank of India and/or State Bank of India, Confirmation of balances with other banks against current accounts in and outside India.

(2) *Deposits and Other Accounts.* The verification steps are :

Fixed Deposits : Checking the Register of fixed deposits with the receipts'counterfoil, endorsements in the receipts for discharge, lien, etc.; Review of internal accounting controls, recomputation of interest accrued upto the balance sheet date; and Appraisal of the system of records including the control over the serial numbers of the deposit receipts.

Saving Bank Deposits : Random checking of interest calculations, passbooks, and cross-check of the Savings Bank Account with individual ledger accounts.

Current Account : Random checking to find out (i) the cases of dishonour of cheques, (ii) the cases where the balances fall below the minmium limit, and (iii) the addition and deletion of individual accounts.

Contingencies Accounts : Scrutiny of the amounts of different reserves maintained for meeting any known contingencies, such as provision for bad and doubtful debts, unadjusted suspense account, etc., and their adequacy under circumstances.

(3) *Acceptances, Endorsements and Other Obligations.* The verification steps should be to :

(i) Examine the bank's arrangements with the customers with respect to the securities, charging of commission, payment of bills, etc.;

(ii) Scrutinise the details of the bills register to find out the outstanding dues ;

(iii) See the validity of the securities provided as guarantees by the customers ; and

(iv) Cross check the constituents' liabilities for these items appearing on the Assets side of the balance sheet.

Note : The expression 'other obligations' includes letters of credit issued and guarantees given by the bank on belalf of its constituents.

(4) *Borrowings from others.* The usual verification steps are to :

(i) Examine the various sources of borrowings— other banks, agents, etc.;

(ii) Determine the amounts as to the classification secured and unsecured, with reference to the available evidential matter, such as certificates of agents from whom borrowed etc.

(5) *Loans and Advances.* In case of a bank, such advances given to the customers may be of four types : loans, cash credits, overdrafts, and bills purchased and discounted. However, the necessary verification steps are to :

(i) Estimate the credit worthiness of the borrowers ;

(ii) Ensure that such loans and advances, etc. do not exceed the prescribed limits and are allowed against the security of commodities, hypothecated or pledged ;

(iii) Examine the hypothecation deeds and other agreements with the borrowers ;

(iv) Check up whether these securities are valid and authentic ; and

(v) See that appropriate interest is determined and realised.

6. *Investments.* The usual steps for verification are :

(i) Inspection of these investments, their valuation, and disclosures as required under the law ;

(ii) Obtaining the confirmation certificates from the actual holders of such investments ; and

(iii) Confirming that these investments are valid, not time—barred from the investment register.

7. *Bills purchased and discounted.* The verification should be on the following lines :

(i) Whether the assignments of the titles to the bank are appropriate.

(ii) Whether a detailed classification statement is prepared by a reference to the relevant documents to pinpoint the outstandings.

(iii) Whether the margins are reasonable to cover decline in values.

In addition to the above, it is necessary to ascertain the bills on hand at the time of audit and check them with the relevant ledger. Further, it should be verified as to whether the discount relating to the succeeding year is carried forward as a liability under the head 'unexpired discounts'.

8. *Inter-branch, Inter-company, and Overseas transactions.* These may include all transactions relating to bank drafts, telegraphic transfers, bills for collection, etc. in and outside India. The verification steps are to :

(i) See that the code system for Telegraphic Transfers is reliable and being operated by a responsible officer.

(ii) Ensure that the system of communication between the issuing branch and the receiving branch is foolproof.

(iii) Look for authorisation as to prices for inter-branch and inter-company dealings.

(iv) Check up the returns rendered by overseas branches of these dealings.

(v) Confirm that any drafts and TT's issued but remaining unpaid on the date of balance sheet appear as a liability.

(vi) Ensure that (a) the bills for collection are consecutively numbered and their particulars entered in the register, and (b) on collection Cash Account is debited with the full amount received and the Customer's Account credited after deducting the bank's collecting commission.

9. *Money at Call and short notice.* The verification steps for the purposes of audit are to :

(i) Ascertain and confirm as to (a) whether the branch is duly authorised to operate in call money market and (b) if so, whether the recording function is separate from the investment execution function.

(ii) Examine physically each of the securities on the date of the balance sheet.

(iii) Confirm that the totals of detailed records agree with the control account.

(iv) Ensure that this item is properly disclosed under 'Property and Assets' — side of the balance sheet with the amounts (if any) separately for (a) Securities of the Central and State Governments and other Trustee securities, including treasury bills of the Central and State Governments, (b) Fully paid ordinary shares, (c) Partly paid ordinary shares, (d) Debentures or bonds, (e) Other investments, and (f) Gold.

Appendix 1 to Chapter 12

Salient features of the Insurance Act, 1938 which govern the accounts and audit of the insurance companies (except the Life Insurance Corporation of India for which a separate enactment exists).

1. Every insurance company is required to deposit with the Reserve Bank of India, cash or approved securities or both (estimated at the market value on the day of the deposit) of the amounts specified in the Act or Rules against the following classification :

(a) Fire Insurance ; (b) Marine Insurance ; (c) Misc. Insurance ; (d) Any two Insurance ; (e) All the three Insurance ; (f) Marine Insurance exclusively for country craft or cargo or both.

2. Where an insurance company carries on business of more than one class, it should keep a separate account of all receipts and payments in respect of each class (fire, marine, miscellaneous) and also for each sub-class of miscellaneous insurance business.

3. Every insurance company is required to maintain two types of register, *viz.* (a) Register of policies and (b) Register of claims. The register of policies should contain information about the name and address of policyholder, the date of effect of the policy and assignment in respect of each policy issued by the company. The register of claims should contain the particulars relating to the date of claim, name and address of the claimant, date on which the claim was discharged, and date of rejection of any claim with the grounds therefor.

4. Every general insurance company must, at the end of each calender year, prepare : (1) a Balance Sheet in the form set forth in part II of the First Schedule, (2) A Profit and Loss Account and a Profit and Loss Appropriation Account in the forms set forth in Part II of the Second Schedule, and (3) Separate Revenue Accounts for different classes of insurance business in the forms set forth in Part II of the Third Schedule, and in accordance with the regulations contained in the Part I of the Schedule referred to.

5. The following special duties are cast upon the auditors of every general insurance company.

(a) Four copies of the annual accounts signed by the Chairman, two directors and the principal officer have to be submitted to the Controller of Insurance, and one of these four copies should also be signed by the company auditor.

(b) The Company should not grant any loans or temporary advances to any director, manager, actuary, auditor, or any other officer, except the loans on mortgage and loans to agents to the extent of commission earned by them. The auditor must see that there is no breach of this provision.

(c) The Company should incorporate in its revenue accounts a certificate signed by the chairman, two directors and the principal officer and also by the auditor to the effect that all direct and indirect expenses incurred by the management have been fully debited in the revenue accounts as expenditure.

(d) The balance sheet should contain the following certificates namely :

(i) a certificate explaining as to how the values of the investments in stocks and shares have been arrived at, how the market values have been ascertained for the purpose of comparison ;

(ii) a certificate with respect to the value of items appearing in 'Reversions and Life Interests' by an Actuary stating that the values of all the assets have been reviewed as at the date of balance sheet, and that in their belief the assets are shown in the aggregate amounts not exceeding their realisable or market value under different heads, *viz.* — Loans, Reversions and Life Interests, Investments, Agents' balances, Outstanding premiums, Sundry debtors, Bills receivable, etc. ;

(iii) a certificate signed by the chairman and others, and also by the auditor stating that no part of the assets of the life insurance fund has been directly or indirectly applied in contravention of the provisions of the Act relating to the application and investment of life insurance funds ;

(iv) a certificate signed by the auditor stating that he has verified : (1) the balances and securities relating to the insurer's loans, reversion and life interests, and investments ; (2) the investments and transactions relating to any trusts undertaken by the insurer as trustee ; (3) the balance sheet and accounts of every insurer whose assets and liabilities are incorporated therein, in the case of a combined balance sheet.

(v) a certificate stating as to whether the values in respect of 'Holdings in Subsidiary

Companies' or 'House Property in India or out of India' have been increased since the previous year and whether such increase is not solely due to (1) the cost of subsequent additions, and (2) the increased profits, etc.

6. In addition to the above statutory requirements, the Institute of Chartered Accountants of India in consultation with the Executive Committee of the General Insurance Council have issued the following auditing procedures relating to the verification of agents' balances :

(a) The company, at the end of each year, should obtain confirmation of the agents' balances. It should also furnish to the Controller of Insurance a statement of balances confirmed and not confirmed by the agents (duly signed by its principal officer and authenticated by the auditor after test check) along with the Annual Accounts Return.

(b) The company should maintain the agents' accounts in the prescribed form.

(c) Whenever policies are cancelled, the unrecovered amounts of premiums should be debited to 'Policies Cancellation Account'; similarly the premiums refunded, on account of the policies being cancelled or premiums charged for a short period or small risk, should be debited to 'Premiums Refund Account', and the premiums debited to the agents' accounts becoming irrecoverable should be debited to "Agents' Account written off".

(d) The company should furnish to the Controller of Insurance a statement of the agents' balance written off (as distinct from other balances or bad debts written off) duly countersigned by the auditor.

(e) The accounts of the branches of general insurance company are required to be audited by qualified auditors either at the branches or at the head office where the vouchers are kept.

(f) The company should furnish, as regards the Revenue Accounts, separate details of the expenses of management under the head like : Directors' Fees, Salaries, Gratuity and Pension, Contribution to Provident Fund, Bonus. Travelling, Stationery & Printing, Publicity & Advertisement, Entertainment, Compensation to Directors, Audit Fee, Legal Expenses, Rent, Sundry Expenses, Head Office Expenses in case of foreign companies.

Notes : (1) *'Combined Balance Sheet'* includes any combined statement made by an insurer of assets and liabilities in the form of a balance sheet which includes the assets and liabilities of any other insurer.

(2) *'Market Value'* means as respects any assets the market value thereof as ascertained from published market quotations, or, if there be no such value, its fair value as between a willing buyer and a willing seller.

Q. 1. What are the special points that you would usually take into consideration in the audit of accounts of an Insurance business.

A. 1. : Insurance. The auditor should take into consideration the following special points:

1. The nature and type of business; whether the company is engaged in one or more of the classes of insurance business, *viz.* Fire, Marine and other insurance.

2. Compliance by an insurance company with the provisions of the General Insurance Business (Nationalisation) Act, 1972, the applicable provisions of the Insurance Act, 1938, and some of provisions of the Companies Act, 1956 which are applicable to certain insurance business under Section 117 of the Insurance Act, 1938.

3. The certificate of registration issued by the Controller of Insurance and its renewal on an annual basis.

4. The maintenance of accounts and funds for all receipts and payments separately in respect of each class of insurance business (fire, marine, and miscellaneous, etc.) and also for each sub-class of insurance business in case miscellaneous insurance business is also carried on, unless compliance with such provisions is waived by the Controller of Insurance.

5. Internal accounting and administrative controls in operation relating to the receipts and payments of cash.

6. Examination of the items of income (e.g., insurance premium, interests on deposits and securities lodged with the R.B.I., Commission on reinsurance) and of expenses (e.g., claims, commission and management expenses) and assets, such as investments, cash and bank balance, loans and advances, etc.

7. Verification of the items in the Financial statements (i.e., Balance Sheet, Profit and Loss Account, Revenue Account, etc.) and their disclosure and presentation in accordance with the Regulations prescribed to obtain an assurance that they exhibit 'true and fair' view of the financial position of the company and the results of its operations and the changes in its financial position for the year, in conformity with generally accepted accounting principles applied on a consistent basis.

Q. 2. Specify the special points to be considered in the audit of an Educational Institution.

A. 2. Educational Institution. The auditor should look into the following special points :

1. The nature of institution ; that is, whether it is established under the Trust deeds or the Acts of Parliament/State Legislature, as the case may be.

2. The rules and regulations relating to administration, accounts and audit.

3. The resolutions concerning the management of affairs including accounts that have been recorded in the minutes of the governing body or council or syndicate or committee.

4. The nature and extent of internal checks and of accounting controls in respect of receipts and payments, grants-in-aid (from the University Grants Commission, Government), donations, caution money and library deposits, stipends and scholarships, annual sports, annual prizes and purchases of books and laboratory instruments, etc.

5. The scale of fees to be collected, outstanding fees and liabilities, proper use of the research grants, and the allocation of funds to seminars/professional development/educational projects/publications, etc.

6. Physical verification of assets (e.g., laboratory equipment, furniture, vehicles, etc.) and stores including laboratory chemicals and re-agents.

7. Examination of the items appearing in the Income and Expenditure statement and in the balance sheet of the institution.

CHAPTER 13 AUDIT REPORTS AND CERTIFICATES, NOTES AND QUALIFICATION

Learning Objectives : *After reading and carefully studying this chapter, the student should :*

- Acquaint himself with the types of reporting obligations as they relate to the statutory audit.
- Be able to distinguish between reports and certificates, and notes and qualifications.

Q.13.1: Define Auditor's Report.

Ans. : Auditor's Report : Report on the results of the auditor's examination. It consists of two paragraphs basically — the first describing the scope of the auditor's examination, the second containing the auditor's opinion on the financial statements examined.

Q.13.2 : The auditor of a limited company was not successful in persuading the Directors of the company to amend the accounts on the points proposed by him. Prepare a draft of the report that the auditor will submit in this case. Take four imaginary points to qualify the report.

Or, State the matters required by the Companies Act, 1956, to be stated in the Auditor's Report to the shareholders on the accounts of a company audited by such auditor.

Ans.

To
The Managing Director,
XYZ Company Limited,
Kolkata - 700 001

Dear Sir,

We have audited the attached Balance sheet of XYZ Company Ltd., as at 30th June, 200X and the annexed Profit and Loss Account for the year ended on that date, and report that :

1. We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit ;

2. In our opinion, proper books of account as required by law have been kept by the company so far as it appears from our examination of the books ;

3. The Balance Sheet and the Profit and Loss Acount dealt with by this report are in agreement with the books of account;

4. In our opinion and to the best of our information and according to the explanations given to us, the said accounts read with the notes thereon and subject to the exceptions stated below, give the information required by the Companies Act, 1956 in the manner as required under the Act and give a true and fair view of the state of affairs of the company as at 30th June, 200X and of the profit for the year ended on that date :

(a) The provision for depreciation on plant and equipment shown at Rs. 12.60 lakhs is inadequate and according to our computation this should be Rs. 12.95 lakhs.

(b) The provision for bad and doubtful debts for Rs. 310 lakhs has not been considered which in our opinion are quite old and have become bad.

(c) The company has given an advance of Rs. 5,00,000/- to a director in contravention of the provision contained in Section 295 of the Companies Act, 1956.

(d) The company has valued the stocks at a current market price which is higher than the cost price to the tune of Rs. 3,75,000/-

5. As required by the Companies (Auditor's Report) Order 2003, issued by the Central Government, we further report that :

(i) The company has maintained proper records showing full particulars, including quantitative details and situation of fixed assets. We are informed that the fixed assets have been physically verified by the management and no serious discrepancies have been noticed by them ;

(ii) A physical verification of inventory in respect of finished goods, stores and spare parts, and raw materials has been conducted during the year by the management, and no significant discrepancies have ben noticed on such verification as compared to book records ;

(iii) In our opinion, the procedures of physical verification followed by the management are reasonable and adequate ;

(iv) In our opinion, the rate of interest and terms and conditions on which the company has taken a loan from PQR Company (P) Ltd., listed in the Register maintained under Section 301 of the Companies Act are not *prima facie* prejudicial to the interests of the company ;

(v) The Company has not granted any loans or advances in the nature of loans except interest-free advances to its employees and a director which are being repaid as stipulated ;

(vi) In our opinion the internal control procedures of the company relating to purchase of inventory and fixed assets and the sale of goods are commensurate with the size and nature of business of the company ;

(vii) In the case of public deposits received by the company, the directions issued by the Reserve Bank of India and the provisions of Sections 58A and 58AA of the Companies Act, 1956 and the applicable rules framed thereunder have been complied with ;

(viii) In our opinion, the company's present internal audit system is commensurate with its size and nature of business ;

(ix) The Central Government has not prescribed the maintenance of cost records by the company under Section 209(1)(d) of the Companies Act, 1956 for any of its products ;

(x) The company has regularly deposited, during the year, provident fund Employee's State Insurance, investor education and protection fund, income tax, sales tax, Wealth tax, Customs duty, excise duty, cess and other statutory dues with the appropriate authorities ;

(xi) No amounts in respect of income tax, wealth tax, sales tax, customs duty and excise duty and cess, etc were outstanding for over 6 months ;

(xii) The company has not defaulted in repayment of dues to a financial institution or bank or debenture holders ;

(xiii) The documents and records for loans and advances granted on the basis of securities by way of pledge of shares / debentures, etc., are adequate ;

(xiv) The company has not given any guarantee for loans taken by others from bank or financial institutions ;

(xv) The company has applied 'term loans' for the purpose for which these were obtained ;

(xvi) The company has not used any short-term funds for long-term investments and vice versa ;

(xvii) The company has not made any preferential allotment of shares to parties and companies covered in the Register (under Section 301 of the Act) ;

(xviii) The company has created securities in respect of debentures issued.

(xix) The company has disclosed the end use of money raised by public issues.

Kolkata, 28th August, 200X

K. P. Duttachowdhury
Partner, Chartered Accountants

Q.13.3: Mention four items of a qualified audit report.

Ans. : See Q. 13. 2 Para 4 — (a) to (d).

Q.13.4: Describe various matters that are required to be reported by the auditor under the Companies (Auditor's Report) Order, 2003.

Or, Briefly explain the requirements of the Companies (Auditor's Report) Order 2003 under Section 227(4A) of the Companies Act, 1956, in respect of : (a) Fixed Assets, (b) Internal Control, (c) Internal Audit, (d) Finished Stock & Stores, (e) Loans given and/ or taken by the company, and (f) Provident Fund dues.

Ans. : In accordance with the Companies (Auditor's Report) Order, 2003 the following matters should be included in the Auditor's Report on the accounts of the companies :

1. Whether the company is maintaining proper records to show full particulars, including quantitative details and the situation of fixed assets; Whether these fixed assets have been physically verified by the management, and if any serious discrepancies were noticed on such verification, whether the same have been properly dealt with in the books of account ;

If a substantial part of fixed assets have been disposed off during the year, whether it has affected the going concern.

2. Whether physical verification of inventory has been conducted by the company management at reasonable periods ;

3. Whether the procedures of physical verification of inventory followed by the management are reasonable and adequate in relation to the size of the company and the nature of its business. If not, the inadequacies in such procedures should be reported ;

Whether the company is maintaining proper records of inventory ;

4. Has the company either granted or taken any loans, secured or unsecured, to / from companies, firms or other parties covered in the register maintained under Section 301 of the Act. If so, give the number of parties and amount involved in the transactions ;

Whether the rate of interest and other terms and conditions of loans given or taken by the company, secured or unsecured, are prima facie prejudicial to the interest of the company ;

5. Whether payment of the principal amount and interest are also regular ;

If overdue amount is more than one lakh, whether reasonable steps have been taken by the company for recovery / payment of the principal and interest.

6. Whether there is an adequate internal control procedure commensurate with the size of the company and the nature of its business for the purchase of inventory and fixed assets and for the sale of goods ;

Whether there is a continuing failure to correct major weaknesses in internal control ;

7. Whether transactions that need to be entered into a register in pursuance of Section 301 of the Act have been so entered ;

Whether each of these transactions have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time. (This information is required only in case of transactions exceeding the value of five lakh rupees in respect of any party and in any one financial year) ;

8. If the company has accepted deposits from the public, whether the directives of the Reserve Bank of India and the provisions of Sections 58A and 58AA of the Companies Act and the rules framed thereunder, wherever applicable, have been complied with. If not, the nature of contravention should be stated ;

If an order has been passed by the Company Law Board whether the same has been complied with or not ?

9. In the case of listed companies and / or other companies having a paid-up capital and reserves exceeding to Rs. 50 lakhs as at the commencement

of the financial year concerned, or having an average annual turnover exceeding 5 crore rupees for a period of three consecutive financial years immediately preceeding the financial year concerned, whether the company has an internal audit system commensurate with its size and nature of its business.

