Auditing Theory

DCOM204

Edited by:
Manpreet Kaur

LOVELY PROFESSIONAL UNIVERSITY

LOVELY PROFESSIONAL UNIVERSITY

AUDITING THEORY

Editing By

Manpree Kaur

Printed by
EXCEL BOOKS PRIVATE LIMITED
A-45, Naraina, Phase-I,
New Delhi-110028
for
Lovely Professional University
Phagwara

SYLLABUS

Auditing Theory

Objectives: The course is designed with an objective to enable students to understand the way auditing is conducted and put them in a position to identify the areas of fraud and errors in the accounts and take corrective actions while presenting the audit report.

S. No.	Description
1.	Origin of audit, definition, accountancy vs. auditing, objects of an audit, different classes of audit, location of errors, generally accepted auditing practice, audit evidence, auditing in depth, accounting/auditing statements.
2.	Audit function of an auditor, Integrity, Objectivity and independence of an auditor, section 226, section 314 and code of ethics.
3.	Audit planning, factors affecting audit planning, audit programming and quality control for audit
4.	Considerations of laws and regulations in an audit of financial statements and audit procedures.
5.	**Internal control:** Meaning, importance, internal check, internal audit, evaluation of internal control.
6.	**Vouching:** Meaning, substantial procedures and vouching of cash transactions and trading transactions. Audit of Financial statement: Audit of income statement and position statement in respect of the depreciation, valuation of inventory, share capital, reserve and surplus, current assets and liabilities, investment, fixed assets.
7.	Appointment, right, duties and liabilities of an auditor.
8.	**Cost Audit:** Meaning, procedures, CARO, MAOCARO, Management Audit-meaning, procedures and benefits.
9.	Audit of banking companies, audit of cooperative banks and institutions, audit of general insurance business companies, audit of partnership accounts and audit of government companies.
10.	**Auditing in an EDP Environment:** Problems in an EDP Environment, control in an EDP Environment and computer assisted auditing techniques.

CONTENT

Notes

Unit 1: Introduction to Auditing

CONTENTS

Objectives

After studying this unit, you will be able to:

- Describe the origin of audit;
- Define audit;
- Differentiate between accountancy and auditing;
- Know the objectives of auditing;
- Know different classes of audit;
- Locate errors.

Introduction

It is clear from the above definitions that auditing is the systematic and scientific examination of the books of a accounts and records of a business so as to enable the auditor to satisfy himself that the Balance Sheet and the Profit and Loss Account are properly drawn up so as to exhibit a true and fair view of the financial state of affairs of the business and profit or loss for the financial period. Unit explains the origin of audit and standards as defined by Company's Act and by the Institute of Chartered Accountants of India. Unit tries to define audit, and explain various aspects of auditing and duties and responsibilities of an auditor. Two objectives of auditing are primary and secondary. The main object of auditing is to help the auditor to form an opinion as to whether the books of account and the financial statements show true and fair view of the business and the subsidiary object of auditing is to detect and prevent errors and

Notes

frauds in the books of accounts. Different classes of audit and locating different errors are explained.

1.1 Origin of Audit

From the time of ancient Egyptians, Greeks and Romans, the practice of auditing the accounts of public institutions existed. Checking clerks were appointed in those days to check the public accounts. To locate frauds as well as to find out whether the receipts and payments are properly recorded by the person responsible was the main objective of auditing of those days.

During the 18th century industrial revolution brought in large scale production, steam power, improved facilities and better means of communication. This resulted in the origin of joint stock form of organizations. Shareholders contribute capital of these companies but do not have control over the day-to-day working of the organization. The shareholders who have invested their money would naturally be interested in knowing the financial position of the company. This originated the need of an independent person who would check the accounts and report the shareholders on the accuracy of the accounts and the safety of their investment.

The Indian Companies Act, 1913 defined the qualification, power, duties and procedure of appointment of the Auditor. The audit of Joint Stock Company made compulsory by this Act. Educational qualification certificate were issued by the Central and State Governments to those who undergone the prescribed course. In the year 1949, Chartered Accountants Act was passed. Company's Act, 1956 further elaborated the provisions related to the auditing and accounts of the companies. Now a person to do the auditing must be qualified as per the standards of the Institute of Chartered Accountants of India.

The word 'Audit' is originated from the Latin word 'audire' which means 'to hear'. In the earlier days, whenever there is suspected fraud in a business organization, the owner of the business would appoint a person to check the accounts and hear the explanations given by the person responsible for keeping the account and funds. In those days, the audit is done to find out whether the payments and receipt are properly accounted or not. The objective of modern day accounting is not only for the verification of cash but to report the financial position of the undertaking as disclosed by its Balance sheet and Profit and Loss Account.

1.2 Defining Audit

Audit may be defined as 'an official inspection of an individual's or organization's accounts, typically by an independent body'. A precise definition of the term 'Auditing' is difficult to give. Some of the definitions given by different authors are as follows:

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

"Spicer and Pegler expanded the above definition as follows:

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

Notes

According to Lawrence R. Dicksee,

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

R. K. Mautz defines auditing as being

"concerned with the verification of accounting data, with determining the accuracy and reliability accounting statement and reports."

It is clear from the above definitions that auditing is the systematic and scientific examination of the books of a accounts and records of a business so as to enable the auditor to satisfy himself that the Balance Sheet and the Profit and Loss Account are properly drawn up so as to exhibit a true and fair view of the financial state of affairs of the business and profit or loss for the financial period. The Auditor will have to go through various books and accounts and related evidence to satisfy him about the accuracy and authenticity to report the financial health of the business.

1. An examination and verification of a company's financial and accounting records and supporting documents by a professional, such as a Certified Public Accountant.
2. An audit is an IRS examination of an individual or corporation's tax return, to verify its accuracy. There are three types of audits: correspondence audits (the IRS mails a request for additional information), office audits (an interview is conducted at a local IRS office), and field audits (an interview is conducted at a taxpayer's place of business, for a corporate tax return). Since there is always the chance of an audit, experts recommend keeping good records to support all the information in a return. The reason detailed and accurate bookkeeping is so important is that the burden of proof is on the filer, not the IRS (*Investorwords).*

Caution Ensure there is a clear understanding what auditing is about and what purpose it serves.

Self Assessment

Fill in the blanks:

1. The audit of Joint Stock Company made compulsory by .....
2. A person to do the auditing must be qualified as per the standards of the.....
3. Audit may be defined as an official inspection of an individual's or organization's accounts, typically by .....
4. Auditing is the systematic and scientific examination of the ..... and .....
5. There are three types of audits: (a).....; (b) .....; and (c) .....

1.3 Difference between Auditing and Accounting

1. The role of accountancy is to record the transaction in the book of accounts, extraction of trial balance, preparation of trading and profit and loss account and balance sheet etc. On the other hand auditing is the examination of books of account and checking the financial statement for the purpose of finding out the true and fair position and results of operation

Notes

of a concern. Audit is concerned with detailed examination of the complete accounting records but it does not involve the preparation of accounts.

2. If the auditor is asked to write the books of accounts, extract an agreed trial balance and profit and loss account and Balance sheet, he would be doing the work of an accountant and not the work of an auditor. Preparation of account is not the part of auditing. An auditor, using his appointing authority, needs to check thoroughly, whether the Profit and Loss account and the Balance Sheet have been properly drawn up and revel the 'true and fair view' of the state of affairs and results of operation of the concern and report it to the parties interested.

3. Auditing without the prior existence of accounts is not possible. When the accountant finishes his work, the auditor starts his work.

1.4 Objects of an Audit

There are two types of object of auditing.

Main Object

The main object of auditing is to help the auditor to form an opinion as to whether the books of account and the financial statements show true and fair view of the business. Auditor has to check the books of account and financial statements keeping the main object in mind. According to de Paula: The main object of audit is to ascertain that the balance sheet and profit and loss account of an undertaking do show true and fair view of its financial position and earnings. A similar view was observed by the Institute of Chartered Accountants of India when it state that, the objective of an undertaking do show true and fair view of its financial position and earnings.

Secondary or Subsidiary Objects

The subsidiary object of auditing is to detect and prevent errors and frauds in the books of accounts.

1.5 Advantages of Auditing

It is compulsory for all the organizations registered under the Companies Act must be audited. There are advantages in auditing the accounts even when there is no legal obligation for doing so. Some of the advantages are listed below:

1. Audited accounts are readily accepted in Government authorities like Income tax Dept., Sales Tax dept., Land Revenue departments, banks etc.