10. If the maintenance of cost records has been prescribed by the Central Government under Section 209(1)(d) of the Companies Act, 1956, whether such accounts and records have been made and maintained ;

11. Whether the company is regular in depositing undisputed statutory dues including Provident Fund, Investor Education and Protection Fund, Employees' State Insurance, Income tax, Sales tax, Wealth tax, Customs Duty, Excise duty, Cess and any other statutory dues with the appropriate authorities, and if not , the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated by the auditor ;

In case dues of sales tax / income tax / customs duty / wealth tax / excise duty / cess have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending may please be mentioned. (A mere representation to the department shall not constitute the dispute).

12. Whether in case of a company which has been registered for a period not less than five years, its accumulated losses at the end of the financial year are not less than fifty per cent of its net worth and whether it has incurred cash losses in such financial year and in the financial year immediately preceeding such financial year also ;

13. Whether the company has defaulted in repayment of dues to a financial institution or bank or debenture hoiders ? If yes, the period and amount of default to be reported.

14. Whether aduquate documents and records are maintained in cases where the company has granted loans and advances on the basis of security by way of pledge of shares, debentures and other securities ; If not, the deficiencies to be pointed out.

15. Whether the provisions of any special statute applicable to chit fund, nidhi or mutual benefit fund society have been duly complied with ;

16. Whether the net-owned funds to deposit liability ratio is more than 1:20 as on the date of balance sheet ;

Whether the company has complied with the prudential norms on income recognition and provisioning against substandard / default / lost assets ; Whether the company has adequate procedures for appraisal of credit proposals / requests, assessment of credit needs and repayment capacity of the borrowers ;

Whether repayment schedules of various loans granted by the nidhi is based on the repayment capacity of the borrower and would be conducive to recovery of the loan amount ;

17. If the company is dealing or trading in shares, securities, debentures and other investments, whether proper records have been maintained of the transactions and contracts and whether timely entries have been made therein ; Also whether the shares, securities, debentures and other investments have been held by the company in its own name except to the extent of the exemption, if any, granted under Section 49 of the Companies Act, 1956 ;

18. Whether the company has given any guarantee for loans taken by others from banks or financial institutions, the terms and conditions whereof are prejudicial to the interest of the company ;

19. Whether term loans were applied for the purpose for which the loans were obtained ;

20. Whether the funds raised on short-term basis have been used for long-term investment and vice versa ; If yes, the nature and amount is to be indicated ;

21. Whether the company has made any preferential allotment of shares to parties and

companies covered in the register maintained under section 301 of the Act and if so, whether the price at which shares have been issued is prejudicial to the interest of the company ;

22. Whether securities have been created in respect of debentures issued ;

23. Whether the management has disclosed on the end-use of money raised by public issues and the same has been verified ; and

24. Whether any fraud on or by the company has been noticed or reported during the year ; If yes, the nature and amount involved is to be indicated.

Q.13.5: Write a brief note on : Auditor's Report (Notes) to management.

Ans. : *Auditor's Report (Notes) to Management :* The auditor's primary function is to report to the shareholders in a general meeting. Now-a-days, he normally issues a report in the form of notes to management, in addition. This report may touch upon the following matters (for example) :

1. Internal Control weaknesses and recommendations for rectification ;

2. Accounting system's inconsistencies and any material errors ;

3. Client's failure to adhere to the audit time-tables ;

4. Defective accounting procedures or policies ; and

5. Non-compliance with the statutory or legal or professional pronouncements in so far as the maintenance of the books of account is concerned.

The specific purposes of this report are : (a) to reduce the possibility of error or fraud by making the management alert and sensitive to the situations; and (b) to put on record the existence of weaknesses so that necessary clarification from the senior level management can be obtained without creating misunderstanding.

It has, however, to be borne in mind that the report when finalised should contain only the significant items, listed in order of importance. It should be sent to the directors with a copy to the chief accountant, and an answer should be requested and followed up.

Q.13.6: Distinguish between : (a) Report and Certificate, (b) Qualificatory Note and Explanatory Note (or Clarificatory Note).

Ans. : (a) *Report and Certificate :* Joseph Lancaster defines the term 'Report' as "a statement of collected and considered facts so as to give a clear and concise information to the persons who are not already in possession of the full facts of the subject matter". The term 'Certificate' refers to a written confirmation of the accuracy of the facts and information stated therein. In audit parlance, the distinction between these two terms may be summed up as under :

Report	Certificate
1. It is a document titled as such through which an auditor expresses his opinion on financial statements and/or about its components or items examined.	1. It is a document titled as such in which an independent accountant authenticates the validity of facts and/or data after he is satisfied with the financial information on verification.
2. It may contain auditor's 'opinion' or 'no opinion'.	2. It does not convey any opinion.
3. It is made out on the basis of information made available to the auditor.	3. It is issued by an independent accountant on those facts and data which are capable of absolute verification.
4. It may not guarantee correctness of financial information in absolute terms.	4. It should guarantee absolute correctness of financial information and other related matters.

To illustrate further, it can be stated that an auditor's opinion to the shareholders of the company on the state of affairs of the business under Section 227(2) or Section 233B of the Companies Act, 1956 is a report ; whereas the statement of bonus computation, after it is verified and authenticated by an independent accountant in accordance with the Payment of Bonus Act, 1965, becomes a certificate.

(b) *Qualificatory Note and Explanatory Note :* The expression 'qualificatory note' refers to those notes on the accounts of a company which are considered by the statutory auditors as matters to be qualified in their reports : whereas the expression 'explanatory note' refers to those notes on accounts which are considered by the management of the company as matters to be explained or clarified depending on particular circumstances or situations or events. Thus the former expression constitutes an auditors dissatisfaction on a matter which may have the effect of distorting the 'true and fair view' of the state of affairs of the company and the latter expression concerns itself to explain or clarify a matter that has been laid down as facts in the accounts of the company for the knowledge and understanding of the shareholders.

To illustrate the above concepts further, the notes on accounts vide 1 and 2 below are explanatory notes and notes vide 3 and 4 below in the auditor's report are qualificatory notes :

1. Gratuity payments have been accounted for on a cash basis and accordingly, no provision has been made for the accrued gratuity liability as at 31st December, 200X. The net of tax liability as at 31st December, 20CX in respect of retirement gratuity based on actuarial valuation amounted to Rs. 10 lakhs approximately (Gross liability Rs. 18 lakhs) (Last year - Gross Rs. 15 lakhs ; Net of tax Rs. 9.5 lakhs).

2. Acceptances for purchases of machinery under I.D.B.I. Bills Rediscounting Scheme are guaranteed by the State Bank of India in whose favour the company has executed Counter Guarantees. The Counter Guarantees are secured by hypothecation of the machinery purchased under the above Scheme.

3. The company accounts for its gratuity liability as and when paid. Non-provision of accrued gratuity liability as on 31st December, 200X as actuarially valued is Rs. 18 lakhs.

4. Unclaimed dividend over three years amounting to Rs. 15,000 has not been transferred to the General Revenue Account of the Central Government as per Section 205A(5) of the Companies Act, 1956.

Q.13.7: Distinguish clearly between a 'note' and 'qualification' to the Report, bringing out their meanings.

Ans. : *Note :* The term 'note' refers to any matter of information or fact which is necessarily to be disclosed in an Annual Report of Accounts and/or in an Audit Report with a view to presenting a 'true and fair view' of the state of affairs of a company for the knowledge and information of all concerned and interested.

With respect of Financial Accounts and Audit Reports, a 'note' may pertain to contingent liability, contractual liability, counter-guarantees executed, treatments of Capital Reserve, Statutory Gratuity, etc., and specially on the following points :

Licensed/Installed capacity and actual production.
Particulars of Finished Goods — opening stock, closing stock & sales (both in quantity and value).
Details of raw materials consumed (Quantity and value).
Value of raw materials, spare parts, and components, including stores consumed, separately, for imported and indigenous varieties.
Value of imports.
Foreign exchange earnings.
Expenditure in Foreign currency.
Remittances in Foreign currency (say, dividends).
Rearrangement of previous year's figures, if any, so as to make them comparable with the current year's figures, etc.

Qualification : The term 'qualification' refers to an expression of an opinion, on the part of an Auditor, disagreeing upon any point or making certain reservations so as to dissociate himself from assuming any responsibility for such points or matters which have been qualified by him in his Audit Report. That means, 'qualification' constitutes an Auditor's dissatisfaction upon any point (or objections on any matter) that may have the effect of distorting 'true and fair view' of the state of affairs of the company and that have been laid down as facts in his Audit Report, as a result of the examination of the books of accounts (Financial as well as Cost Accounts).

Distinction : The fundamental distinction between the two terms 'note' and 'qualification' is that the former is concerned with disclosing material information on accounts so as to present the 'truth and fairness' of the state of affairs on the part of an entity for the knowledge of such accounts and also for the satisfaction of the Auditor, while the latter contains an element of Auditor's disagreement with the management with respect to the cost and/or financial statements and expresses the existence of other circumstances, and in the Auditor's judgement, the effect of the matter is or may be material to the Cost and/or Financial Statements.

Q.13.8: What precautions will you take to certify as 'true and fair' Balance Sheet and Profit & Loss Account of a Limited Company ?

Or, State the general guidelines for consideration of 'true and fair view' of the Financial accounting statements of a limited company.

Ans. : Precautions before certification as to 'true and fair' :

The following precautions should be taken by an auditor before he certifies the Profit and Loss Account and the Balance Sheet of a company as 'true and fair'—

1. That the P & L account discloses the results of the working of the company clearly and correctly.

2. That there was no manipulation of accounts.

3. That the company has not resorted to any means which may have the effect of creating a secret reserve—which is entirely inadmissible.

4. That there was neither over-valuation nor under-valuation of assets or liabilities.

5. That he has obtained all the information and explanation which were necessary for the purpose of his audit.

6. That the financial statements are in agreement with the books of account and returns.

7. That the books of account and returns and the financial statements are not only arithmetically correct but they are substantially accurate.

8. That the systems of internal controls and checks in operation are reliable and if not, the tests of compliance and substantive nature do not reveal any discrepancies.

Q.13.9: Write a brief note on the concept of 'True and fair view'.

Ans. : The Companies Act, 1956 requires that financial statements of a company should give a 'true and fair view' and every auditor has to make a report on the financial statements stating whether the said accounts, among other things, give a 'true and fair view'. But the golden rule of 'true and fair view' is not a legally defined term. In this respect, the Accounting Standards Committee in U.K. states that "accounts will not be true and fair unless the information they contain is sufficient in quantity and quality to satisfy the reasonable expectations of the readers (users) to whom they are addressed. On this question, the accountants can express informed professional opinion as to what, in current circumstances, the accounts should reasonably contain". This concept, thus, refers not only to information that is quantitatively and qualitatively sufficient but also requires accounting and auditing profession to specify the criteria or standards for the same.

Q.13.10: Discuss the significance of the phrase 'true and fair' as used in an audit certificate.

Ans. : *True and Fair :* A typical Financial Audit certificate contains—"In our opinion and to the best of our information and according to the explanations given to us the accounts subject to notes thereon give the information required by the Companies Act, 1956, in the manner so required and give a **true and fair view** of ... .".

This phrase has not been defined either by the Companies Act, 1956 or by the Council of the Institute of Chartered Accountants of India. According to **dictionary meaning,** the word 'true' is "agreement with reality; that which is true or according to the facts of the case; the true state of things or facts, etc." and the word 'fair' is "free from blemish; impartial; just; equitable; etc." According to **some auditors,** the pair of words 'true and fair view' should be dropped from the audit certificate as the expression fails to reflect the characteristics relating to the balance sheet. But it appears that the expression has been correctly chosen, should we try to understand it from the meaning attached. By the use of the words 'true and fair view of ... ...', the underlying idea is definitely to put emphasis on the following two basic aspects in so far as the audit certificate is concerned.

(i) 'true'-view, i.e., whether the true state of things of facts is revealed—the revelation may be true of truth or untruth, and

(ii) 'fair'-view, i.e., whether the attributes of impartiality, equitability and reasonability are revealed.

Let us assume that a Balance Sheet and Profit and Loss Account, which have been prepared on the basis of false vouchers and documents, are authenticated by the Auditor in his audit certificate stating 'true and fair view' of the state of affairs of the business. In this case, the audit certificate is definitely false and issued perfunctorily as it has not revealed the true state of things or facts.

To cite another example, two firms P and Q operate under same conditions having the same amount of capital initially. It is assumed that the incomes and real expenses are identical, but the reported profits by them are different as because different methods of valuation of closing stocks have been adopted. In both cases, the audit certificate stating 'true and fair view' holds good as it has taken into account the concept of 'truth' under the doctrine of 'disclosure' relating to the choice of valuation method chosen.

As regards the meaning of the word, 'fair', Stettler observes it as "a pervasive concept— which extends to every phase of financial statement ... ... covers such matters as the adequacy of the provisions made ... ..., the propriety with which items have been classified ... ..., and the appropriateness of the descriptions of the various amounts shown in the statements."

Regarding the significance of the phrase 'true and fair' in the audit certificate, the following judgement in the case of Deputy Secretary, Ministry of Finance, Govt. of India *vs.* S. N. Dasgupta is quite relevant :

"It is the duty of the auditor to verify not merely the arithmetical accuracy of the balance sheet, but it is substantially accurate and to see that it includes the particulars required by the Articles and the Statute and contains the correct representation of the state of the company affairs".

Q.13.11: "The audit report should contain a clear written expression of opinion on the financial information." What are the contents and basic elements included in the auditor's report ?

Or, What are the essentials of a good 'Auditor's Report'?

Ans. : *Contents.* An independent auditor's report should generally contain the following :

1. A scope paragraph : This should identify the financial statements (viz., Balance Sheet, Statement of financial position, Statement of income etc.) examined and should state whether the examination was made in accordance with generally accepted auditing standards.

This should also identify whether financial statements have been prepared on a basis other than generally accepted accounting standards.

The auditor should ensure that proper titles are used for financial statements. For example, cash-basis financial statements might be titled as follows :

(a) Statement of assets and liabilities arising from cash transactions.

(b) Statement of increases or decreases in funds arising from cash transactions.

Similarly, a financial statement prepared on a statutory or regulatory basis might be titled 'Statement of Income : Statutory Basis'.

2. An opinion paragraph : This should identify—

(a) the specified elements, accounts, or items examined ;

(b) the basis on which these elements are presented, and any agreements, if applicable, specifying a basis ;

(c) the source of significant interpretations made by the client, if there is an agreement ;

(d) the acceptable accounting policies which have been consistently applied for the preparation of the financial information ; and

(e) the relevant regulations and statutory requirements which have been complied with.

In addition, this paragraph should express an opinion as to—

(a) whether the specified elements, accounts, or items are presented fairly on the basis indicated ;

(b) whether the financial information as a whole is consistent with that of the preceeding period ;

(c) whether there is an adequate disclosure of all relevant material matters.

Basic Elements : The auditor's report should include the following basic elements :

(a) Title, (b) Addressee, (c) A paragraph describing the scope of the auditor's work, (d) A paragraph expressing his opinion on the financial statements, (e) Signature, (f) The auditor's address, and (g) The date of the report.

Q.13.12: What is a clean audit report ?

Ans. : *Clean audit report :* An audit report is termed as clean only when it is issued by the auditor unconditionally and without any reservation or opinion. Such report signifies that the audited financial statements give a true and fair view of the state of affairs of a company for the given period. In other words, a clean audit report is issued when (i) the accounts prepared are in conformity with normally accepted accounting principles, (ii) the transactions give a true recording of events, and (iii) all the disclosure requirements as per schedule VI of the Companies Act 1956 have been properly complied with.

Short Answer Questions :

Q. 1. What are the different types of audit report ?

Or, Indicate the 'types of opinion' that may be expressed in the auditor's report.

A. 1. The audit report may be of four types : (1) Unqualified or Clean. (2) Qualified, (3) Adverse, and (4) Disclaimer of opinion.

Q. 2. What are (i) Qualified opinion, (ii) Unqualified opinion, (iii) Disclaimer of opinion, and (iv) Adverse opinion expressed in the auditor's report ?

A. 2. (i) Qualified Opinion : An opinion that 'except for' or 'subject to' the effects of a specified matter that the financial statements present fairly financial position, results of operations, and changes in financial position in conformity with GAAP consistently applied. The specific matter may be :

1. Lack of sufficient competent evidence.
2. Restrictions on the scope of the audit.
3. Financial statements depart from GAAP.
4. GAAP not consistently applied.
5. Significant uncertainties affect the financial statements (SAS).

Note : The auditor, for some of these matters, may give an adverse opinion or disclaim an opinion. It is issued when the auditor concludes that his report can adequately disclose the effect of the limitation on scope disagreement, or uncertainty.

(ii) Unqualified Opinion : An opinion that the financial statements present fairly financial position, results of operations, and changes in financial position in conformity with the GAAP consistently applied.

Note : This type of opinion may be expressed only on the basis of an examination made in accordance with generally accepted auditing standards. It is issued when the auditor is satisfied in all material respects with the matters dealt with the 'Basic principles governing an audit'. The auditor's report should express this satisfaction in a clear and affirmative manner.

(iii) Disclaimer of Opinion : A statement that the auditor does not express an opinion on the financial statements. It is used when there is a scope limitation and may, if the auditor wishes, be used for an uncertainty.

The auditor disclaims his opinion when the possible effect on a limitation on scope or uncertainty is so material that he is unable to form an opinion on the financial statements taken as whole.

(iv) Adverse Opinion : An opinion that the financial statements do not present fairly financial position, results of operations, or changes in financial position in conformity with GAAP (SAS).

Note : It is issued when the effect of a disagreement is so substantially material that the auditor concludes that a 'qualification' is not adequate to disclose the misleading or incomplete nature of the financial statements.

CHAPTER 14

INVESTIGATION AND AUDIT

Learning Objectives : *After reading and carefully studying this chapter, the student should :*

- Be able to appreciate that 'investigation' is not similar to 'audit'.
- Be able to understand the investigation procedures under a variety of circumstances.

Q.14.1 : What is 'Investigation'? How does it differ from 'Audit'?

Or, "Investigation is a critical examination of records and therefore, is similar to an audit" Comment.

Ans. : *Investigation :* An examination of books and records preliminary to financing or for any specified purpose, sometimes differing in scope from the ordinary audit. The Companies Act, 1956 does not define the term. It only states about the circumstances when an investigation of a limited company should be carried out.

Thus, 'investigation' is not similar to 'audit' although the knowledge of full facts is necessary to both. The scope of investigation is even beyond the books and records of a company.

Difference between the two :

Investigation	**Audit**
1. It is not compulsory under the Companies Act.	1. It is compulsory under the Companies Act.
2. It can be undertaken by any person.	2. It is undertaken by a chartered accountant.
3. It is carried out on behalf of company directors, or other third parties, e.g., Bankers, Incoming partner, or Government.	3. It is carried out on behalf of the shareholders or proprietors of a business enterprise.
4. The period to be covered by it is not fixed and may extend to any number of years.	4. The period to be covered by it is fixed and extends to twelve months only.
5. Its purposes may be anything and depend on the requirements and/or circumstances, e.g., purchase or sale of business, merger, investment decisions, profitability or productivity analysis, misappropriation of cash or goods, manipulation of accounts, etc.	5. Its purposes are definite. Its purpose is to ascertain whether the proper books are maintained as required by law, and to see whether the balance sheet gives a true and fair view of the state of affairs as on a particular day and whether the Profit and Loss Account reflects a true and fair view of profit or loss for the year.
6. It takes into account the other facts and causative factors in addition to the books of accounts.	6. It is concerned with the examination of the books of account and related records only.

Q.14.2 : Enumerate the circumstances under which the Central Govt. may order 'investigation' of a limited company.

Ans. : *Investigation—under what circumstances :*

The Companies Act., 1956, under its Section 237, states the specific circumstances when the Central Government may order for investigation into the affairs of the limited companies. These are as follows :

1. When the shareholders numbering not less than two hundred or the members holding not less than one-tenth of the total voting power of the company submit an application for the purpose, in the case of a company having a share capital.