2. By auditing the accounts errors and frauds can be detected and rectified in time.

3. Audited accounts carry greater authority than the accounts which have not been audited.

4. For obtaining loan from financial institutions like Banks, LIC, HUDCO, HDFC, IFCI etc., previous years audited accounts evaluated for determining the capability of returning the loan.

5. Regular audit of account create fear among the employees in the accounts department and exercise a great moral influence on clients staff thereby restraining them from commit frauds and errors.

6. Audited accounts facilitate settlement of claims on the retirement/death of a partner.

Notes

7. In the event of loss of property by fire or on happening of the event insured against, Audited accounts help in the early settlement of claims from the insurance company.

8. In case of Joint Stock Company where ownership is separated from management, audit of accounts ensure the shareholders that accounts have been properly maintained, funds are utilized for the right purpose and the management have not taken any undue advantage of their position.

9. To determine the value of the business in the event of purchase or sales of the business, audited account will be the treated as the base for the evaluation.

10. The audit of accounts by a qualified auditor also help the management to understand the financial position of the business and also it will help the management to take decision on various matters like report in internal control system of the organization or setting up of an internal audit department etc.

11. If the accounts have been audited by an independent person, disputes between the management and labor unions on payment of bonus and higher wages can be settled amicably.

12. In the event of admission of a new partner, audited accounts will facilitate the formation of terms and conditions for joining the new partner. Last 3 years audited accounts and balance sheet will give a general idea about the growth and financial position of the business to the new partner.

Notes It is compulsory for all the organizations registered under the Companies Act must be audited.

Self Assessment

Fill in the blanks:

6. Audit is concerned with detailed examination of the complete accounting records but it does not involve the .....

7. Auditing without the ..... is not possible. When the accountant finishes his work, the auditor starts his work.

8. To determine and judge the reliability of the ..... and the supporting accounting records of a particular financial period is the main purpose of the audit.

9. Detection of fraud or errors is a ..... objective of the audit.

10. Overvaluation of closing stock or incorrect allocation of expenditure or receipt between capital and revenue are some of the examples of ..... .

1.6 Different Types of Audit

There are three different classes of audit that can be performed:

1. ***First Party Audit:*** An audit performed within an organization by that organization's own auditing resource. It is also referred to as an Internal Audit.

2. ***Second Party Audit:*** An audit of contractors/suppliers undertaken by or on behalf of a purchasing organization. This may include the audit of organizations or divisions supplying goods or services to others within the same group. It is also referred to as a Supplier Audit.

Notes

3. ***Third Party Audit:*** An audit of an organization performed by a body that is independent of the organization being audited, e.g. Certification Body (Registrar) or Regulatory Body.

There are following types of audit:

Statutory audit: This is the audit governed by statute such as the Company's Act.

Non-statutory audit: This are the audit not specially required by law this scope of the audit will be outline by the contract between the auditor and the clients.

External audit: External audit is that is critical review of the representation of the published financial statements it is compulsory for all company's which are listed in the stock exchange.

Internal Audit: This is a review of operation carried out sometimes continuously specially assigned staff with in the client business.

Final Audit: Final audit is commenced when all account has been closed and final accounts are been prepared.

Social Audit: Social audit is performed to know the corporate social responsibility.

System audit: A quality audit conducted on a QMS would be called a system audit. It can be described as a documented activity performed to verify, by examination and evaluation of objective evidence, that applicable elements of the QMS are appropriate and effective.

Adequacy audit is a review to verify the sufficiency of documentation for defining work and of records as evidence of satisfactory work completion.

Product audit is an examination of a particular product (i.e. hardware, processed material, software or service) to evaluate whether it conforms to requirements (i.e. specifications, performance standards).

Process audit is performed to verify that processes are working established limits. A process quality audit examines an activity to verify that the inputs, actions, and outputs are in accordance with defined requirements.

Compliance audit is an audit to ensure you're in compliance with relevant specifications, contract, or regulation.

1.7 Difference between Internal Audit and Statutory Audit

Following are the main points of difference between internal audit and statutory audit:

1. ***Appointment:*** The management of the organization makes the appointment of an internal auditor. The statutory auditor is appointed by different authorities. First statutory auditors are appointed by the shareholders in the annual general meeting.