2. When the members not less than one-fifth of the persons on the company's register of members submit an application for the purpose, in the case of a company not having a share capital.

3. When the Register of companies submits a report for the purpose.

4. When a court declares by its order as such.

5. When a company adopts a special resolution for the purpose.

6. When the business of the company is being conducted with an intention to defraud its creditors, members or any other persons, or otherwise for a fraudulent or unlawful purpose, or in a manner oppressive to any of its members, or that the company was formed for any fraudulent or unlawful purpose.

7. When persons concerned with the formation of the company or the management of its affairs have in connection therewith been guilty of fraud, misfeasance or other misconduct towards the company or towards the members.

8. When members of the company have not been given all the information with respect to its affairs which they might reasonably expect, including information relating to the calculation of the commission payable to a managing director, director, or manager of the company.

It is to be noted that the order of the Central Government is not necessary when the investigation is carried out by the company itself or under the court's order.

Q.14.3 : Briefly indicate the points to which you would give attention when carrying out an investigation on behalf of a client with respect to : (A) Purchase of a running business, (B) Admission of a partner, (c) Loan to a company, (D) Valuation of 'goodwill', (E) Valuation of 'shares', and (F) Suspicion of 'fraud'.

Ans. : (A) *Purchase of a running business* : The following points should be looked into :

1. **Nature of business :** A limited company or a trading concern or a partnership business.

2. **Status of business :** Recently incorporated or an old one having an image in the market. Whether the shares are quoted in the Stock Exchanges.

3. **Accounting aspects :** The position of assets and liabilities, existence of various fixed assets and their values, existence of raw-materials and stores and finished goods and their values, value of investments, trend of sales and profits, age schedule of debtors, nature and types of contingent liabilities, contracts and agreements with the parties, etc. The study of important accounting ratios, such as Gross profit ratio, Net profit ratio, Return on Capital employed, Earnings per share, Dividend per share, Current ratio, Liquidity ratio, Stock turnover ratio, Cost ratios, Debtors/Creditors ratios, etc. for three to five years would also give indications as to the past performances for meaningful comparisons with those of other similar businesses in the same industry.

4. **Capital and organisation aspects :** The present structure (viz., authorised, issued, called-up and paid-up capital) and the reserve capital, if any; the rights of shareholders; accumulated reserves; rates of dividend declared for the past 3 to 5 years, etc.

(B) *Admission of a Partner* : The need for an investigation may arise both from (i) an incoming partner and (ii) existing partners. The following points should be investigated :

On behalf of an incoming partner :

1. Review of the existing partnership deed to ascertain as to the clause that may be unsuitable to a new partner.

2. The accounting aspects [as enumerated against A(3)].

3. The amount of goodwill to be brought in by a new partner and the basis of goodwill calculation. If the amount proposed by the existing partners is lumpsum, then a comparison should be made with the amounts calculated on the basis of super-profits, or certain year's purchase of average net or gross profits. In the latter case, the profit figure should

be checked from all aspects to ensure that it is not inflated.

4. Ascertaining as to whether goodwill will be retained in the partnership business, or utilised in paying off debts, or invested in other business, or taken away by the existing partners.

5. Review of the proposed profit sharing scheme with reference to the capital of other partners and also the future prospects of the business.

6. Ascertaining the role of the new partner if admitted, and examining the conditions as to salary, commission, etc.

On behalf of existing partners :

The investigation should be conducted more or less on the lines indicated above. But the investigating auditor should carry on his investigation to ascertain the extent of additional benefits that are likely to arise to the business and other partners on the admission of a new partner. He should, therefore, consider the following points :

1. The specific criteria and objectives for admission of a new partner; that is, whether for additional capital, new lines of business activities, special skill and knowledge of the new partner, excessive work load with the existing business, etc.

2. The probable impact on the affairs of the management, if a new partner is admitted.

3. The amount of goodwill that should be charged from the new partner and its uses.

4. The scheme of profit sharing among the partners.

(C) *Loan to a company* : Such loan to a company may be given by a bank or other parties. The investigating auditor on behalf of a client (bank or party) should consider the following points, among others :

1. The purposes for which a company requires the loan.

2. The terms of repayment of the loan, and the capacity of the company to fulfil them.

3. The nature and kind of securities pledged by the company for such loan and their status.

4. The nature and kind of assets including stores proposed to be hypothecated for such loan.

5. The borrowing powers of the company and the authorisation thereof in the articles and in the board's resolution of the company.

6. The financial position, the trend of operational activities in the recent past, the future projection of activities, the debtors/creditors position, the status of current liabilities and contingent liabilities, etc. of the company.

7. The information about the other loans, if any, taken by the company and the extent of arrears of repayment, if any.

8. The details of insurance policies and the risks covered and the present position regarding the payment of premiums.

9. The present position with respect to the payment of various taxes to the Government and the adequacy of the provision for taxation.

10. The position of the cash flow *vis-a-vis* the funds flow broken into several periods for the current year as well as for the next few years duly projected on the basis of action plans and programmes of the company.

(D) *Valuation of Goodwill* : The investigator should keep in mind that the following circumstances or events necessitate the valuation of goodwill :

(a) When a new partner is admitted.

(b) When a partner retires or dies.

(c) When the firm is sold to or amalgamated with another firm.

(d) When there is a change in the profit sharing ratio among the partners existing.

The investigating auditor should consider the following factors :

1. Nature of industry, its past performance with respect to profits and dividends and its future prospects.

2. The basis of valuation of assets and their values.

3. The general reputation of the company and its products and/or services.

4. The nature of management and the composition of the partners or directors, their integrity and skill.

5. The capital structure, the incidence of taxation, and the state of commercial and technical advantages possessed by the firm over others in the similar industry.

6. The method adopted for valuing goodwill. While checking the valuation methods, it is necessary to examine the following ;

Methods	Check-points
(a) Simple profit method— i.e., valuation based on certain number of years' purchase of the average profits of the past few years.	(a) Whether the following adjustments have been made while calculating average profits : (1) All actual expenses and losses not likely to occur in the future are added back to profits; (2) All profits likely to come in future are added; (3) Actual profits not likely to recur are deducted; (4) Expenses and losses expected to be borne in future are deducted.
(b) Super profit method— i.e., valuation based on the difference between future maintainable operating profit and normal profit.	(b) (1) Choice of normal rate of return for representative firms in the industry and determination of the amount of capital employed. (2) Whether the following adjustments have been made to arrive at the future maintainable profits (i) calculation of past average taxed earnings, (ii) projection of future maintainable taxed profits and (iii) preferential rights, and the manner in which these are determined.

[*Note :* The student are advised to go through this topic on 'Goodwill' discussed in the chapter on Assets and Liabilities — Verification and Valuation.]

(E) *Valuation of Shares :* The first and foremost thing for the investigating auditor should be to ascertain which of the following circumstances necessitate the valuation of shares :

(a) Assessments under the Estate duty, Gift tax or Wealth tax Acts ; (b) Conversion of share (i.e., preference to equity, etc.) ; (c) Purchase of shares; (d) Formulation of amalgamation or absorption schemes ; (e) Compensation to the shareholders on the acquisition of shares by the Government ; (f) Proposal to sanction on the security of shares ; (g) Acquisition of shares under the reconstruction scheme, etc.

He should also consider the following points :

1. Whether the shares are quoted or unquoted.

2. Whether the shares relate to a private limited company.

3. Whether there is a direction from the court.

4. Whether a large block of shares is under transfer.

5. Whether the articles of association of a company so provide.

6. Whether the method adopted for valuation has taken into account the pertinent factors, like earning capacity, value of assets employed, value of goodwill, the trends of profits and dividends, etc., and whether the data on them have been considered with reference to the audited accounts.

(F) *Suspicion of Fraud :* Broadly, there are three types of fraud—misappropriation of cash, misappropriation of goods; and manipulation of accounts. Because of the variety of items, the investigator should be aware that the procedure of investigation would vary in content and depth.

Misappropriation of Cash : The investigating auditor, when entrusted with this task, should bear in mind that this type of fraud generally involves either or all of the cases, such as cash received but not recorded or recorded for a shorter amount, cash paid against false bills or vouchers, fictitious entries in records etc. He should, therefore, consider the following points :

1. The systems of cash receipts and disbursements, and cash sales and purchases, and the existence of internal checks at various stages.

2. The separation of duties and incompatible functions, e.g., an employee who receives and deposits cash and cheque should not prepare sales invoices or reconcile bank accounts; an authorised cheque-signer should not approve vouchers for payment.

3. Testing cash transactions with a 'block reconciliation' for a selected period to obtain the proof of cash.

['Block reconciliation' involves the steps like : (a) Confirm with bank and trace to ending balance on previous month bank statement and beginning balance on current month bank statement. (b) Trace to current month bank statement and authenticated deposit slip. (c) Obtain or prepare a list of outstanding cheques : determine whether each cheque on list (i) cleared with current month bank statement (by examination of cancelled cheque) or (ii) was listed as outstanding at the end of the current month. (d) Compare with general ledger or cash book. (e) Prepare a list of deposit from bank statement and note the date of each deposit. (f) Prepare a list of deposits from cash book and note the date of each deposit. (g) Compare these two lists between (e) and (f) and investigate any significant delays between dates. (h) Trace to cut-off bank statement and authenticated deposit slip. (i) Prepare and total a list of cancelled cheques included in the bank statement. (j) Perform bank reconciliation. (k) Prepare and total a list of disbursements from cash book and (i) account for serial numbers of all cheques cleared during the month for signatures and (iii) compare with the cash book as to date, number, payee and amount. (1) Confirm with bank and trace to ending balance on current month bank statement and beginning balance on cut-off bank statement.]

4. The systems of maintaining petty cash.

5. The systems of authorisation with respect to withdrawals (by partners); advances paid and adjustments; payments of commission, discounts, 'duplicate' bills, 'proforma' invoices, donations and charities, etc.

Misappropriation of Goods : The investigating auditor should consider the following points in particular :

1. The systems of internal accounting and administrative control with regard to the production and/ or receipts and despatches of goods.

2. The systems of record keeping and its adequacy.

3. The systems of authorisation with respect to receipts, issues, transfers and returns of all goods including the internal check and control of all relevant documents.

4. The procedures adopted for the issue of free samples to customers and of goods for internal use and captive consumption in the manufacture of other goods or in the assembly of other final products.

Manipulation of Accounts : The following points should be looked into by an investigating auditor :

1. The stock-in-trade and the valuation thereof. Whether the methods of valuation are proper and consistent from period to period.

2. The internal accounting controls associated with administrative routines with respect to purchases, sales, disposals and transfers of various goods and the payment of wages to a large number of workmen.

3. The rates and amounts of depreciation charged in the accounts. Whether the method is followed consistently from period to period, and in accordance with the applicable laws.

4. The appropriateness of the allocation of capital and revenue expenditure in the accounts, and whether the accounting policy in this regard is consistently followed.

5. The valuation of all assets and liabilities and their consistent application, and the criteria chosen for revaluation of assets as a matter of policy.

6. Inter-company transactions and the transactions relating to the personal expenses of the directors or other officers with a view to checking their admissibility or otherwise.

Q.14.4 : If you are asked by a bank, which proposes to lend a large sum of money to an existing business, to make investigation of the accounts of that business, state briefly how would you do so ?

Ans. : See Q. 14. 3 (C).

Q.14.5 : Mr. Gobinda Ray wants to join Chowdhury Brothers as a partner. He requests you to carry out an investigation into business on his behalf.

Indicate the points to which you will pay special attention before you can give a favourable report to Mr. Gobinda Ray in this connection.

Ans. : See Q. 14. 3 (B) — On behalf of an incoming partner.

CHAPTER 15

RECENT TRENDS IN AUDITING

Learning objectives : *After reading and carefully studying this chapter, the student should :*

- Acquaint himself with the nature and significance of
  - Cost audit • Management audit • EDP audit
  - Tax audit • Social audit • Environment audit
- Know about
  - Accounting Standards (AS) • Standard Auditing Practices (SAP) • Audit Committee & functions

Q.15.1: Define and explain the concept of 'Cost Audit'.

Ans. : *Definitions :*

1. "Cost audit is the verification of the correctness of cost accounts and of the adherance to the cost accounting plan." [ICMA Termmology.]

2. "Cost audit is an audit of efficiency, of minute details of expenditure while the work is in progress and not postmortem examination. Cost audit is mainly a preventive measure, a guide for management policy and decision, in addition to being a barometer of performance." [ICWA].

Thus, cost audit comprises :

(1) Verification of the accuracy of the cost accounts in so far as the cost ascertainment of processes, production, or services, or products are concerned, and (2) Check on the adherance to the detailed systems of cost accounting and its related records and documents, either through own initiation of business concern or on the issuance of an order for cost audit by the Central Govt. under the provisions contained in the Indian Company Law.

This audit when introduced under the strength of a statute or law is called Statutory Cost Audit. The Institute of Cost and Works Accountants of India defines Statutory Cost Audit as a "system of audit introduced by the Government of India for the review, examination, and appraisal of the cost accounting records and added information required to be maintained by specified industries."

Concept : The ICWAI's definition of Cost audit is much wider in its concept and scope than that of ICMA. The ICWAI's definition puts emphasis on the evaluation of the efficiency of operations and the propriety of management actions and decisions and executive policies and programmes. In this sense, cost audit is synonymous with efficiency audit as it ensures that every rupee invested in the concern gives the optimum return, and further ensures the balancing of investments between different functions so as to give optimum results.

The concept of cost audit also includes propriety audit as it seeks to highlight the cases where the company's funds have been used in a negligent or inefficient manner and the factors which could have been controlled but have not been done resulting in increase in the cost of production.

Q.15.2: Discuss the purposes of Cost Audit.

Ans. : *Purposes :* The purposes of cost audit are :

1. To see that the cost accounting principles have been properly followed in the maintenance of cost accounts records in the manner and in the forms as prescribed under the relevant Cost Accounting Records Rules.

2. To compare historical or actual costs with those attainable under efficiency audit.

3. To examine earning, efficiency or inefficiency of the organisation and optimise the use of resources

—national, financial, physical, and human, and to achieve the rated capacity of the organisation.

4. To institute cost consciousness.

5. To facilitate inter-firm comparison of costs, selling price fixation, tariff rate determination.

6. To ensure, in the sense of propriety and efficiency :

(a) Whether the planned expenditure would give optimum results.

(b) Whether the size and channels of expenditure were designed to produce best results, and

(c) Whether the return on the capital employed could or could not be improved by adopting some alternative plan of action.

Q.15.3: Discuss the objects of Cost Audit.

Ans. : The objects of cost audit are two-fold ; viz., (A) General objects, and (B) Social objects.

(A) **General Objects** of Cost audit are :

1. To detect the errors of principle of cost accounting, and frauds that are usually made in cost records.

2. To verify the adequacy of the books of account and records relating to cost.

3. To arrive at the value of work-in-progress and closing stock of finished goods as accurately as possible.

4. To verify that the cost records have been duly reconciled periodically with the financial books of account so as to ensure accuracy.

5. To verify that the total cost of each product, process, operation and job is ascertained accurately.

6. To verify the inter-company transaction via records showing the details of contracts in respect of : (i) purchase and sale of raw materials, process materials, components, etc. (ii) utilisation/supply of plant facilities and consultancy services on administration, technical, managerial, etc., with a view to determining the reasonableness or otherwise of the rates charged or paid.

7. To verify the statistical statements and other data furnished to the Central Excise, and Directorate of Technical Development, etc., so as to see that these are reconciled.

8. To assist the management by highlighting deficiencies or inefficiencies in the use of material, labour, and machines.

9. To compare historical costs with those attainable under efficiency audit.

10. To prevent undesirable practices on the part of the management and thus, exercise control on the whole of the expenditure by thorough analysis of the productive and non-productive factors.

11. To advise the management for the adoption of alternative courses of action by preparing cost plan, especially in regard to : rectification of general imbalance in production facilities, fuller utilisation of installed capacity, budgetary control system, inventory policies, key limiting factors causing production bottlenecks.

(B) **Social Objects** of Cost audit are to protect the interest of shareholders, stopping erosion of the value of capital, production of quality products at reduced prices, control of inflation, and overall improvement of socio-economic structure by higher productivity and higher national income, etc.

The aforesaid objectives can be achieved in the manner stated below :

1. *Increasing productivity* : Efficient management of material and labour and optimum utilisation of installed capacities increase productivity. Cost audit brings to light these factors and so aids the management and the Govt. to bring about improvements of the existing economic condition of the country.

2. *Price fixation and price control mechanism* : The Govt.'s Order to conduct cost audit acts as a counter-weight to monopolistic attitude of certain industries to increase commodity prices. The role of the Bureau of Industrial Costs and Prices in studying the cost structure in fixing the prices in the right direction benefits the society.

3. *Cost consciousness in both public and private sectors* : Compulsory maintenance of cost accounting records is also applicable to the public sector companies. Cost audit creates cost consciousness in respect of the use of national, physical, financial and human resources in these sectors of economy.

4. *Identifying uneconomic product lines* : Cost audit, aimed at locating uneconomic product, gives a

clue to the industry to divert their resources into productive and remunerative channels which in turn serves the society.

5. *Guard against evasion of tax :* Cost audit ensures correct valuation of the work-in-progress and stock-in-trade, and eliminates the tendencies of inflating costs and reporting least profit of the business. So, "The interest of the Government regarding the payment of correct taxes by the industry are also taken care of in the process."

6. *Benefits to consumers :* ICWAI observes, "Cost audit aims at increasing the added value through increased profitability per unit of input or resources. This added value can be shared by all the participants and certainly part of the benefit may reasonably be expected to be passed down to the consumer by way of reduced prices."

7. *Foreign exchange earnings :* In a foreign market, the products are highly competitive as to both quality and price. Application of marginal costing technique either to accept or to reject or to improve uneconomic line of operation calls for a more reliable and sophisticated data .Cost audit can ensure such data as these are authenticated by a cost auditor.

8. *Employment generation :* Effective utilisation of men, materials, and money generates surpluses giving scope for new investment opportunities, and thus, benefits the society for new employment opportunities.

Thus, it can be concluded that cost audit is a part of social audit and it serves not only the national objectives of conserving productive resources for further expansion of economy and employment but also the social objective of making available to the consumer manufactured products at reasonable prices.

Q.15.4: (a) Explain the concept of management Audit. (b) Discuss the scope of Management Audit.

Ans. : (a) *Concept :*

Management audit may be defined as the systematic and dispassionate examination, analysis, and appraisal of management's overall performance. It takes into account both financial and non-financial factors including economic environment, their effect on the administration and goals of the business organisation. It is essentially a procedure or a form of appraisal of the total performance of the management by means of an objective and comprehensive examination of the organisation structure, its components such as department, its plans and policies, methods of process or operation and controls, and its use of physical facilities and human resources. Thus, management audit signifies critical assessment of management of the enterprise from the broadest possible point of view. The thrust of this audit is, therefore, on evaluation with appropriate analysis for improvement of contribution towards industrial development.

In this regard, George A. Terry states : "The planning, organising, actuating and controlling compared to what might be called the norm of successful operation is the essential meaning of management audit. It reviews the company's past, present and future. The areas the company covers are examined with a view to determine whether the company is achieving maximum results out of its endeavours".

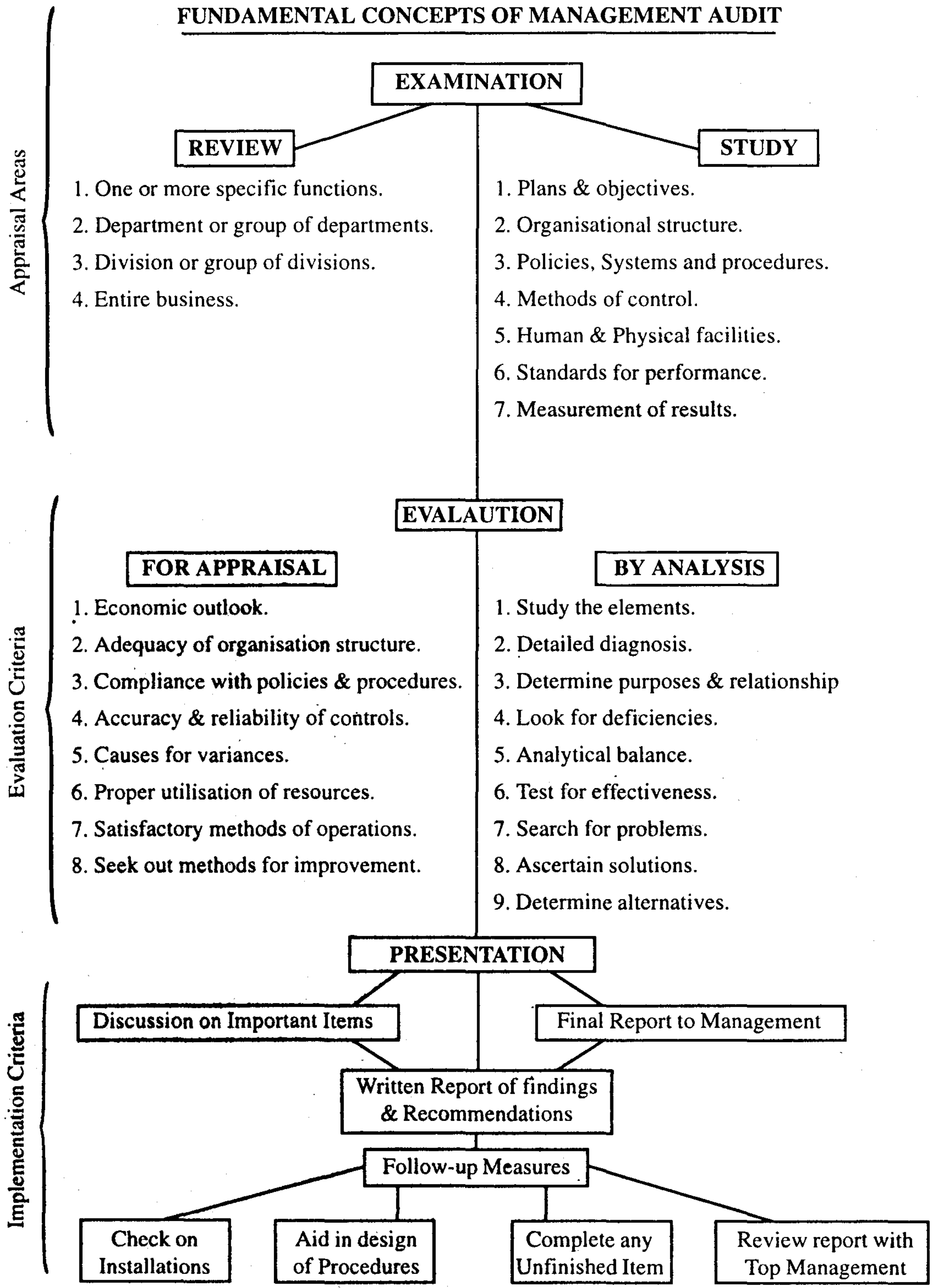
Quotes :

1. Management audit concerns itself with the whole field of activities of the concern, from top to bottom, starting, as always, where management control is concerned, from the top, because we are primarily concerned with where the general management is functioning smoothly and satisfactorily.— T. G. Rose.

2. Management audit may be defined as a comprehensive and constructive examination of an organisation structure of a company, institution, or branch of Government, or of any component thereof, such as a division or department, and its plans and objectives, its means of operation and its use of human and physical facilities. —Willam P; Leonard.

3. Management audit is an informed and constructive analysis, evaluation and series of recommendations regarding the broad spectrum of plans, processes, people and problems of an economic entity.—Campfield.

In a schematic diagram :



(b) *Scope :*

The scope of management audit can be as broad as the management process itself. If the term 'scope' implies spheres for action, then it is concerned with the whole field of activities of a business concern from top to bottom of a managerial hiararchy. In this context, Campfield outlines a few scope as below :

1. *Studying the prescribed organisation* : Renewing formal organisation structure, personal inter-relationships, policies, procedures, information systems and flows, and decision centers in order to determine what management has established as optimum arrangements for running an entity.

2. *Evaluating the 'live-entity'* : Determining such problems as what operating people are really trying to accomplish, the schedules and routines they have established to attain objectives, and a measure of the results achieved in the light of predetermined goals and standards of performance.

3. *Searching for profit inhibitors* : Uncovering poor organisational structuring and responsibility assignment, break-downs in operations, programming and work flow, inadequate and ineffective communication, evaluation and measurement, and disclosing results that fall significantly below established standards.

Since the concept of management audit requires the appraisal and assessment of total organisation or management processes and examines in depth the functioning of the system and its performance, its scope is synonymous with the appraisal areas identified by the American Institute of Management. These are as follows :

1. *Economic function vis-a-vis social responsibility* : This involves appraising the public esteem value of the company in relation to different interests like shareholders, employees, creditors, distributors, consumers, and the community in which it operates.

2. *Corporate structure* : The appraisal is made through testing measures like flow of information, span of supervision, authority relations, and centralisation/decentralisation of authority.

3. *Health of earnings* : This requires appraising the extent to which the resources have realised the profit in real and tangible terms.

4. *Service to shareholders* : The assessment is made mainly on three basic criteria : (a) Risk minimisation to investment, (b) Reasonable return on investment, and (c) Reasonable appreciation of capital over a period of time.

5. *Research and development* : The extent to which these activities carried on in the past was successful in the company's past progress and was contributory to the future development.

6. *Analysis of the Board of Directors* : The assessment on three fundamental elements, viz., (a) quality of each Director and his contribution, (b) team work, and (c) trusteeship role.

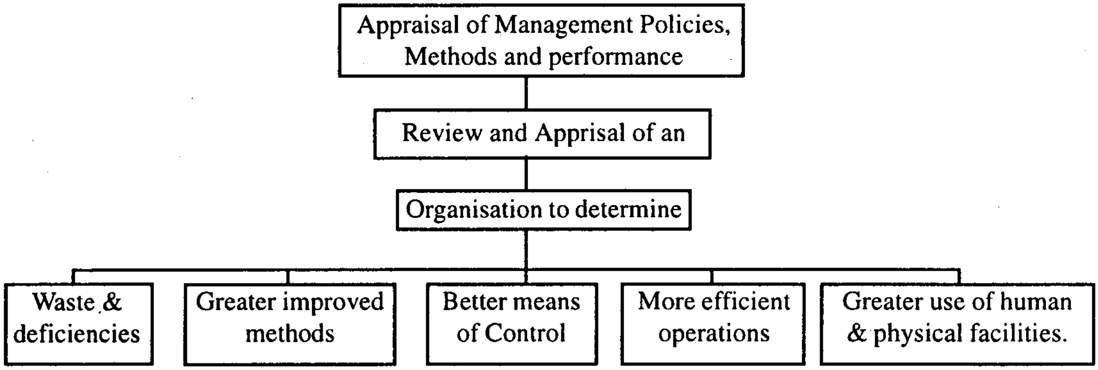
7. *Fiscal and financial policies* : The evolution of capital management system, dividend policy, fiscal policy and controls, and their application in different areas of corporate activity.

8. *Production efficiency* : The evaluation of the management sub-systems relating to materials, labour, waste control, machinery, production policy and the achievements in terms of quantity and quality.

9. *Sales vigour* : The measurement and evaluation of the criteria, such as : (a) development of sales personnel, (b) attainment of past sales potentials, and (c) current sales policies to realise further sales potential.

10. *Executive evaluation* : The assessment of personnel qualities as being elements for business leaders, e.g., ability, industry, and integrity.

The scope of management audit can be expressed by a chart below :



Q.15.5 : Suggest and enumerate the 'appraisal areas' that should occupy the attention of the management audit team.

Ans. : See. Ans. to Q. 15.4 (Last part : Appraisal areas identified by the American Institute of Management).

Q.15.6: Explain the concept of Social Audit, and identify the main objectives for which such audit should be undertaken.

Ans. : *Concept :*

The meaning and content of 'Social Audit' are synonymous with that of social responsibility accounting. The term 'social audit' is understood in different connotatious by different scholars to include various practices, such as :

1. Inventory of 'social programmes' undertaken by a company and of their 'social impacts'.

2. Estimates in terms of money of various company activities having 'special social significance'.

3. Results of surveys on environmental pollution, employment discrimination, occupational health and safety, etc., undertaken at the instance of the Govt.'s regulatory measures.

4. Critical reports of surveys made on an area external to a company or industry, for example, sexual discrimination, caste discrimination, etc.

"Social auditing is defined as a systematic attempt to identify, analyse, measure (if possible), evaluate and monitor the effect of an organisation's operations on society (that is, specific social groups) and on the public well-being". [According to Blake, Fredick and Myers].

Social audit via social responsibility accounting may, therefore, be defined as a systematic assessment of and reporting on those parts of the activities of the company that have a social impact. A firm should earn a satisfactory profit no doubt but it must also assume its social responsibility as a member of society. The concept of social audit via social responsibility is, thus, a counter-weight to that of an enterprise's profit.

Objectives :

The main objectives of which the social audit should be undertaken are :

1. To identify and measure the periodic net social contribution of an individual firm, which includes not only the costs and benefits internalised to the firm, but also those arising from externalities affecting different social segments.

2. To help determine whether an individual firm's plans, strategies and practices that directly affect the relative resources and earnings are consistent with social principles.

3. To make available in an optimum manner to all social commitments, relevant information on a firm's objectives, ultimate goals, policies, programmes, performances and contributions to the social goals. Relevant information is that which should provide for a scheme of public accountability and public decision-making regarding capital choices and social resources allocation.

Q.15.6 : (a) What is meant by Tax Audit ? (b) Mention the main categories of Tax Audit. (c) Who can be a Tax Auditor ?

Ans. : Tax Audit : Various Sections of the Income Tax Act of 1961 make it obligatory for assessees to have their accounts prepared for tax purposes, duly audited by chartered Accountants.

(b) **Main categories :**

(1) *Compulsory Tax Audit* : Section 44AB of the Income Tax Act of 1961 regulates this audit. This audit is compulsory for accounts (relating to a previous year) in case of every person carrying on business or profession and having sales turnover or gross receipts of Rs. 40 lakhs for business, Rs. 10 lakhs for profession, as the case may be.

(2) *Special Tax Audit* : Sections 142 (2A) and 142(2D) of the Income Tax Act of 1961 regulate this audit. If an income tax officer, in course of any proceedings before him, is of the view having regard to the nature and complexily of the assessee's accounts and the interests of revenue that is necessary to do so, he may, with the prior approval of the Commissioner of Income Tax, direct the assessee to get his accounts audited by a chartered accountant nominated by the Commissioner of Income Tax and furnish a report of such audit.

This is in addition to the compulsory tax audit under section 44AB.

(3) *Other Tax Audits* : Various Sections of the Income Tax Act provide for such audits. Some of them are given below.

Section of I.T. Act	Subject matter
50B	Computation of capital gains on slump sale.
80HHB(3)	Deduction relating to profits from eligible foreign projects.
80HHF	Deduction in respect of exports of film/television/TV news/telecast /software and software rights.

Detailed rules prescribed under the I.T. Act guide these audits.

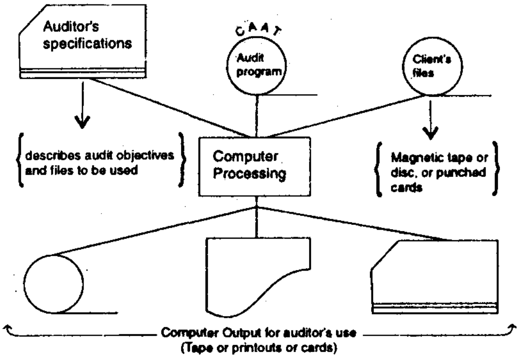
(c) **Tax Auditor :** A chartered accountant in practice or persons qualified under Sec. 226(2) of the Companies Act can act as auditors of companies for tax audit purposes.

Q.15.7: What do you understand by : Computer-Assisted Audit Techniques (CAATs) ?

Ans. : (A) *Computer-Assisted Audit Techniques :*

The overall objectives, scope and standard of an audit do not undergo any change when an audit work is performed in an EDP environment. The standard for evaluation of control procedures for audit purpose is equally applicable to the activities done under an EDP equipment as is expected for the activities under the manual or mechanical systems. The only difference is that the auditor, in the course of the application of his auditing procedures in an EDP environment, should have to consider some methods or techniques (other than those usually adopted in manual or mechanical systems) so as to use the computer as an audit tool. These various uses of the computer by an auditor for the development and application of techniques suitable to him and to the circumstances are known as 'Computer-Assisted Audit Techniques' (CAATs). In other words, the expression means and concerns itself to those auditing techniques that take assistance of a computer for being applied to an audit in an EDP environment. The application of Computer Assisted Audit Techniques assumes its importance especially when there is absence of input documents or the lack of a visible 'audit trail' in the performance of compliance and substantive audit procedures. The uses of CAATs, thus, improve the effectiveness and efficiency of auditing procedures that are necessary in an EDP environment. These techniques can be applied to a computer of any type or size although some special considerations relating to small business computer environments might be necessary. In other words, audit techniques have to be tailored to suit the particular EDP system in operation.

Although adequate knowledge and training are necessary to apply CAATs in actual audit practice, the concepts can be illustrated in chart and narrative form. The following diagram shows the generalised operational method, altough individual systems differ from one audit firm to the other.



Q.15.8 : Enumerate the audit functions that are capable of being performed by a generalised computer audit programme.

Ans. : The following audit functions can be performed by a generalised computer audit programme :

(1) Test of details of transactions and balances for example, the use of audit software to test all (or a sample) of the transactions in a computer file; Scanning or examining computer records for exceptional or unusual characteristics and obtaining lists of (say): accounts receivable balances over the credit limit, unusually large inventory balances, unusual payroll situation (i.e., excessive overtime); checking Payroll/Interest/Depreciation calculations.

(2) Analytical review procedures for example, the use of audit software to identify unusual fluctuations or items; Comparing data on different records of files and listing unusual or irregular results, such as comparing accounts receivable master file balances between two dates with accounts receivable debits and credits contained in detailed transaction files between the same dates : Selecting and obtaining various samples, such as fixed assets changes, inventory items, items from the Income Statement; Preparing various analyses and demanding certain accounts, viz., trial balances, accounts receivables and inventory turnover, debtor's aging schedules, etc.

(3) Compliance tests of general EDP controls-for example, the use of test data to test access procedures to the programme libraries.

(4) Compliance tests of EDP controls-for example, the use of test data to test the functioning of a programmed procedure.

Q.15.9 : Why are special audit techniques employed by the auditor to verify the computer-based records ?

Ans. : *Computer-based Records—Why special audit techniques :*

In a computerised recording and accounting system the greatest problem, the auditor is confronted with, is in the missing 'audit trails' and in keeping a track of the calculations made inside the computer which ultimately result in output documents. Normally once the input data have been fed into a computer, the auditor does not know what will go on inside the computer. He can only expect to obtain the output and try to relate input data—which is not very often possible because of the transformation. Further, the auditor not being present always in EDP premises to watch the stages of processing must have to have a satisfactory audit on the actual data procesing system in operation. He also needs evidence with which he can evaluate computer—based records. For this, he has to make use of special audit techniques called 'computer-assisted audit techniques'(CAATs).

Q.15.10 : (a) What is meant by : Environment Audit ? (b) Give an outline of Environment Audit Report ?

Ans. : (a) *Environment Audit :* All industries seeking authorisation under the Air, Water, and Environmental Protection Acts are required to effect environmental audit on an annual basis and submit the report in the prescribed form under the Environment Protection Rules to the State Pollution Control Board.

(b) *Environmental Audit Report :* Outline.

The report specifies various details of pollutants and wastes, pollution control measures, investment proposals for environment protection, abatement of pollution, etc.

The Report contains nine parts. Of them, main parts are stated as below :

Part B : Water and Raw material consumption during the current year/previous year for each of the products and per unit of product.

Part C : Pollution generated, pollutants-wise (e.g., air, water) quantity and percentage variation from prescribed standards with reasons.

Part D : Hazardous Wastes from process / pollution control facilities, quantity during the current year / previous year.

Part E : Solid wastes from process / pollution control facilities / recycling, quantities during the current year / previous year.

Part F : Disposal practices as to hazardous / solid wastes.

Part G : Impact of pollution control measures.

Part H : Additional investment proposal for environment protection.

Part I : Abatement of pollution.

Q.15.11 : What is 'Special Audit' under the Companies Act.

Ans. : *Special Audit* : It is one that is conducted (i) under the specific directions of the Central Government, and (ii) under Section 233A of the Companies Act, 1956 in certain cases. The Central Government appoints either a chartered accountant in practice (as defined in the Chartered Accountants Act, 1949) or the company's auditor himself to conduct such special audit. This special audit is ordered by the Central Government in any of the following circumstances :

1. When the affairs of the company are not managed in accordance with sound business principles.

2. When the company is managed in a manner likely to cause serious injury or damage to the interest of the trade, industry or business to which it pertains.

3. When the financial position of the company is such as to endanager its solvency.

Q.15.12 : Distinguish between 'Statements' and 'Guidance Notes' issued by the Institute of Chartered Accountants of India (ICAI).

Ans. : *Statements' and Guidance Notes' issued by the ICAI* : 'Statements refer to those issued by the ICAI on accounting and auditing matters including the 'statements' on 'standard auditing practices'. Their purposes are to secure compliance by the members on matters which are critical for the proper discharge of their functions. Thus, the 'statements' are mandatory and the auditors while discharging their attest function are duty-bound to (1) examine whether the statements on accounting matters have been complied with in the presentation and disclosure of financial statements, and (2) ensure that the 'statements' on auditing matters have been followed in the audit of financial information. In the case of non-performance in accordance with such statements, the auditor's report should indicate as to material departures.

The examples of 'Statements' are : Statements on : Payments of Auditors for other services, Qualification in Auditor's Report, Responsibility of joint Auditors, Treatment of retirement Gratuity in Accounts, Accounting for Foreign Currency Translation, etc.

'Guidance Notes' are in the nature of recommendations issued by the ICAI. These are designed primarily to provide guidance to members on matters which may arise in the course of their professional work and on which they may require assistance in resolving problem issues. Thus, these are not mandatory like 'statements', and the auditors should consider these guidance notes in relation to the circumstances of each case.

The ICAI, however, has pointed out that the following 'Guidance Notes' should be considered as mandatory :

(i) Treatment of Interest on Deferred payments, and

(ii) Provision for Depreciation in respect of Extra or Multiple Shift Allowance.

Q.15.13 : (a) What is meant by : Accounting Standards ? (b) State their importance. (c) What are the sources of existing Accounting Standards ? (d) Briefty state the statutory/legal provisions regarding formulation and enforcement of Accounting Standards.

Ans. : (a) Accounting Standards : These are a sort of professional guidelines. These are legal mandates for presentation of and/or measuring monetary transactions or transformations and financial statements in a harmonious, credible, comparable, and acceptable manner.

Financial statements based on duly established accounting standards ensure more readily acceptable, and meaningful disclosure of information for diverse groups of users, such as shareholders, investors, financiers, stock exchanges, employees, government, taxation authorities and the general public.

(b) Importance : With the increasing trend of globalisation of business and capital markets, the need for globally acceptable and comparable accounting standard has assumed greater significance. As such, the financial statements prepared in accordance with the Accounting Standards are more easily comparable with global annual accounts.

This is of particular importance for a developing country like India intending to expand business globally.

(c) Sources : The main sources of Indian Accounting Standards are :

(1) *International Accounting Standards (IAS) :* These aim at ensuring world wide uniformity in financial accounting and reporting. These are formulated by the International Accounting Standards Committee (IASC), constituted in 1973 as the independent body authorised by its member bodies including India. These standards are adopted by the European Economic Council (EEC), Australia and many Asian Countries.

(2) *National Accounting Standards :* Developed and formulated by professional accounting bodies of many countries including India based on IAS and/or US GAAP, these are likely to be eventually integrated as internally feasible and acceptable common base.

(3) *US Standards :* Compliance with US GAAP is mandatory for business firms in U.S.A. Selective and judicious application of US GAAP may help Indian firms in promoting business in U.S.A.

(d) Statutory enforcement :

According to the Section 211 of the Companies Act of 1956, 'Accounting Standards' mean standards recommended by the Institute of Chartered Accountant of India (ICAI) and as may be prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards (NACAS) set up under Section 210 A of the said Act.