2. ***Qualification:*** Qualifications of the statutory auditor are prescribed in the Companies Act, 1956. Essentially a person should be a practicing Chartered Accountant to be appointed as a statutory auditor. There is no fixed qualification for the position of an internal auditor.

3. ***Objects:*** The main object of the statutory audit is to form an opinion on the financial statement of the organization auditor has to state that whether the financial statements are showing the true and fair view of the affairs of the organization or not. The main object of the internal audit is to detect and prevent the errors and frauds.

4. ***Scope:*** The scope of the statutory audit is fixed by the Companies Act, 1956. It cannot be changed by mutual consent between the auditor and the management of the audited

Notes

business unit. The scope of the internal audit is fixed by the mutual consent of the auditor and the management of the unit under audit.

5. ***Remuneration:*** Remuneration of the statutory auditor is fixed by the appointing authority, i.e. in case of first auditors, the auditors the directors fix the remuneration in case of the subsequent auditors the company in its general meeting fixes the remuneration. In case of internal auditor the management who appoints him fixes his remuneration.

6. ***Report:*** The statutory auditor submits his report to the shareholder of the company in its general meeting. The internal auditor submits his report to the management of the company who is also his appointing authority.

7. ***Removal:*** The procedure of removal of the statutory auditor is very complex. Only the company in the general meeting can remove the auditor. It also has to take the permission of the Central Government. The management of the entity can remove internal auditor.

An audit is a detailed examination of records, frequently financial in nature, in a search for existing errors or inaccuracies. Audits are typically related to tax records, and the Internal Revenue Service frequently conducts them to find inconsistencies in income and tax findings. Companies also conduct audits to make sure their bookkeeping operations are correct and funds are not missing. While audits can be useful, they are not perfect and correcting audit errors can be a time-consuming process.

Notes Always keep business expenses and personal expenses entirely separate to make for easier tax returns and financial reporting. Keep copies of all your business records and have receipts and statements for any expenses or tax deductions that you claim.

Instructions

1. Create copies of any files or paperwork that can prove the audit information is incorrect. Always keep the originals, but the copies will be needed to prove your claim.

2. Hire an accountant who can look over your evidence and verify that your figures are correct. He can then compare it to the audit results and help your draft up a report reporting the discrepancies.

3. Notify the auditing firm in writing of the audit mistakes and include the copies of your records that verify your report. Your account's report should also be included. If this is a tax audit, your accountant can assist you in refilling your tax returns that point out the discrepancies of the audit.

1.8 Objectives of Audit

For a better understanding we could classify the objective of audit as:

1.8.1 Primary Objectives

To determine and judge the reliability of the financial statement and the supporting accounting records of a particular financial period is the main purpose of the audit. As per the Indian Companies Act, 1956 it is mandatory for the organizations to appoint a auditor who, after the examination and verification of the books of account, disclose his opinion that whether the

Notes

audited books of accounts, Profit and Loss Account and Balance Sheet are showing the true and fair view of the state of affairs of the company's business. To get a true and fair view of the companies' affairs and express his opinion, he has to thoroughly check all the transactions and relevant documents of the company made during the audited period. Which will help the auditor to report the financial condition and working result of the organization? While carrying out the process of audit, the auditor may come across certain errors and frauds. But detection of fraud or errors is not the primary objective of the audit. They are come under the secondary objectives of audit.

Did u know? Audit also disclose whether the Accounting system adopted in the organization is adequate and appropriate in recording the various transactions as well as the setbacks of the system.

1.8.2 Secondary Objectives

In order to report the financial condition of the business, auditor has to examine the books of accounts and the relevant documents. In that process he may come across some errors and frauds. We may classify these errors and frauds as below:

1. ***Detection and Prevention of Errors:*** Following types of errors can be detected in the process of auditing.

   (a) *Clerical Errors:* Due to wrong posting such errors may occur. Money received from Microsoft credited to the Semens' account is an example of clerical error. Even though the account was posted wrongly, the trial balance will agree. We can classify clerical errors as below:

      (i) **Errors of Commission:** These errors are errors caused due to wrong posting either wholly or partially of in the books of original entry or ledger accounts or wrong totaling, wrong calculations, wrong balancing and wrong casting of subsidiary books. For example ₹ 5000 is paid to Microsoft for the supply of windows program and the same is recorded in the cash book. While posting the ledger the Microsoft's account is debited by ₹ 500. It may be due to the carelessness of the accountant. Most of these errors of commission are reflected in the trial balance and can be identified by routine checking of the books.