Till such prescription by the NACAS, the standards issued by the ICAI shall be deemed to be the prescribed Accounting Standards. The NACAS will give advice and recommendations to the Central Government on formulation of accounting standards for adoption by the companies or class of companies. The NACAS shall comprise a chairperson being a person of eminence in the sphere of accountancy, finance, business administration, business law, economics or similar subjects and Members representing diverse interest groups viz., the three Statutory Professional Institutes of Chartered Accountants, Cost and Works Accountants, and Company Secretaries of India, Central Government, Reserve Bank of India, Comptroller and Auditor General of India, present or former Professor of Accountancy, Finance, business management from an University or deemed University, The Central Board of Direct Taxes, The Securities and Exchange Board of India (SEBI), and Chambers of Commerce and Industry.

Section 211 of the Companies Act also stipulates that every Profit & Loss Account and every Balance Sheet of a company has to comply with prescribed Accounting Standards and any deviation therefrom has to be disclosed together with reasons and financial effects, if any.

Q.15.14 : Explain the Role of Securities and Exchange Board of India (SEBI) in regard to 'Accounting Standards'.

Ans. : The Malegaon Committee of the SEBI, after due consideration of the subject of accounting standards, has advised that in many areas Indian Accounting Standards were comparable with the International Accounting Standards in both coverage and content. Yet, there was urgent need for additional accounting standards in some areas.

The SEBI Committee recommended the following additional accounting standards :

(1) Consolidated Financial Statements for all Subsidiaries : This is for a company holding 51% or more of share capital.

(2) Segment Reporting : This is with respect to multiple business and/or product lines.

(3) Disclosure and Treatment of related party transactions.

(4) Treatment and disclosure of deferred taxation.

The Malegaon Committee further recommends that there should be uniform accounting norms or standards for (a) the Capital Market and its intermediaries, and (b) valuation methods on Net Assets Value (NAV) of Mutual Funds.

Q.15.15 : (a) What is meant by : 'Standard Auditing Practices' (SAP) ? (b) What are their sources ? (c) What are their objectives ?

Ans. : **(a) Standard Auditing Practices (SAPs)** : The SAPs are those auditing practices (also termed 'auditing standards') that have been issued by the Institute of Chartered Accountants of India (ICAI) for general acceptance and global recognition— for being followed by the auditors and accounts examiners, where independent examination of published accounts or financial statements is necessary. These SAPs have to consider the recognised policies and principles, relevant legal provisions, prevailing custom and usage, business environment and accepted Accounting Standards.

(b) Sources : The two primary sources of the SAPs are :

(1) *The International Auditing Practices Committee (IAPC)*, constituted by the International Federation of Accountants (IFAC), of which ICAI is a member—to formulate International Auditing Guidelines (IAG).

(2) *National level Auditing Practices Committee*, formed by the ICAI. It considers IAG's of the IAPC while formulating the SAPs.

(c) Objectives : The objectives of SAPs are to ensure general acceptance and uniform application of auditing practices/standards by all independent auditors of published financial statements with a view to assuring users of such statements or reports about results, financial position and changes thereto, if any.

Of the twenty two SAPs, SAPs 1 to 20 are all mandatorily to be followed by the practising Chartered Accountants.

Q.15.16 : (a) What is meant by : Audit Committee ? (b) What are its main functions ? (c) State the provisions of the Companies Act relating to Audit Committees.

Ans. : (a) Audit Committee : It is a committee or sub-group of the full Board of Directors of a company, formed for overseeing and monitoring — on behalf of the Board — preparation of meaningful financial statements and reports, relying on the senior-level finance manager, internal auditors, and external auditors.

The composition of an audit committee depends on relevant provisions / requirements of the regulatory authority like SEBI and the Companies Act.

(b) Main Functions : An Audit Committee's basic function is to act as a catalyst for efficient and transparent financial reporting and as a bridge between the Board of Directors, Internal Auditors, and External Auditors.

The major functions of an audit committee include :

(i) Overseeing the process of financial reporting and disclosure of financial information to ensure correct, adequate, and reliable financial statements;

(ii) reviewing draft annual financial statements with reference, inter alia, to changes in accounting policies and practices, compliance with 'going concern' assumption, accounting standards, legal and stock exchange requirements, qualifications in the draft form of the Auditors' report before submission to the Board;

(iii) discussing with management and the internal and/or external auditors the adequacy or otherwise of internal control and internal audit systems, important findings of the internal auditors and follow-up actions thereon; and

(iv) Checking material defaults, statutory or otherwise.

(c) Company Law Provisions : The new Section 292A (introduced in the year 2000) of the Companies Act contains the provisions relating to Audit Committee. These are summarised below :

(1) Every public company having a paid-up capital of Rs. 5 crores or more must constitute an audit committee.

(2) The audit committee shall comprise a minimum of three directors and such other number of directors as the Board may determine; two-thirds of the total number of members of such a committee must be directors other than the managing or whole-time directors. The members shall elect a chairperson of the committee from among themselves.

(3) The committee shall act according to the terms of reference set in writing by the Board. The auditor, the internal auditor (if any), and the director-in-charge of Finance, must attend and participate at meetings of the committee without any voting rights. The committee should interact periodically with the auditors about internal control systems, scope of audit including the auditor's observations, review half-yearly and yearly financial statements before submission to the Board and also ensure compliance with internal control systems.

(4) The committee is empowered to probe into any matter specified in the terms of reference, and for that purpose, to have full access to information contained in the company's records, and if required, external professional expert advice.

(5) The audit committee's recommendations on financial management and audit report shall be binding on the Board. The Board must record reasons for non-acceptance of such recommendation, if any, and communicate the same to shareholders.

(6) The annual report of the company must disclose the composition of the audit committee.

(7) The chairperson of this committee must attend the company's annual general meeting (AGM) to provide any clarification on matters regarding the audit.

APPENDIX

APPENDIX 1 TO CHAPTER 15

A note on the Accounting Standards (formulated by the Institute of Chartered Accountants of India) that guide and regulate the Auditing Practices in India.

The Institute has so far issued twentyeight definitive accounting standards.

A brief description of the first ten accounting standards issued by the Institute is given in the following paragraphs :-

Accounting Standard-1 : Disclosure of Accounting Policies. The purpose of this standard is to promote better understanding in the preparation and presentation of financial statements by establishing the disclosure of significant accounting policies and changes therein the financial statements and the manner of doing so. The Standard describes 'going concern', 'consistency' and 'accrual' as the fundamental accounting assumptions in the preparation and presentation of financial statements. In selection of accounting policies by an enterprise the primary consideration as per the standard is that the financial statements should give a 'true and fair view'. 'Prudence', 'substance over form' and 'materiality' have been identified in the standard as the other major considerations governing selection and application of accounting policies.

Accounting Standard-2 : Valuation of Inventories. The standard seeks to narrow differences in the current practices and to ensure adequate disclosure of inventories in the financial statements. It advises that inventories should be valued at lower of historical cost and net realisable value. It recommends that historical cost of inventories should normally be determined by using 'FIFO', 'LIFO' and 'average cost' formulae. The net realisable value in the standard has been defined as the actual estimated selling price in the ordinary course of business, less cost of completion and cost necessarily to be incurred in order to make the sale.

Accounting Standard-3 : Cash Flow Statements. This statement reflects the changes in financial position and summarises for a given period the sources and applications of funds of an enterprise. The standard recommends that such a statement should be published along with annual accounts though in India there is no legal requirement to publish such a standard to provide information relating to the movement of funds within the enerprise during the year and their consequent effect on its financial position.

Accounting Standard-4 : Contingencies and Events occuring after the balance sheet date. The standard recommends that amount of a contingent loss should be provided for a charge in the income statement on satisfaction of specified condition(s). In case the specified condition(s) is/are not met, the existence of a contingent loss should be disclosed in the financial statements. It also recommends that assets and liabilities should be adjusted for events occuring after the balance sheet date that provide additional evidence to assess the estimation of amounts relating to conditions existing at the balance sheet date.

Accounting Standard-5 : (Revised) Net Profit or Loss for the period, Prior Period and Extra-ordinary items and changes in Accounting Policies. The standard recognises that items which are non-recurring in nature require special consideration. It recommends that prior-period and extra-ordinary items should be separately disclosed in the income statement of the current year together with their nature and amount, and in a manner that their impact on the current income statement can be perceived. It explains the circumstances when a change in an accounting policy should be made. It also recommends that impact and adjustments of such change, if material, should be quantified and disclosed in the financial statements of the period in which such change is made.

Accounting Standard-6 : Depreciation accounting. The standard makes recommendations concerning the accounting treatment of such issues as allocation of depreciable amount, estimation of useful life of a depreciable asset, change is depreciation policy, change of historical cost of a depreciable asset, revaluation of depreciable assets, etc.

Accounting Standard-7 : Accounting for Construction Contracts. The feature which characterises a construction contract dealt with in this standard is the fact that the date at which the contract is secured and the date when the contract activity is completed fall into different accounting periods. The standard recognises and recommends two alternative methods, namely, the percentage of completion method and the completed contract method in accounting for construction contracts. The standard explains the essential ingredients of these two methods and deals with the method of disclosue of the accounting policy adopted by a construction enterprise.

Accounting Standard-8 : Accounting for Research and Development. The standard recommends items of costs which should be included in the reseach and development costs and their treatment in the financial statements. It lays down the criteria which should be satisfied to defer research and development costs to future periods, the accounting treatment for the deferred research and development costs and the disclosure requirements in this regard.

Accounting Standard-9 : Revenue Recognition. The standard is mainly concerned with the timing of recognition of revenue in the income statement of an enterprise. It lays down the conditions to recognise revenue from sale of goods, rendering of services and the use by others of enterprise's resources yielding interest, royalties and dividends. It explains that when uncertainties exist regarding the determination of the amount or its associated costs, these uncertainties may influence the timing of revenue recognition. The standard recommends that an enterprise should also disclose the circumstances in which revenue recognition has been postponed, pending the resolution of significant uncertainty.

Accounting Standard-10 : Accounting for Fixed Assets. The standard recognises the fact that fixed assets often comprise a significant portion of the total assets of an enterprise, and therefore, are important in the presentation of financial position. Furthermore, the criteria as to whether an expenditure represents an asset or an expense can have a material effect on an enterprise's reported results of operations. The standard makes recommendations concerning determination of book value of a fixed asset under various situations, accounting treatment of gains or losses on fixed asset(s), disclosure requirements regarding the fixed assets, etc.

Other Accounting Standards :

The other Accounting Standards, issued by the Institute of Chartered Accountants of India (ICAI), are listed below.

Accounting Standard No.	Subject matter
11.	Accounting for the Effects of changes in Foreign Exchange Rates.
12.	Accounting of Government Grants.
13.	Accounting for Investments.
14.	Accounting for Amalgamations.
15.	Accounting for Retirement Benefits in the Financial Statements of Employers.
16.	Borrowing costs.
17.	Segment Reporting.
18.	Related Party Disclosures.
19.	Leases.
20.	Earnings per Share.
21.	Consolidated Financial Statements.
22.	Accounting for Taxes on Income.
23.	Accounting or Investments for Associates in Consolidated Financial Statements.
24.	Discontinuing Operations (Recommendatory).
25.	Interim Financial Reporting.
26.	Intangible Assets (for listed/unlisted companies with Turnover above 500 crores and for other companies).
27.	Financial Reporting for interests in Joint Venture-Domestic or Foreign.
28.	Valuation of Fixed Assets based on Net Recoverable or Net Realisable Value being less than the carrying amount or net book value, the reduction from book value being recognised as impairment loss and shown as an expense.

The Accounting Standards 1, 4, 5, 7 to 11 and 22 are mandatory.

APPENDIX 2 TO CHAPTER 15

List of Standard Auditing Practices (SAP), as recommended by the Auditing Practices Committee (APC) of the Institute of Chartered Accountants of India.

The Institute has so far issued twentytwo definitive Standard Auditing Practices (SAP). These are binding on its members.

SAP No.	Subject-matter
1.	Basic principles governing an Audit, *viz.*, inter alia, integrity, independence, confidentiality, competence and skills; audit planning and evidence; accounting system and internal control; conclusions and reporting.
2.	Objective and scope of Audit (including responsibility for financial statements).
3.	Documentation (including, inter alia, working papers; permanent and current audit files; ownership and custody).
4.	Fraud and Error (including risks, responsibilities for detection and reporting).
5.	Audit Evidence.
6.	Study and Evoluation of Accounting System and Related Internal Controls in Connection with an Audit (including, inter alia, objectives and limitations, communication of weaknesses).
7.	Relying on work of internal Auditor (including, inter alia, scope and objectives, relationship with external auditor, general and specific evaluation of internal audit work).
8.	Audit planning (including, inter alia, developing overall plan and audit programme based on knowledge of client's business).
9.	Using the work of an Expert.
10.	Using the work of another Auditor.
11.	Representations by management.
12.	Responsibility of Joint Auditors.
13.	Audit Materiality.
14.	Analytical Procedures.
15.	Audit Sampling.
16.	Going Concern.
17.	Quality control for Audit work.
18.	Audit of Accounting Estimates.
19.	Subsequent Events.
20.	Knowledge of the Business.
21.	Consideration of Laws and Regulations in an audit of financial statements.
22.	Initial Engagement—opening balances.

Note : The SAPs 1 to 20 have been made mandatory as on 1.4.2000. Besides, the following Statements are also mandatory :

(a) Statement on Auditing Practices.

(b) Statement on Payments to Auditors for other services.

(c) Statement on Companies (Auditor's Report) Order, 2003.

(d) Statement on Qualifications in Auditor's report.

(e) Statement on Amendments to Schedule VI to the Companies Act.

STATUTORY FORMS OF FINAL ACCOUNTS

1. COMPANIES ACT, 1956

SCHEDULE VI

(SEE SECTION 211)

[1] PART 1

A FORM OF BALANCE SHEET

[2] The Balance Sheet of a company shall be either in horizontal form or vertical form

A. HORIZONTAL FORM

Balance sheet of .... [Here enter the name of the Company]

As at .... [Here enter the date as at which the balance sheet is made out]

Instruction in accordance with which liabilities should be made out	*LIABILITIES* *Figures for the previous year Rs. (b)*	*Figures for the current year Rs. (b)*	*ASSETS* *Figures for the previous year Rs. (b)*	*Figures for the current year Rs. (b)*	*Instruction in Accordance with which assets should be made out*
*Terms of redemption or conversion (if any), of any redeemable preference capital to be stated, together with earliest date of redemption or conversion. +Particulars of any option on unissued share capital to be specified. +Particulars of the different classes of preference shares to be given. [1][Specify the source from which bonus shares are isued, e.g., capitalisation of profits or reserves or from Share Premium Account.] [+Any capital profit on reissue of forfeited shares should be transferred to Capital Reserve.	***SHARE CAPITAL** Authorised ... shares of Rs. ... each. +Issued (distinguishing between the various classes of capital and stating the particulars specified below, in respect of each class) ..... shares of Rs. .....each. Subscribed (distinguishing between the various classes of Capital and stating the particulars, specified below in respect of each class). (c) ..... shares of Rs. .... each. Rs. .... called up. Of the above shares .... shares are allotted as fully paid-up pursuant to a contract without payments being received in cash. [2][Of the above shares .... shares are allotted as fully paid-up by way of bonus shares*]		***FIXED ASSETS** Distinguishing as far as possible between expenditure upon (a) goodwill, (b) land (c) buildings (d) lease-holds, (e) railway sidings, (f) plant and machinery, (g) furniture and fittings, (h) development of property, (i) patents, trade-marks and designs, (j) livestock and (k) vehicles, etc.		*Under each head the original cost and the additions thereto and deduction therefrom during the year. and total depreciation written-off or provided up to the end of the year to be stated. [1][Where the original cost aforesaid and additions and deductions thereto, relate to any fixed asset which has been acquired from a country outside India, and in consequence of a change in the rate of exchange at any time after the acquisition of such asset, there has been an increase or reduction in the liability of the company, as expressed in Indian currency, for making payment towards the whole or a part of the cost of the asset or for repay-

[1] Substituted by Act No. 65 of 1960, Section 217.

[2] Inserted by Notification No. GSR 220(E), dated 12.3.1979.

Instruction in accordance with which liabilities should be made out	LIABILITIES Figures for the previous year Rs. (b)	Figures for the current year Rs. (b)	ASSETS Figures for the previous year Rs. (b)	Figures for the current year Rs. (b)	Instruction in Accordance with which assets should be made out
	Less : Calls unpaid : [3][(i) By managing agent or secretaries and treasurers and where the managing agent or secretaries and treasurers are a firm, by the partners thereof, and where the managing agent or secretaries and treasurers are a private company by the directors or members of that company.] (ii) By directors. (iii) By others. [2][+*Add* : Forfeited shares (amount originally paid up)].				ment of the whole or a part of moneys borrowed by the company from any person, directly or indirectly, in any foreign currency specially for the purpose of acquiring the asset (being in either case the liability existing immediately before the date on which the change in the rate of exchange takes effect), the amount by which the liability is so increased or reduced during the year, shall be added to, or, as the case may be, deducted from the cost, and the amount arrived at after such addition or deduction shall be taken to be the cost of the fixed asset. *Explanation* 1 : This paragraph shall apply in relation to all balance sheets that may be made out as at the 6th day of June 1966, or any day thereafter and where, at the date of issue of the notification of the Government of India, in the Ministry of Industrial Development and Company Affairs (Department of Company Affairs), G.S.R. No. 129, and the 3rd day of January, 1968, any balance sheet, in relation to which this paragraph applies, has already been

Instruction in accordance with which liabilities should be made out	*LIABILITIES* Figures for the previous year Rs. (b)	Figures for the current year Rs. (b)	*ASSETS* Figures for the previous year Rs. (b)	Figures for the current year Rs. (b)	*Instruction in Accordance with which assets should be made out*
					made out and laid before the Company in Annual General Meeting, the adjustment referred to in this paragraph may be made in the first balance sheet made out after the issue of the said notification. **Explanation 2 :** In this paragraph, unless the context otherwise requires, the expressions "rate of exchange", "foreign currency" and "Indian currency" shall have the meanings respectively assigned to them under sub-section (1) of Section 43A of the Income Tax Act, 1961 (43 of 1961), and *Explanation 2 and Explanation 3* of the said sub-section shall, as far as may be, apply in relation to the said paragraph as they apply to the said sub-section (1). [1][In every case where the original cost cannot be ascertained, without unreasonable expense or delay, the valuation shown by the books shall be given. For the purpose of this paragraph, such valuation shall be the net amount at which an asset stood in the company's books at the commencement of this Act after deduction of the amounts previously provided or written-off

Instruction in accordance with which liabilities should be made out	*LIABILITIES* Figures for the previous year Rs. (b)	Figures for the current year Rs. (b)	*ASSETS* Figures for the previous year Rs. (b)	Figures for the current year Rs. (b)	*Instruction in Accordance with which assets should be made out*
					for depreciation or diminution in value, and where any such asset is sold, the amont of sale proceeds shall be shown as deduction.] Where sums have been written-off on a reduction of capital or a revaluation of assets, every balance sheet, (after the first balance sheet) subsequent to the reduction or revaluation shall show the reduced figures and with the date of the reduction in place of the original cost. Each balance sheet for the first five years subsequent to the date of the reduction, shall show also the amount of the reduction made. Similarly, where sums have been added by writing up the assets, every balance sheet subsequent to such writing up shall show the increased figures with the date of the increase in place of the original cost. Each balance sheet for the first five years subsequent to the date of writing up shall also show the amount of increase made. [1][*Explanation* : Nothing contained in the preceding two paragraphs shall apply to any adjustment made in accordance with the second paragraph.]

Instruction in accordance with which liabilities should be made out	*LIABILITIES* *Figures for the previous year Rs. (b)* / *Figures for the current year Rs. (b)*	*ASSETS* *Figures for the previous year Rs. (b)* / *Figures for the current year Rs. (b)*	*Instruction in Accordance with which assets should be made out*
	RESERVES AND SURPLUS	**INVESTMENTS**	
*Additions and deductions since last balance sheet to be shown under each of the specified heads. The word "fund" in relation to any "Reserve" should be used only where such Reserve is specifically represented by earmarked investments.	[2](1) Capital Reserves. (2) Capital Redemption Reserve. (3) Share Premium Account *(cc)*. (4) Other Reserves specifying the nature of each Reserve and the amount in respect thereof. *Less :* Debit balance in profit and loss account (if any) *(h)*. [(5) Surplus *i.e.*, balance in proit and loss account after providing for proposed allocations, namely : Dividend, Bonus or Reserves. (6) Proposed additions to Reserves. (7) Sinking Funds.]	Showing nature of investments and mode of valuation., for example, cost or market value and distinguishing between : *(1) Investments in Government or Trust Securities. *(2) Investments in shares, debentures or bonds (showing separately shares fully paid-up and partly paid-up and also distinguishing the different classes of shares and showing also in similar details investments in shares, debentures or bonds of subsidiary companies (3) Immovable properties. [1][(4) Investments in the capital of partnership firms.] [2][(5) Balance of unutilised monies raised by issue.]	*Aggregate amount of company's quoted investment and also the market value thereof shall be shown. Aggregate amount of company's unquoted investments shall also be shown. [1][All unutilised monies out of the issue must be separately disclosed in the Balance Sheet of the company indicating the form in which such unutilised funds have been invested.]
		CURRENT ASSETS, LOANS AND ADVANCES : **A. CURRENT ASSETS**	
	SECURED LOANS :		
3[Loans from Directors 4[* * *] Manager should be shown separately. Interest accrued and due on Secured Loans should be included under the appropriate sub-heads under the head.	*(1) Debentures+ *(2) Loans and Advances from Banks. *(3) Loans and Advances from subsidiaries. *(4) Other Loans and Advances.	(1) Interest accrued on Investments. ++(2) Stores and spare parts : [5][(3) Lose Tools] ++(4) Stock-in-trade **(5) Works-in-Progress. +(6) Sundry debtors : (a) Debts outstanding for	++Mode of valuation of stock shall be stated and the amount in respect of raw material shall also be stated separately where practicable. ** Mode of valuation of works-in-progress shall be stated.

Instruction in accordance with which liabilities should be made out	*LIABILITIES* Figures for the previous year Rs. (b)	Figures for the current year Rs. (b)	*ASSETS* Figures for the previous year Rs. (b)	Figures for the current year Rs. (b)	*Instruction in Accordance with which assets should be made out*
Secured Loans The nature of he security to be specified in each case. Where loans have been guaranteed by[1][* * *] Managers and/or directors, a mention thereof shall also be made and also the aggregate amount of such loans under each head. +Terms of redemption or conversion (if any) of debentures issued to be stated together with earlier date of redemption or conversion.			a period exceeding six months. (b) Other debts.[2] *Less :* Provision (7A) Cash balance on hand. (7B) Bank balances : (a) with Scheduled Banks, and (b) with others.		+In regard to Sundry Debtors particulars to be given separately of — (a) debts considered good and in respect of which the company is fully secured; and (b) debts considered good for which the company holds no security other than the debtor's personal security; and (c) debts considered doubtful or bad. Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member to be separately stated. [1][Debts due from other companies under the same management within the meaning of sub-section (1B) of Section 370, to be disclosed with the names of the companies. The maximum amount due by directors or other officers of the company at any time during the year to be shown by way of a note. The [1][Provisions to be shown under this head should not exceed the amounts of

Instruction in accordance with which liabilities should be made out	*LIABILITIES*		*ASSETS*		*Instruction in Accordance with which assets should be made out*
	Figures for the previous year Rs. (b)	*Figures for the current year Rs. (b)*	*Figures for the previous year Rs. (b)*	*Figures for the current year Rs. (b)*	
					debts stated to be considered doubtful or bad and any surplus of such [2][provision if already created. should be shown at every closing under "Reserves and Surplus" (in the liabilities side) under a separate sub-head "Reserve for Doubtful or Bad Debts"]. [4][*In regard to bank balances, particulars to be given separately of : (a) the balances lying with Scheduled Banks on current accounts, call accounts and deposit accounts; (b) the names of the bankers other than Scheduled Banks and the balance lying with each such banker on current accounts, call accounts and deposit accounts and the maximum amount outstanding at any time during the year from each such banker; and (c) the nature of the interest, if any, of any director or his relative or 1[* * *] in each of the bankers (other than Scheduled Banks) referred to in (b) above.] [2][All unutilised monies out of the issue must be separately disclosed in the Balance Sheet of the

Instruction in accordance with which liabilities should be made out	*LIABILITIES*		*ASSETS*		*Instruction in Accordance with which assets should be made out*
	Figures for the previous year Rs. (b)	*Figures for the current year Rs. (b)*	*Figures for the previous year Rs. (b)*	*Figures for the current year Rs. (b)*	

+[1][Loans from directors, 2[* * *] manager should be shown separately. Interest accrued and due on Unsecured Loans should be included under the appropriate sub-heads under the head "Unsecured Loans".]
+Where loans have been guaranteed by 4[* * *] managers and/or Directors, mention thereof shall also be made and also aggregate amount of such loans under each head.
*See note (d) at foot of Form
[The name(s) of the small scale industrial undertaking(s) to whom the company owe any sum together with interest outstanding for more than thirty days, are to be disclosed.]
The period for which the dividends are in arrear or if there is more than one class of shares, the dividends on each such class are in arrear, shall be stated.
The amount shall be stated before deduction of income tax, except that in the case of tax-free dividends the amount shall be shown free of income tax and the fact that it is so shown shall be stated.
The amount of any guarantees given by the company on behalf of Directors or other officers of the company shall be stated and, where practicable, the general nature and amount of each such contingent liability, if material, shall also be specified.

UNSECURED LOANS

(1) Fixed Deposits.
+(2) Loans and Advances from subsidiaries.
+(3) Short Term Loans and Advances :
(a) From Banks
(b) From others
(4) Other Loans and Advances :
(a) From Banks
(b) From others

Current Liabilities and Provisions

A. Current Liabilities

[1][(1) Acceptances.
(2) Sundry creditors

[1][(i) Total outstanding dues of small scale industrial undertaking(s); and
(ii) Total outstanding dues of creditors other than small scale industrial undertaking(s).]

(3) subsidiary companies.
(4) Advance payments and unexpired discounts for the portion for which value has still to be given e.g., in the case of the following classes of companies : Newspaper, Fire Insurance, Theatres, Clubs, Banking, Steamship Companies, etc.
(5) Unclaimed Dividends
(6) Other Liabilities (if any)
(7) Interest accrued but not due on loans.

B. PROVISIONS

1[(8) Provision for taxation.
(9) Proposed dividends.
(10) For contingencies.
(11) For provident fund scheme
(12) For insurance, pension and similar staff benefit schemes.
(13) Other provisions.]

A footnote to the balance sheet may be added to show separately :
(1) Claims against the company not acknow-ledged as debts.
(2) Uncalled liability on shares partly paid.
++(3) Arrears of fixed cumulative dividends.
(4) Estimated amount of contracts remaining to be executed on capital account and not provided for.
+(5) Other money for which the company is contingently liable.

B. Loans and Advances

(8)[3][(a) Advances and loans to subsidiaries]
[5][(b) Advances and loans to partnership firms in which the company or any of its subsidiaries is a partner]
(9) Bills of Exchange
(10) Advances recoverable in cash or in kind or for value to be received, e.g., Rates, Taxes, Insurance, etc.
[1][(11) * * *]
(12) Balance with Customs, Port Trust, etc. (where payable on demand).

MISCELLANEOUS EXPENDITURE

(to the extent not written-off) [2][or adjusted] :
(1) Preliminary expenses.
(2) Expenses including commission or brokerage on underwriting or subscription of shares or debentures
(3) Discount allowed on the issue of shares or debentures.
(4) Interest paid out of capital during construction (also stating the rate of interest).
(5) Development expenditure not adjusted.
(6) Other items (specifying nature)

company indicating the form in which such unutilised funds have been invested.]
*The above instructions regarding "Sundry Debtors" apply to "Loans and Advances" also.
1[+Show here the debit balance of profit and loss account carried forward after decuction of the uncommitted reserves, if any.]

General Instructions for preparation of Balance Sheet

(a) The information required to be given under any of the items or sub-items in this Form, if it cannot be conveniently included in the balance sheet itself, shall be furnished in a separate Schedule or Schedules to be annexed to and to form part of the balance sheet. This is recommended when items are numerous.

(b) Naye Paise can also be given in addition to Rupees, if desired.

(c) In the case of [1][subsidiary companies] the number of shares held by the holding company as well as by the ultimate holding company and its subsidiaries must be separately stated.

The auditor is not required to certify the correctness of such shareholdings as certified by the management.

[(cc) The item "Share Premium Account" shall include details of its utilisation in the manner provided in Section 78 in the year of utilisation.]

(d) Short Term Loans will include those which are due for not more than one year as at the date of the balance sheet.

(e) Depreciation written-off or provided shall be allocated under the different asset heads and deducted in arriving at the value of Fixed Assets.

(f) Dividends declared by subsidiary companies after the date of the balance sheet [1][should not be included] unless they are in respect of period which closed on or before the date of the balance sheet.

(g) Any reference to benefits expected from contracts to the extent not executed shall not be made in the balance sheet but shall be made in the Board's report.

[2][(h) The debit balance in the Profit and Loss Account shall be shown as a deduction from the uncommitted reserves, if any.]

(i) As regards Loans and Advances, [3][amounts due by the Managing Agents or Secretaries and Treasurers, either severally or jointly with any other persons to be separately stated;] 4[the amounts due from other companies under the same management within the meaning of sub-section (1B) of Section 370 should also be given with the names of the companies] the maximum amount due from everyone of these at any time during the year must be shown.

(j) Particulars of any redeemed debentures which the company has power to issue should be given.

(k) Where any of the company's debentures are held by a nominee or a trustee for the company, the nominal amount of the debentures and the amount at which they are stated in the books of the company shall stated.

[5](l) A statement of investments (whether shown under "Investment" or under "Current Assets" as stock-in-trade) separately classify-

1. Substituted by Notification No. GSR 414, dated 21.3.1961.
2. *Ibid.*
3. Reference to managing agent, secretaries and treasurers redundant after abolition of the system by Act. 17 of 1969 w.e.f. 3.4.1970.
4. Substituted by Notification No. GSR 414, dated 21.3.1961.
5. Substituted by Notification No. 494(E), dated 30.10.1973.

ing trade investments and other investments should be annexed to the balance sheet, showing the names of the bodies corporate (indicating separately the names of the bodies corporate under the same management) in whose shares or debentures, investments have been made (including all investments, whether existing or not, made subsequent to the date as at which the previous balance sheet was made out) and the nature and extent of the investment so made in each such body corporate, provided that in the case of an investment company that is to say, a company whose principal business is the acquisition of shares, stock, debentures or other securities, it shall be sufficient if the statement shows only the investments existing on the date as at which the balance sheet has been made out. In regard to the investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given in the statement.

(m) If, in the opinion of the Board, any of the current assets, loans and advances have not a value on realisation in the ordinary course of business at least equal to the amount at which they are stated, the fact that the Board is of that opinion shall be stated.

(n) Except in the case of the first balance sheet laid before the company after the commencement of the Act, the corresponding amounts for the immediately preceding financial year for all items shown in the balance sheet shall be also given in the balance sheet. The requirement in this behalf shall, in the case of companies preparing quarterly or half-yearly accounts, etc., relate to the balance sheet for the corresponding date in the previous year..

(o) The amounts to be shown under Sundry Debtors shall include the amounts due in respect of goods sold or services rendered or in respect of other contractual obligations but shall not include the amounts which are in the nature of loans or advances.

[6](p) Current accounts with directors, [7][* * *] and Manager, whether they are in credit or debit, shall be shown separately.]

[8](q) A small scale industrial undertaking has the same meaning as assigned to it under clause (j) of Section 3 of the Industries (Development and Regulation) Act, 1951.]

6. Substituted by Notification No. GSR 414, dated 21.3.1961.

7. Reference to managing agent, secretaries and treasurers redundant after abolition of the system by Act. 17 of 1969 w.e.f. 3.4.1970.

8. Inserted by Notification No. GSR 129(E), dated 22.2.1999.

Part 1 *(Contd.)*

B. VERTICAL FORM

Name of the Company ....

Balance Sheet as at ....

	Schedule No.	*Figures as at the end of current financial year*	*Figures as at the end of previous financial year*
1. Sources of funds :			
(1) Shareholders' funds			
(a) Capital			
(b) Reserves and Surplus			
(2) Loan funds			
(a) Secured loans			
(b) Unsecured loans			
Total :			
II. Applications of Funds :			
(1) Fixed assets			
(a) Gross block			
(b) Less depreciation			
(c) Net block			
(d) Capital work-in-progress			
(2) Investments			
(3) Current assets, loans and advances :			
(a) Inventories			
(b) Sundry debtors			
(c) Cash and bank balances			
(d) Other current assets			
(e) Loans and advances			
Less :			
Current liabilities and provisions :			
(a) Liabilities			
(b) Provisions			
Net current assets.			
(4) (a) Miscellaneous expenditure to the extent not writen-off or adjusted			
(b) Profit and Loss Account			
Total :			

[1] Inserted by Notification No. GSR 220(E), dated 12.3.1978.

Notes :

1. Details under each of the above items shall be given in separate Schedules. The Schedules shall incorporate all the information required to be given under A — Horizontal Form — read with notes containing general instructions for preparation of balance sheet.

2. The Schedules, referred to above, accounting policies and explanatory notes that may be attached shall form an integral part of the balance sheet.

3. The figures in the balance sheet may be rounded off to the nearest '000' or '00' as may be convenient or may be expressed in terms of decimals of thousands.

4. A foot-note to the balance sheet may be added to show separately contingent liabilities.

Part II

Requirements as to Profit and Loss Account

1. The provisions of this Part shall apply to the income and expenditute account referred to in sub-section (2) of Section 210 of the Act, in like manner as they apply to a profit and loss account, but subject to the modification of references as specified in that subsection.

2. The profit and loss account —

   (a) shall be so made out as clearly to disclose the result of the working of the company during the period covered by the account; and

   (b) shall disclose every material feature, including credits or receipts and debits or expenses in respect of non-recurring transactions or transactions of an exceptional nature.

3. The profit and loss account shall set out the various items relating to the income and expenditute of the company arranged under the most convenient heads; and, in particular, shall disclose the following information in respect of the period covered by the account :

(i) [1][(a) The turnover, that is, the aggregate amount for which sales are effected by the company, giving the amount of sales in respect of each class of goods dealt with by the company, and indicating the quantities of such sales for each class separately.]

[2][(b) Commission paid to sole selling agents within the meaning of Section 294 of the Act.

(c) Commission paid to other selling agents.

(d) Brokerage and discount on sales, other than the usual trade discount.]

[3][(ii) (a) In the case of manufacturing companies :

(1) The value of the raw materials consumed, giving itemwise break-up and indicating the quantities thereof. In this break-up, as far as possible, all important basic raw materials shall be shown as separate items, The intermediates or components procured from other manufacturers may, if their list is too large to be included in the break-up, be grouped under suitable headings without mentioning the quantities, provided all those items which in value individualy account for 10 percent or more of the total value of the raw material consumed shall be shown as separate and distinct items with quantities thereof in the break-up.

(2) The opening and closing stocks of goods produced, giving break-up in respect of each class of goods and indicating the quantities thereof.

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1. Substituted by Notification No. GSR 494(E), dated 30.10.1973.
2. Substituted by Notification No. GSR 414, dated 21.3.1961.
3. Substituted by Notification No. 494(E), dated 30.10.1973.

(b) In the case of trading companies, the purchases made and the opening and closing stocks, giving break-up in respect of each class of goods traded in by the company and indicating the quantities thereof.

(c) In the case of companies rendering or supplying services, the gross income derived from services rendered or supplied.

(d) In the case of a company, which falls under more than one of the categories mentioned in (a), (b) and (c) above, it shall be sufficient compliance with the requirements herein if the total amounts are shown in respect of the opening and closing stocks, purchases, sales and consumption of raw material with value and quantitative beak-up and the gross income from services rendered is shown.

(e) In the case of other companies, the gross income derived under different heads.

Note 1.– The quantities of raw materials purchases, stocks, and the turnover shall be expressed in quantitative denominations in which these are normally purchased or sold in the market.

Note 2.– For the purpose of items (ii) (a), (ii) (b) and (ii) (d), the items for which the company is holding separate industrial licences shall be treated as separate classes of goods but where a compay has more than one industrial licence for production of the same item at different places or for expansion of the licensed capacity, the item covered by all such licences shall be treated as one class. In the case of trading companies, the imported items shall be classified in accordance with the classification adopted by the Chief Controller of Imports and Exports in granting the import licences.

Note 3.– In giving the break-up of purchases, stocks and turnover, items like spare parts and accessories, the list of which is too large to be included in the break-up, may be grouped under suitable headings without quantities, provided all those items, which in value individually account for 10 percent or more of the total value of the purchases, stocks, or turnover, as the case may be, are shown as separate and distinct items with quantities thereof in the break-up.]

(iii) In the case of all concerns having works-in-progress, the amounts for which [1][such works have been completed] at the commencement and at the end of the accounting period.

(iv) The amount provided for depreciation, renewals or diminution in value of fixed assets.

If such provision is not made by means of a depreciation charge, the method adopted for making such provision.

If no provision is made for depreciation, the fact that no provision has been made shall be stated [1][and the quantum of arrears of depreciation computed in accordance with Section 205(2) of the Act shall be disclosed by way of a note].

(v) The amount of interest on the company's debentures and other fixed loans, that is to say, loans for fixed periods, stating separately the amount of interest, if any, [2][paid or payable] to the managing director [3][* * *] and the manager, if any.

(vi) The amount of charge for Indian income tax and other Indian taxation on profits, including, where practicable, with Indian income-tax any taxation imposed elsewhere to the extent of the relief, if any, from Indian income-tax and distinguishing, where practicable, between income-tax and other taxation.

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1. Substituted by Act 65 of 1960, Section 217
1. Inserted by Notification No. GSR 414, dated 21.3.1961.
2. Inserted by Act 65 of 1960, Section 217
3. Reference to managing agent, secretaries and treasurers redundant after abolition of the system by Act 17 of 1969 with effect from 3.4.1970.

(vii) The [4][amounts reserved for—]

(a) repayment of share capital; and

(b) repayment of loans.

(viii) (a) The aggregate, if material, of any amounts set aside or proposed to be set aside, to reserves, but not including provisions made to meet any specific liability, contingency or commitment known to exist at the date as at which the balance sheet is made up.

(b) The aggregate, if material, of any amounts withdrawn from such reserves.

(ix) (a) The aggregate, if material, of the amounts to set aside to provisions made for meeting specific liabilities, contingencies or commitments.

(b) The aggregate, if material, of the amounts withdrawn from such provisions, as no longer required.

(x) Expenditure incurred on each of the following items, separately for each item–

(a) Consumption of stores and spare parts.

(b) Power and fuel.

(c) Rent.

(d) Repairs to buildings.

(e) Repairs to machinery.

(f) (1) Salaries, wages and bonus.

(2) Contribution to provident and other funds.

(3) Workmen and staff welfare expenses [5][to the extent not adjusted from any previous provision or reserve.

Note. [1][1]– Information in respect of this item should also be given in the balance sheet under the relevant provision or reserve account.]

Note.2 [* * *]

(g) Insurance.

(h) Rates and taxes, excluding taxes on income.

(i) Miscellaneous expenses :

[3][Provided that any item under which the expenses exceed one percent of the total revenue of the company or Rs. 5,000, whichever is higher, shall be shown as a separate and distinct item against an appropriate account head in the Profit and Loss Account and shall not be combined with any other item to be shown under Miscellaneous Expense'.]

(xi) (a) The amount of income from investments, distinguishing between trade investments and other investments.

(b) Other income by way of interest, specifying the nature of the income.

(c) The amount of income-tax deducted if the gross income is stated under sub-paragraphs (a) and (b) above.

(xii) (a) Profits or losses on investments [4][showing distinctly the extent of the profits and losses earned or incurred on account of membership of a partnership firm] [5][to the extent not adjusted from any previous provision or reserve.