      (ii) **Errors of Omission:** When there is no record of transactions in the books of original entry or omission of posting in the ledger could lead to such errors. Sales not recorded in the sales book or omission to enter invoices in the purchase book is examples of Errors of Omission. Errors due to entire omission will not affect the trial balance. Errors due to partial omission will affect the trial balance and can be detected.

      (iii) **Compensating Errors** are errors committed in such a way that the net result of these errors on the debit side and credit side would be nullify the net effect of the error. For example, Ram's account which was to be debited for ₹ 5000 was credited for ₹ 5000 and similarly, Sita's Account which was to be credited for ₹ 5000 was debited for ₹ 5000. These two mistakes will nullify the effect of each other. Unless detailed investigation is undertaken such errors are difficult to locate as both the sides of the trial balance are equally affected.

   These types of errors are said to occur when they offset the effect of each other either wholly of partially.

Notes

Example: If a person was to be credited by ₹ 1,000 and he is wrongly debited by ₹ 1,000 and he is wrongly debited by ₹1,000 was trial balance. It may also occur when the name of two persons are interchanged for each other. For examples, we buy goods from Mr.B.

(b) *Errors of Duplication:* These types of errors occur when a particular transaction is recorded twice in the books of account. Since they are also posted twice these do not affect the trial balance.

(c) *Errors of Principle:* While recording a transaction, the fundamental principles of accounting is not properly observed, these types of errors could occur. Overvaluation of closing stock or incorrect allocation of expenditure or receipt between capital and revenue are some of the examples of such errors. Such errors will not affect the trial balance but will affect the Profit and Loss account. It may occur due to lack of knowledge of sound principles of accounting or can be committed deliberately to falsify the accounts. To detect such errors, the auditor has to do a careful examination of the books of account.

When accountings principles are violated in writing the books of account the error of principal occurs. For example, when wrong account head is chosen to record a transaction, error of principal occurs. When expenses of capital nature are debited to revenue or vice versa it is said that error of principal has occurred.

2. ***Detection and Prevention of Frauds:*** To get money illegally from the organization or from the proprietor frauds are committed intentionally and deliberately. If it remains undetected, it could affect the opinion of the auditor on the financial condition and the working results of the organization. Therefore, it is necessary for the auditor to exercise utmost care to detect such frauds. It can be committed by the top management or by the employees of the organization. Frauds could be of the following types:

(a) *Misappropriation of Cash:* Since the owner has very limited control over the receipt and payments of cash, misappropriation or defalcation of cash is very common specially in big business organizations. Cash can be misappropriated by various ways as mentioned below:

(i) Recording fictitious payments

(ii) Recording more amount than the actual amount of payment

(iii) Suppressing receipts

(iv) Recording fewer amounts than the actual amount of payment.

There should be strict control over receipts and payments of cash known as "Internal check system" to prevent such frauds. The auditor should check the Cash Book with original records, bills register, invoices, vouchers, counterfoils or receipt books, wage sheets, salesman's diary, bank statements etc. in order to discover such frauds.

(b) *Misappropriation of Goods:* Companies handling with high value goods are prey to this kind of misappropriation. Without proper records of stock inward and stock outward, it is difficult for the auditor to find out such fraud. Periodical and surprise checking of stock and maintaining the proper record of inward and outward movement of stock can reduce the possibility of such fraud.

(c) *Falsification or Manipulation of Accounts:* In order to achieve certain specific objectives, accounts may be manipulated by those responsible persons who are in the top management of the organization. They prepare accounts such a manner that they

Notes

disclosed only a fake picture not the true picture. Some of the ways used in manipulating the accounts are as follows:

(i) Inflating or deflating expenses and incomes.

(ii) Writing off of excess or less bad debts.

(iii) Over valuation or under valuation of closing stock.

(iv) Charging excess or less depreciation.

(v) Charging capital expenditures to revenue and vice-versa.

(vi) Providing for excess or less doubtful debts.

(vii) Suppressing sales and purchase or showing fictitious sales and purchases, etc.

(d) *Window Dressing* is the way of presenting the financial data in a much better position than the original position. It is known as window dressing. Some of the reasons for doing window dressing are as follows:

(i) To win the confidence of shareholders.