Note. Information in respect of this item should also be given in the balance sheet under the relevant provision or reserve account.]

(b) Profits or losses in respect of transactions of a kind, not usually undertaken by the company or undertaken in circumstances

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1. Submitted by Notification No. GSR 414, dated 21.3.1961.
2. Inserted by Act 65 of 1960, Section 217
1. Note renumbered as Note 1 by Notification No. 1665, dated 9.10.1971.
2. Omitted by Notification No. SO. 723 (E), dated 18.9.1990.
3. Inserted by Notification No. GSR 494(E), dated 30.10.1973.
4. *Ibid.*
5. Inserted by Act 65 of 1960, Section 217.

of an exceptional or non-recurring nature, if material in amount.

(c) Miscellaneous income.

(xiii) (a) Dividends from subsidiary companies.

(b) Provisions for losses of subsidiary companies.

(xiv) The aggregate amount of the dividends paid, and proposed, and stating whether such amounts are subject to deduction of income-tax or not.

(xv) Amount, if material, by which any items shown in the profit and loss account are affected by any change in the basis of accounting.

[6][4 The profit and loss account shall also contain or give by way of a note detailed information, showing separately the following payments provided or made during the financial year to the directors (including managing directors), [7][***] or manager, if any, by the company, the subsidiaries of the company and any other person —

(i) managerial remuneration under Section 198 of the Act paid or payable during the financial year to the directors (including managing directors). [1][***] manager, if any :

(ii) [2][***];

(iii) [3][***];

(iv) [4][***];

[5][(vi) other allowances and commission including guarantee commission (details to be given)];

(vii) any other perquisites or benefits in cash or in kind (stating approximate money value where practicable);

(viii) pensions, etc. :

(a) pensions,

(b) gratuities,

(c) payments from provident funds, in excess of own subscriptions and interest thereto,

(d) compensaion for loss of office.

(e) consideration in connection with retirement from office.]

4A. The profit and loss account shall contain or give by way of a note a statement showing the computation of net profits in accordance with Section 349 of the Act with relevant details of the calculation of the commissions payable by way of percentage of such profits to the directors (including managing directors), [6][***] or manager (if any).

4B. The profit and loss account shall further contain or give by way of a note detailed information in regard to amounts paid to the auditor, [7][whether as fees, expenses or otherwise for services rendered–]

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6. Substituted for para 4 by paras 4, 4A and 4B by Act 65 of 1960, Section 217.
7. Reference to managing agent, secretaries and treasurers redundant after aboolition of the system by Act 17 of 1969 with effect from 3.4.1970.
1. Reference to managing agent, secretaries and treasurers redundant after abolition of the system by Act 17 of 1969 with effect from 3.4.1970.
2. *Ibid.*
3. *Ibid.*
4. *Ibid.*
5. Substituted by Notification No. GSR 78, dated 4.1.1963.
6. *Ibid.*
6. Reference to managing agent, secretaries and treasurers redundant after abolition of the system by Act 17 of 1969 with effect from 3.4.1970.
7. Substituted by Notification No. GSR 78, dated 4.1.1963.

(a) as auditor; [8][***]

[9][(b) as adviser, or in any other capacity, in respect of–

(i) taxation matters;

(ii) company law matters;

(iii) management services, and

(c) in any other manner].

[1][4C. In the case of manufacturing companies, the profit and loss account shall also contain, by way of a note in respect of each class of goods manufactured, detailed quantitative information in regard to the following, namely :

(a) the licensed capacity (where licence is in force);

(b) the installed capacity; and

(c) the actual production.

Note 1.– The licensed capacity and installed capacity of the company as on the last date of the year to which the profit and loss account relates, shall be mentioned against items(a) and (b) above, respectively.

Note 2.– Against item (c), the actual production in respect of the finished products meant for sale shall be mentioned. In cases where semi-processed products are also sold by the company, separate details thereof shall be given.

Note 3.– For the purpose of this paragraph, the items for which the company is holding separate industrial licences shall be treated as separate classes of goods but where a company has more than one industrial licence for production of the same item at different places or for expansion of the licensed capacity, the item covered by all such licences shall be treated as one class.

4D. The profit and loss account shall also contain by way of a note the following information, namely :

(a) value of imports calculated on C.I.F. basis by the company during the financial year in respect of :

(i) raw materials;

(ii) components and spare parts;

(iii) capital goods;

(b) expenditure in foreign currency during the financial year on account of royalty, know-how, professional, consultation fees, interest, and other matters;

(c) value of all imported raw materials, spare parts and components consumed during the financial year and the value of all indigenous raw materrials, spare parts and components similarly consumed and the percentage of each to the total consumption;

(d) the amount remitted during the year in foreign currencies on account of dividends, with a specific mention of the number of non-resident shareholders, the number of shares held by them on which the dividends related;

(e) earnings in foreign exchange classified under the following heads, namely :

(i) export of goods calculated on F.O.B. basis;

(ii) royalty, know-how, professional and consultation fees;

(iii) interest and dividend;

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8. The word 'and' omitted by Notification no. GSR 455, dated 27.4.1974.

9. Substituted. Ibid.

1. Substituted for para 4C by paras 4C and 4D by Notification No. GSR 494(E), dated 30.10.1973.

(iv) other income, indicating the nature thereof:]

5. The Central Government may direct that a company shall not be obliged to show the amount set aside to provisions other than those relating to depreciation, renewal or diminution in value of assets, if the Central Government is satisfied that the information should not be disclosed in the public interest and would prejudice the company, but subject to the condition that in any heading stating an amount arrived at after taking into account the amount set aside as such, the provision shall be so framed or marked as to indicate that fact.

6. (1) Except in the case of the first profit and loss account laid before the company after the commencement of the Act, the corresponding amounts for the immediately preceding financial year for all items shown in the profit and loss account shall also be given in the profit and loss account.

(2) The requirement in sub-clause (1) shall, in the case of companies preparing quarterly or half-yearly accounts, relate to the profit and loss account for the period which ended on the corresponding date of the previous year.

PART III

Interpretation

7. (1) For the purposes of Parts I and II of this Schedule, unless the context otherwise requires–

(a) the expression "provision" shall, subject to sub-clause (2) of this clause, mean any amount written-off or retained by way of providing for depreciation, renewals or diminution in value of assets, or relained by way of providing for any known liabilityof which the amount cannot be determined with subs-tantial accuracy;

(b) the expression "reserve" shall not, subject as aforsaid, include any amount written-off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability;

(c) the expression "capital reserve" shall not include any amount regarded as free for distribution through the profit and loss account; and the expression "revenue reserve" shall mean any reserve other than a capital reserve;

and in this sub-clause the expression "liability" shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities.

(2) Where—

(a) any amount written-off or retained by way of providing for depreciation, renewals or diminution in value of assets, not being an amount written-off in relation to fixed assets before the commencement of this Act; or

(b) any amount retained by way of providing for any known liability, is in excess of the amount which in the opinion of the directors is reasonably necessary for the purpose, the excess shall be treated for the purposes of this Schedule as a reserve and not as a provision.

8. For the purpose aforesaid, the expression "quoted investment" means an investment as respects to which there has been granted a quotation or permission to deal on a recognised stock exchange, and the expression "unquoted investment" shall be constructed accordingly.

[PART IV[2]]

Balance Sheet Abstract and Company's General Business Profile

I. Registration Details [ ]

Registration No. State Code [ ] (Refer Code List)

Balance Sheet Date [ ] [ ] [ ]

Date Month Year

II. Capital raised during the year (Amount in Rs. Thousands)

Public Issue	Rights Issue
[ ]	[ ]
Bonus Issues	Private Placement
[ ]	[ ]

III. Position of Mobilisation and Deployment of Funds (Amount in Rs. Thousands)

Total Liabilities	Total Assets
[ ]	[ ]

SOURCE OF FUNDS

Paid-up-Capital	Reserves and Surplus
[ ]	[ ]
Secured Loans	Unsecured Loans
[ ]	[ ]

APPLICATION OF FUNDS

Net Fixed Assets	Investmens
[ ]	[ ]
Net Current Assets	Misc. Expenditure
[ ]	[ ]
Accumulated Losses	
[ ]	

IV Performance of Company (Amount in Rs. Thousands)

Turnover	Total Expenditure
[ ]	[ ]
Profit/Loss Before Tax+	–Profit/Loss After Tax
[ ]	[ ]

(Please tick appropriate box + for profit, – for loss)

Earning Per Share in Rs.	Divided rate %
[ ]	[ ]

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1. Inserted by Notification No. GSR 388(E), dated 15.5.1995.
2. **Applicability of amendment.**— A Notification GSR No. 388(E), datd 15.5.1995 was issued amending Schedule VI to the Companies Act. In this connection the Department have received letters seeking clarification, whether the requirements of amendments are to be complied with in respect of the Balance Sheet for the financial year 1994-95 or these are to be complied with only in relation to financial year 1995-96. It is therefore hereby clarified that this amendment to Schedule VI will be required to be complied with in relation to the financial year closing after 15.5.1995. [*Press Note No. 2/95 [No. 3.3.24.94-CL-VI, dated 18.7.1995].*

V. Generic Names of Three Principal Products/Services of Company (as per monetary terms)

Item Code No. (ITC Code)

Product Description

Item Code No. (ITC Code)

Product Description

(ITC Code)

Item Code No.

Product Description

Note : For ITC Code of Products please refer to the publication Indian Trade Classification based on harmonized commodity description and coding system by Ministry of Commerce, Directorate General of Commercial Intelligence & Statistics, Kolkata - 700 001.

ANNEXURE I

Code List 1 : State Code

State Code	*State Name*	*State Code*	*State Name*
01	Andhra Pradesh	02	Assam
03	Bihar	04	Gujarat
05	Haryana	06	Himachal Pradesh
07	Jammu & Kashmir	08	Karnataka
09	Kerala	10	Madhya Pradesh
11	Maharashtra	12	Manipur
13	Meghalaya	14	Nagaland
15	Orissa	16	Punjab
17	Rajasthan	18	Tamil Nadu
20	Uttar Pradesh	21	West Bengal
22	Sikkim	23	Arunachal Pradesh
24	Goa	52	Andaman Islands
53	Chandigarh	54	Dadra Island
55	Delhi	56	Daman & Diu
57	Lakshadweep	58	Mizoram
59	Pondichery		

2.FORM NO. 23 AB

(See Rule 7A)

Statement Containing Salient Features of Balance Sheet and Profit and Loss Account etc., as per section 219(1) (b) (iv)

From of Abridged Balance Sheet

Name of the Company ....

Balance Sheet as at ....

Particulars	Figures as at the end of Current financial year	Previous financial year
1. SOURCE OF FUNDS		
(1) Shareholders' funds		
(a) Capital		
(i) Equity		
(ii) Preference		
(b) Reserves and surplus		
(i) Capital reserve		
(ii) Revenue reserve		
(iii) Revaluation reserve		
(iv) Surplus in profit and loss account		
(v) Shafe Premium Reserve		
(vi) Investment Allowance Reserve		
(2) Loan funds		
(a) Debentures (The amouht of convertible/ partly convertible debentures indicating the date of conversion)		
(b) Public deposits		
(c) Secured loans (other than debentures)		
(d) Unsecured loans		
Total of (1) and (2) :		
II. APPLICATION OF FUNDS		
(1) Fixed Assets		
(a) Net block–(Original cost less depreciation)		
(b) Capital work-in-progress		
(2) Investments		
(a) Government securities		
(b) Investment in subsidiary companies		
(i) Quoted		
(ii) Unquoted		
(3) (i) Current assets, loans and advances		
(a) Inventories		
(b) Sundry debtors		
(c) Cash and bank balance		
(d) Other current assets		

Particulars	Figures as at the end of Current financial year	Figures as at the end of Previous financial year
(e) Loans and advances		
(i) To subsidiary companies		
(ii) To others		
Less :		
(ii) Current liabilities and provisions		
(a) Liabilities		
(b) Provisions		
Net current assets (i-ii)		
(4) Miscellaneous expenditure to the extent not writen-off or adjusted		
(5) Profit and Loss Account		
Total 1 to 5 :		

Abridged Profit and Loss Account for the year ending ....

	Particulars	Figures as at the end of Current financial Year	Figures as at the end of Previous financial Year
I.	Income		
	(a) Sale/services rendered (Details to be given separately as per annexure)		
	(b) Dividend		
	(c) Interest		
	(d) Other income (See Note 5)		
	Total		
II.	Expenditure		
	Cost of goods consumed/sold		
	(i) Operating stock		
	(ii) Purchases		
	Less : Closing stock		
	Manufacturing expenses		
	Selling expenses		
	Salaries, wages and other employee-benefits		
	Managerial remuneration		
	Interest		
	Depreciation		
	Auditors' remuneration		
	Provisions for (i) doubtful debts; and		
	(ii) Other contingencies (to be specified)		
	Any other expenses (See Note 5)		
	Total		
III.	Profit/loss before tax (I-II)		
IV.	Provision for taxation		
V.	Profit/loss after tax		
VI.	Proposed dividend :		
	(a) Preference shares		
	(b) Equity shares		
VII.	Transfer to reserves / surplus		

Notes to the abridged Balance Sheet and the abridged Profit and Loss Account

1. The amounts to be shown here should be the same as shown in the corresponding aggregated heads in the accounts as per Schedule VI or as near thereto as possible.
2. The total amount of contingent liabilities and that of capital commitments should be shown separately.
3. All notes forming part of the Accounts as per Schedule VI to which specific attention has been drawn by the auditors or which form a subject-matter of a qualification by the auditor should be reproduced.
4. If fixed assets are revalued, the amount of revaluation should be shown separately for the first five years subsequent to the date of revaluation.
5. Any item which consitutes 20% or more of the total income or expenditure (including provisions) should be shown separately.
6. Amount, if material, by which any items shown in the profit and loss account are affected by any change in the basis of accounting should be disclosed separately.
7. If no provision is made for depreciation, the fact that no provision has been made shall be stated along with the quantum of arrears of depreciation computed in accordance with Section 205(2) of the Act.
8. Market value of quoted investments (both of current year as also of previous year) should be mentioned.
9. Any note forming part of the accounts as per Schedule VI which is in the nature of any explanation regarding compliance with any law should be reproduced.
10. Important ratios of performance such as sales / total assets ratio, operating profit / capital employed ratio, return on net worth, profit/ sales ratio.
11. Details of installed capacity and productivity of main items manufactured should be disclosed.
12. Notes in the abridged balance sheet should be given in the same manner as in the main balance sheet.

The above-stated salient features of balance sheet and profit and loss account should be authenticated in the same manner as the main accounts are to be authenticated.

** Auditor's Report and the comments, if any, of the Comptroller and Auditor-General of India under sub-section (4) of Section 619, in respect of Government Companies and Companies under Section 619B, should be given in full except information under clause (e) of sub-section (1) and sub-section (2A) of Section 217.

*(Subsidiary Company/Companies).

Every holding company shall give a statement relating to its subsidiary company/companies to be furnished in pursuance to clauses(e), (f) and (g) of sub-section (1) of Section 212.

(Signed by Directors/Secretary in the manner prescribed in Section 215(1).

ANNEXURE
Sailent features of additional information on the Profit and Loss Account for the year ended

		Figures for the Current year	*Figures for the Previous year*
		Rs. '000	***Rs. '000***
Sales	Units	Quantity	Quantity
Class of Goods		(Rs. '000)	(Rs. '000)

3(a)UNAUDITED FINANCIAL RESULTS FOR THE THREE MONTHS ENDED ....

		3 Months ended 30 Sept. 2001 (Unaudied) Rs.	*3 Months ended 30 Sept. 2000 (Unaudited) Rs.*	*6 Months ended 30 Sept. 2001 (Unaudited) Rs.*	*6 Months ended 30 Sept. 2000 (Unaudited) Rs.*	*Year to Date 31 Mar. 2001 (Audited) Rs.*
1.	Gross Sales					
2.	*Less :* Excise Duty & Sales Tax					
3.	Net Sales					
4.	Other Income					
5.	Total Expenditure					
	A. Increase/Decrease in Stock in Trade					
	B. Consumption of Raw Materials					
	C. Staff Costs					
	D. Other Expenditure					
6.	Operating Profit					
7.	Interest (Net)					
8.	Exceptional Items					
9.	Gross Profit after Interest but before Depreciation and Taxation					
10.	Depreciation					
11.	Profit before Taxation					
12.	Provision for Taxation					
13.	Net Profit after Tax					
14.	Paid-up Equity Share Capital (Face Value Rs. 10)					
15.	Paid-up Preference Share Capital (Face Value Rs. 10)					
16.	Reserves excluding Revaluation Reserves					
17.	Earnings per Share					
18.	Aggregate of Non-Promoter Shareholding					
	— Number of Shares					
	— Percentage of Shareholding					

Notes :

1. Exceptional items represent :
   - i. Amortisation of expenditure on Y2K compliance/ERP implementation costs (Rs. ...)
   - ii. Amortisation of payments under the Voluntary Retirement Scheme (Rs. ...)
   - iii. Amortisation of expenditure on Website Development (Rs. .....)
2. "Provision for Taxation" for the period ended 30 September 2001 includes Provision for Deferred Taxation (Rs. ...)
3. Accounts for the quarter ended 30 September 2001 were approved and the unaudited results for the quarter ended 30 September 2001 were taken on record at the Meeting of the Board of Directors held on ..... October 2001 at ... These accounts have been subject to 'Limited Review' by Statutory Auditors as required.

QUARTERLY REPORTING OF SEGMENTWISE REVENUE, RESULTS AND CAPITAL EMPLOYED, UNDER CLAUSE 41 OF THE LISTING AGREEMENT

				3 Months ended 30 Sept. 2001 (Unaudited) Rs.	*6 Months ended 30 Sept. 2001 (Unaudited) Rs.*
1.	**Segment Revenue (Net Sales)**				
	a.	Automotive Batteries			
	b.	Industrial Batteries			
	TOTAL				
2.	**Segment Results [Profit (+)/Loss(–) before tax and interest]**				
	a.	Automotive Batteries			
	b.	Industrial Batteries			
	TOTAL				
	Less :	i.	Interest		
		ii.	Other un-allocable expenditure (Net of un-allocable income)		
	Total profit before tax				
3.	**Capital Employed**				
	a.	Automotive Batteries			
	b.	Industrial Batteries			
	TOTAL				

By Order of the Board

Sd/-

Chairman and Chief Executive Officer

Place :
October 2001

(c) GLOBAL COMPANY

CONSOLIDATED STATEMENT OF INCOME (Unaudited)

(Millions of yen, thousands of U.S. dollars, except per share amounts)

	Six months ended		*September 30*
	1994	**1995**	**Change % 1995**
Sales and operating revenue :			
Net Sales			
Operating revenue			
Costs and expenses :			
Cost of sales			
Selling, general and Administrative			
Goodwill write-off			
Operating income (loss)			
Other income :			
Interest and dividends			
Foreign exchange gain, net			
Other			
Other expenses :			
Interest			
Foreign exchange loss, net			
Other			
Income (loss) before income taxes			
Income taxes			
Income (loss) before minority interest			
Minority interest in consolidated sibsidiaries			
Net income (loss)			
Net income (loss) per Depository Share			

CONDENSED CONSOLIDATED BALANCE SHEETS (Unaudited)

(Millions of yen, thousands of U.S. dollars)

ASSETS		*September 30*	
	1994	**1995**	**1995**
Current assets :			
Cash and time deposits			
Marketable securities			
Notes and accounts receivable, less allowances			
Inventories			
Others			
Total current assets			

ASSET	September 30 1994	1995	1995
Noncurrent inventories —			
Investments and advances			
Property, plant and equipment, less depreciation			
Other assets :			
Intangibles			
Goodwill			
Others			
Total other assets			

LIABILITIES AND STOCKHOLDERS' EQUITY			
Current liabilities :			
Short-term debt			
Notes and accounts payable			
Accrued income and other taxes			
Others			
Total current liabilities			
Long-term liabilities:			
Long-term debt			
Accrued pension and severance costs			
Deferred income taxes			
Others			
Total long-term liabilities			
Minority interest in consolidated subsidiaries			
Stockholders' equity :			
common stock, par value			
Additional paid-in capital			

Notes :

1. U.S. dollar amounts have been translated from yen, for convenience only, at the rate of ¥98 = U.S. $1, the approximate Tokyo foreign exchange market rate as of September ....

2. As of September 30 the Company had 953 consolidated subsidiaries. It has applied the equity accounting method in respect of its 31 affiliated companies.

3. Net imcome (loss) per Depository Share is computed based on the average number of common shares outstanding during each period after consideration of the dilutive effect of common stock equivalents.

4. Certain amounts in the consolidated balance sheet as of September 30 (previous year) have been reclassified to conform to the presentation as of September 30 (current year).

5. During the second quarter ended September 30, the Company changed its method of accounting for assessing the carrying value of its investments in acquired businesses including goodwill. The effect of this accounting change was to reduce the goodwill of the entertainment segment associated with the pictures Group x .... million.

II. The Banking Regulation Act, 1949

Third Schedule, Form A (Sec. 29)

1. Form of Balance Sheet

Capital and Liabilities

Rs. P. Rs. P.

1. **Capital (a) :**
   Authorised Capital :
   .... Shares of Rs. .... each ....
   Issued Capital :
   .... Shares of Rs. .... each ....
   Subscribed Capital :
   .... Shares of Rs. .... each ....
   Amount Called up at Rs. .... per share
   Less : Calls unpaid
   Add : Forfeited Shares
2. **Reserve fund and other reserves**
3. **Deposits and other accounts :**
   Fixed Deposits
   Savings Bank Deposits
   Current Account and Contingency Accounts, etc.
4. **Borrowings from other banking companies, agents etc.**
   (i) in India
   (ii) outside India
   Particulars :
   (i) Secured (stating the nature of security)
   (ii) Unsecured
5. **Bills payable**
6. **Bills for collection being bills Receivable (as per contra) :**
   (i) payable in India
   (ii) payable outside India
7. **Other liabilities (c)**
8. **Acceptances, endorsements and other obligations (as per contra) :**
9. **Profit and loss :**
   As per last balance sheet
   Less : Appropriations
   Add : Profit for the year brought forward from Profit and Loss Account
10. Contingent liabilities (d)

Property and Assets

Rs. P. Rs. P.

1. **Cash :**
   In hand and with Reserve Bank (including foreign currency notes)
2. **Balance with other banks :**
   (Showing whether on deposits or current account)
   (i) In India
   (ii) outside India
3. **Money at call and short notice**
4. **Investments** (stating mode of valuation, e.g., cost or market value): (f)
   (i) Securities of the Central and State Governments and other Trustee securities including Treasury Bills of the Central and State Governments.
   (ii) Shares (classifying into preference, ordinary, deferred and other classes of shares and showing separately shares fully paid-up and partly paid-up.
   (iii) Debentures or Bonds
   (iv) Other investments (to be classified under proper heads)
   (v) Gold
5. **Advance** (other than bad and doubtful debts for which provision has been made to the satisfaction of the auditors) :
   (i) Loans, Cash Credits and Overdrafts :
   (a) in India
   (b) outside India
   (ii) Bills discounted and purchased (excluding Treasury Bills of the Central and State Government) :
   (a) payable in India
   (b) payable outside India

Particulars of Advances :
(i) Debts considered good in respect of which the banking company is fully secured.
(ii) Debts considered good for which the banking company holds no other security than the debtors' personal security.

Capital and Liabilities	Rs. P.	Rs. P.	*Property and Assets*	Rs. P.	Rs. P.
			(iii) Debts considered good, secured by the personal liabilities of one or more parties in addition to the personal security of the debtors.		
			(iv) Debts considered doubtful or bad, not provided for.		
			(v) Debts due by directors or officers of the banking company or any of them either severally or jointly with any other persons.		
			(vi) Debts due to companies or firms in which the directors of the banking company are interested as directors, partners or managing agents, or, in the case of private companies, as members.		
			(vii) Maximum total amount of advances including temporary advance made at any time during the year to directors or managers or officers of the banking company or any of them either severally or jointly with any other persons (ff).		
			(viii) Maximum total amount of advances, including temporary advances granted during the year to the companies or firms in which the directors of the banking company are interested as directors, partners or managing agents, or, in the case of private companies, as members (ff).		
			(ix) Due from banking companies.		
			6. **Bills receivable being bills for collection (as per contra) :**		
			(i) payable in India		
			(ii) payable outside India		
			7. **Constituents' liabilities for acceptance endorsements and other obligations** (as **per contra**)		
			8. **Premises** less Depreciation (g).		
			9. **Furniture and fixtures** less Depreciation.		
			10. **Other assets**, including silver (to be specified) (h)		
			11. **Non-banking assets**, acquired in satisfaction of claims (stating mode of valuation) (i)		
			12. **Profit and loss**		
Total Rs.			**Total Rs.**		

Notes :

(a) Capital :

(i) The various classes of capital, if any, should be distinguished.

(ii) Shares issued as fully paid pursuant to any contract without payments being received in cash should be stated separately.

(iii) Where circumstances permit, issued and subscribed capital and amount called up may be shown as one item, e.g., issued and subscribed capital .... Shares of Rs. .... paid-up.

(iv) In the case of banking companies incorporated outside India the amount of deposit kept with the Reserve Bank of India under sub-section (2) of Section II of Banking Regulation Act. 1949, should be shown under this head; the amount, however, should not be extended to the outer column.

(c) Under this heading may be included such items as the following : Pension or insurance funds, unclaimed dividends, advance payments and unexpired discounts, liabilities to subsidiary companies and any other liabilities.

(d) These should be classified under the following categories :

(i) Claims against the banking company not acknowledged as debts.

(ii) Money for which the banking company is contingently liable showing separately the amount of any guarantee given by the banking company on behalf of directors or officers.

(iii) Arrears of cumulative preference dividends.

(iv) Liabilities on Bills of Exchange re-discounted.

(v) Liabilities on account of outstanding Forward Exchange Contracts.

(f) Where the value of the investments shown in the outer column of the balance sheet is higher than the market value, the market value shall be shown separately in brackets.

(ff) Maximum total outstanding balance in all such accounts as a unit on any day during the year should be given under this heading.

(g) Premises wholly or partly occupied by the banking company for the purposes of business should be shown against "premises less depreciation". In the case of fixed capital expenditure, the original cost, and additions thereto and deductions therefrom during the year should be stated, as also the total depreciation written-off. Where sums have been written-off on a reduction of capital, or revaluation of assets, every balance sheet after the first balance sheet subsequent to the reduction or revaluation should show the reduced figures with the date and amount of the reduction made. Furniture, fixtures and other assets which have been completely written-off need not be shown in the balance sheet.

(h) Under this heading may be included such items as the following, which must be shown under heading suitably described : perliminary, formation and organisation expenses, development expenditure, commission and brokerage on shares, interest accrued on investments but not collected, investments in shares of subsidiary companies and any other assets.

(i) Value shown shall not exceed the market value and in cases where the market value is not ascertainable, the estimated realisable value.

Third Schedule—Form B
2. (a) Form of Profit and Loss Account
Profit and Loss Account for year ended .... December ....

EXPENDITURE	Rs. P.	*INCOME*	Rs. P.
Interest paid on deposits, borrowings etc.		*(less provision made during the year for bad and doubtful debts and other usual and necessary provisions) (1) Interest and discount*	
Salaries and allowances and Provident Fund. (2)		Commission, exchange and brokerage	
Directors' and Local Committee Members' fees and allowances		Rents	
Provident Fund		Net profit on sale of investments, gold and silver, land, premises (not credited to Reserves or any particular Fund or Account) and other assets.	
Rent, taxes, insurance, lighting etc.		Net profit on revaluation of investments, gold and silver, land, premises and other assets (not credited to Reserves or any particular Fund or Account)	
Law charges, postage, telegrams and stamps		Income from non-banking assets, and profit from sale of or dealing with such assets	
Auditor's fees		Other receipts	
Depreciation on and repairs to the banking company's property		Loss (if any)	
Stationery, printing, advertisement etc.			
Loss from sale of or dealing with non-banking assets			
Other expenditure			
Balance of Profit			
Total Rs.		**Total Rs.**	

Note :

1. Net loss on sale or revaluation on investments, gold and silver, land, premises and other assets, if any, may be deducted from income.

2. This form shall be accompanied by a note containing the following particulars, namely :

   Particulars of remuneration relating to managing director, manager or chief executive showing separately all payments made or provided during the year in respect of each of the following items and the total of all such items, namely :

   (i) Salaries,

   (ii) allowances,

   (iii) sitting fees,

   (iv) bonus,

   (v) employer's contributions to provident fund, pension fund or any other superannuation fund.

   (vi) payments by way of gratuities, pensions or otherwise, in excess of the employer's contributions and interest thereon, and

   (vii) the monetary value of any other benefits or perquisites.

(b) BANK OF ....

(A Government of India Undertaking)

Balance Sheet as on 31st March and Profit and Loss Account *for the year ended 31st March, ...*

BALANCE SHEET (Rs. in '000s)

	As on 31.03...	As on 31.03......
Capital and Liabilities		
Capital		
Reserves		
Deposits		
Borrowings		
Other Liabilities and Provisions		
TOTAL		
Contingent Liabilities		
Assets		
Cash and Balance with RBI		
Balance with banks		
Investments		
Advances		
Fixed Assets		
Other Assets		
TOTAL		
Bills for Collection		

PROFIT AND LOSS ACCOUNT

	Year ended 31.03....	Year ended 31.03.....
I. Income		
Interest Earned		
Other income		
TOTAL		
II.Expenditure		
Interest Expended		
Operating Expenses		
Provisions and Cont.		
TOTAL		
NET PROFIT AND APPROPRIATION		
III.Net Profit		
IV. Extraordinary item		
Int. on return of Capital		
Profit available for appropriation		
Transfer to :		
Statutory Reserves		
Revenue & other Reserves		
Proposed Dividend (Incl. Dividend Tax)		

PERFORMANCE HIGHLIGHTS

	1997-9	1996-9 ....
* Net Profit (Rs. in crores)		
* Return on Average Assets		
* Securities market to Market		
* Capital Adequacy Ratio (of which Tier)		
* Net NPA		
* Business per Employee (Rs. in lacs)		
* Earning per Share (Rs.)		

	1997-9	1996-9 .....
* Accounting standards for Employee Benefits (AS 15) fully met (Rs. in crores)		
* Public-issue Expense fully written-off (Rs. in crores)		
* More than Rs. ... crores (21.5%) rise in Savings Deposits		
* Flow of Resources to Commercial Sector up by Rs. .... crores (23%)		
* Shareholder base :		

III. The Insurance Act, 1949

The First Schedule, Form A

1. Balance Sheet as at ....

	Life and Annuity Business Rs. P.	*Other Classes of Business* Rs. P.	*Total* Rs. P.
Shareholders' Capital			
(each class to be stated separately)			
Authorised :			
...... shares of Rs. .... each Rs.			
Subscribed :			
...... shares of Rs. .... each Rs.			
Called up :			
...... shares of Rs. .... each Rs. less unpaid call Rs...........			
Reserve or contingency accounts (a) :			
Investment Reserve Account			
Profit and Loss Appropriation Account Balance ...			
BALANCES OF FUNDS AND ACCOUNTS			
Life Insurance Fund :			
(i) Business in India ...			
(ii) Business outside India ...			
Fire Insurance Business Account ...			
Marine Insurance Business Account ...			
Miscellaneous Insurance Business ... Account, (m)		......	
Other accounts, if any (to be specified) (b)		......	
Pension or Superannuation Account (b)		......	
Carried over Rs.			

	Life and Annuity Business Rs. P.	*Other Classes of Business* Rs. P.	*Total* Rs. P.
Loans :			
On Mortgages of property within India ...			
On Mortagages of property outside India ...			
On Security of municipal and other public rates ...			
On Stocks and Shares ...			
On Insurer's Policies within their surrender value ...			
On personal security ...			
To Subsidiary Companies (Other than Reversionary) (f) ...			
Reversions and Life Interests purchased			
Debentures and Debenture Stocks of Subsidiary Reversionary Companies (f) ...			
Ordinary Stocks and Shares of Subsidiary Reversionary Companies (f) ...			
Investments :			
Deposit with the Reserve Bank of India (securities to be specified) ...			
India Government Securities, State Government Securities, British, British Colonial and British Dominion Government Securities ...			
Foreign Government Securities ...			
Indian Municipal Securities ...			
British and Colonial Securities ...			
Carried over Rs.			

	Life and Annuity Business Rs. P.	*Other Classes of Business* Rs. P.	*Total* Rs. P.
Debenture Stock per cent ...			
Loans and Advances (c)...			
Bills payable (c)			
Estimated Liability in respect of outstanding claims, whether due or intimated (d) ...			
Annuities due and unpaid (d) ...			
Outstanding Dividends ...			
Amounts due to other persons or bodies carrying on insurance business (b) ...			
Sundry Creditors (Including outstanding and accruing expenses and taxes)			
Other sums owing by the insurer (Particulars to be given) (c) ...			
Contingent liabilities (To be specified) (c)...			
Carried over Rs.			

	Life and Annuity Business Rs. P.	*Other Classes of Business* Rs. P.	*Total* Rs. P.
Foreign Securities ...			
Bonds, Debentures, Stock and other Securities whereon interest is guaranteed by the India Government or a State Government ...			
Bonds, Debentures, Stocks and other securities whereon interest is guaranteed by the British or any Colonial Government ...			
Bonds, Debentures, Stocks and other securities whereon interest is guaranteed by any Foreign Government ...			
Debentures of any railway in India ...			
Debentures of any railway out of India ...			
Preference or guaranteed shares of any railway in India ...			
Preference or guaranteed shares of any railway out of India ...			
Railway Ordinary Stocks (i) in India, (ii) out of India ...			
Other Debentures and Debentures Stock of Companies incorporated (i) in India, (ii) out of India ...			
Other gurantees and Preference Stocks and Shares of Companies incorporated (i) in India, (ii) out of India ...			
Other ordinary Stocks and Shares of Companies incorporated (i) in India, (ii) out of India ...			
Holdings in Subsidiary Companies (f) House Property (i) in India (ii) out of India ...			
Carried over Rs.			

	Life and Annuity Business Rs. P.	*Other Classes of Business* Rs. P.	*Total* Rs. P.		*Life and Annuity Business* Rs. P.	*Other Classes of Business* Rs. P.	*Total* Rs. P.
				Freehold and Leasehold ground rents and rent charges ...			
				Agents' Balances ...			
				Outstanding Premiums (g) ...			
				Interest, Dividends and Rents Outstanding (d) ...			
				Interest, Dividends and Rents Accruing but not due (d)			
				Amounts Due from other persons or bodies carrying on insurance business (h)			
				Sundry Debtors (i)			
				Bills Receivable			
				Cash :			
				At bankers on Deposit Account			
				At Bankers on Current Account and in hand			
				At call and Short Notice (j)			
				Other Accounts (to be specified) (k)			
Total Rs.				Total Rs.			

The Third Schedule, Form D

2. Form of Revenue Account applicable to Life Insurance Business

Revenue Account of .... for the year ended ....

in respect of ....

	Business within India Rs. P.	*Business out of India* Rs. P.	*Total* Rs. P.		*Business within India* Rs. P.	*Business out of India* Rs. P.	*Total* Rs. P.
Claims under policies (including provision for claims due or intimated)				Balance of Fund at the beginning of the year			
Less re-insurances :				Premium, less Re-insurance			
By Death ...				(i) First year premiums, where the maximum premium paying period :			
By Maturity ...				Two years ...			
Annuities, less re-insurances				Three years ...			
Surrenders (including surrenders of bonus), less re-insurances ...				Four years ...			
Bonuses in cash, less re-insurance				Five years ...			
Bonuses in reduction of premium, less re-insurance				Six years ...			
EXPENSES OF MANAGEMENT				Seven years ...			
1. (a) Commission to Insurance Agents				Eight years ...			
(b) Allowances and Commission [other than commission included in sub-item (a) preceding				Nine years ...			
2. Salaries etc. (other than to agents and those contained in item No. 1)				Ten years ...			
3. Travelling Expenses ...				Eleven years ...			
4. Directors' fees ...				Twelve years or over (including throughout life) ...			
5. Auditors' fees ...				(ii) Renewal premiums ...			
6. Medical fees				(iii) Single premiums ...			
7. Law charges				Consideration for annuities granted less re-insurances ...			
8. Advertisements				Interest, Dividends and Rents less Income-tax thereon ...			
				Registration Fees			
				Other income (to be specified) ...			

	Business within India Rs. P.	*Business out of India* Rs. P.	*Total* Rs. P.		*Business within India* Rs. P.	*Business Out of India* Rs. P.	*Total* Rs. P.
9. Printing and Stationery				Loss Transferred to Profit and Loss Account			
10. Other expenses of management (accounts to be specified)				Transferred from Appropriation Account			
11. Rents for offices belonging to and occupied by the insurer							
12. Rents for other offices occupied by the insurer							
Bad Debts							
United Kingdom, Indian Dominion and Foreign taxes							
Other expenditure (to be specified)							
Transferred to profit and loss account							
Balance of fund at the end of the year as shown in the Balance Sheet Rs.							
Total Rs.				Total Rs.			

The Third Schedule, Form F

3, Form of Revenue Account applicable to Fire Insurance Business, Marine Insurance Business and Miscellaneous Insurance Business

Revenue Account of .... for the year ended ......20........

In Respect of .... Business

		Rs.			Rs.
Claims under Policies, less-insurances :			Balance of Account at the		
paid during the year	Rs.		beginning of the year	Rs.	
Total estimated liability in			Reserve for Unexpired Risk		
respect of outstanding			Additional Reserve (if any)	Rs.	
claims at the end of the year					
whether due or estimated	Rs.		Premium *less* Re-insurances		
Total		Rs.	Interest, Dividends and Rents	Rs.	
Less outstanding at the			*Less* Income tax	Rs.	
end of the previous year	Rs.				
Commission on Direct Business			Commission on Re-insurance ceded		
Commission on Re-insurance accepted			Other incomes (to be specified)		
Expenses of management			*Loss* transferred to Profit and Loss Account		
Bad Debts			Transfer from Appropriation Account		
United Kingdom, Indian Dominion					
and Foreign Taxes					
Other Expenditure (to be specified)					
Profit transferred to Profit and Loss Account					
Balance of Account at the end of the					
year as shown in the Balance Sheet					
Reserve for Unexpired Risks					
being percent of premium					
income of year	Rs.				
Additional Reserve (if any)	Rs.				
		Rs.			Rs.

The Second Schedule, Form B

4, Profit and Loss Account of ......
for the year ended ....

	Rs. P.		Rs. P.
Indian(Central) Taxes on the Insurer's Profits (not applicable to any particular Fund or Account)		Interest, Dividends and Rents (not applicable to any particular Fund or Account) *less :* Income-tax thereon	
Expenses of management (not applicable to any particular Fund or Account)		Profit on realisation of Investments (not credited to Reserves or any particular Fund or Account)	
Loss on Realisation of Investments (not charged to Reserves or any particular Fund or Account)		Appreciation of Investments not credited to Reserves or any particular Fund or Account)	
Depreciation of Investments (not charged to Reserves or any particular Fund or Account)		Profit transferred from Revenue Accounts (details to be given)	
Loss transferred from Revenue Accounts (details to be given)		Transfer Fees	
Other Expenditure (to be specified)		Other Income (to be specified)	
Balance for the year carried to appropriation Account		Balance being loss for the year carried to Appropriation Account	

The Second Schedule, Form C

5, Profit and Loss Appropriation Account of ......
for the year ended 19...........

	Rs. P.		Rs. P
Balance being loss brought forward from last year		Balance at end of the year as shown in the Balance Sheet.	
Balance being loss for the year brought from Profit and Loss Account (as in form B)		Balance brought forward from last year *Less :* Dividends since paid in respect of last year (to be specified and if "free of tax" to be so stated)	
Dividends paid during the year on account of the current year (to be specified and if "free of tax" to be so stated)		Balance for the year brought from Profit and Loss Account (as in Form B)	
Transfers to any particular Funds or Accounts (details to be given)		Balance being loss at end of the year as shown in the Balance Sheet)	