(ii) To obtain further credit.

(iii) To raise the price of shares in the market by paying higher dividend so that shares held may be sold.

(iv) To attract prospective partners or shareholders.

(e) *Secret Reserves:* In secret reserves, accounts are prepared in such a way that they disclose worse picture than actually what they are? The objectives of preparing accounts in this way are:

(i) To conceal the true position from the competitors.

(ii) To avoid or reduce the tax liability

(iii) To reduce the price of shares in the market by not paying dividend or paying lower dividend so that the shares may be bought at a much lower price.

It is very difficult to detect such frauds since these frauds are committed by those persons in the organizations who are at the top positions like directors, managers, financial controllers etc. To detect these kinds of frauds, the auditor must be vigilant and should make searching inquiries to arrive at the true position.

Task Elaborate misrepresentation and misappropriation of accounts with few examples and how audit can help in curbing fraud and errors?

Self Assessment

Fill in the blanks:

11. An audit of an organization performed by a body that is independent of the organization being audited is called .....

12. The ..... object of auditing is to detect and prevent errors and frauds in the books of accounts

Notes

13. ..... audit is performed to know the corporate social responsibility.

14. ..... is an audit to ensure you're in compliance with relevant specifications, contract, or regulation.

Case Study

Cap Gemini and Ernst & Young, Potential Self-Dealing

Auditors have their own codes of ethics. Where there is no code of ethics, or where the code of ethics permits a degree of conflict of interest, the auditors tread at their own risk. The following case study underscores the traditional common law obligations of auditors as fiduciaries, even before the adoption of the Sarbanes-Oxley Act of 2002. This section covers some basic issues in auditing standards. Responding to SEC criticism of ostensible conflicts of interest, some major accounting firms, such as KPMG and Arthur Andersen, have spun off their consulting arms as independently owned and managed entities. Ernst & Young LLP chose another route. The story of E&Y and its alliance with Cap Gemini leads from a regulatory no-action letter to a court case alleging breach of the accountant's fiduciary duty. The tale leads to lessons learned.

Independence of Auditors

SEC No-Action Letter to Ernst & Young LLP on Alliance with Cap Gemini Ernst & Young LLC. By no-action letter dated May 25, 2000, the SEC's Chief Accountant advised Ernst & Young LLP that it would consider E&Y to maintain its independence even though Cap Gemini Ernst & Young were to provide IT services to E&Y audit clients. The no-action letter imposed a number of conditions that (1) limit at the outset and within five years end E&Y's equity interest in Cap Gemini; (2) impose limitations on Cap Gemini's use of the E&Y name; (3) require a strict separation of E&Y and Cap Gemini's corporate governance; (4) forbid any revenue sharing between E&Y and Cap Gemini; (5) forbid any joint marketing agreements between E&Y and Cap Gemini; and (6) restrict any shared services between E&Y and Cap Gemini. Letter of Lynn E. Turner, Chief Accountant of SEC, to Kathryn A. Oberly, Esq., Ernst & Young, May 25, 2000. Litigation Alleging Breach of Accountant's Fiduciary Duty; Liability for Systems Integrator's Nonperformance. Unfortunately, an SEC no-action letter is not a vaccine against client lawsuits. Accountants engaged in management consulting should pay careful attention to a ruling against Ernst & Young, LLP ("E&Y") and its successor in interest (by sale of consulting business), Cap Gemini Ernst & Young, U.S. LLC ("CGEY"). This case is instructive to anyone in a licensed professional capacity engaged in ancilli-ry or multidisciplinary consulting practice.

Pre-trial Ruling

In a pre-trial ruling in early January 2002 on a motion to dismiss, without deciding the final outcome, the court found that E&Y was potentially legally subject to claims of breach of fiduciary duty and punitive damages arising out of a failed software implementation by CGEY, a company in which apparently E&Y is a substantial owner. (The was no allegation or showing of a failure to exercise the skill and care of a reasonably diligent accountant, so the court noted that there were no claims of professional malpractice (whether relating to accounting or computer consulting).

Contd...

Notes

Alleged Misrepresentations by Accountants

The alleged facts of the case, if true, would be particularly egregious. The following reports are provided according to the court's pre-trial decision. Whether the allegations will be proven remains to be seen. In June 2000, E&Y recommended to a client, a medical and nutritional company, to retain CGEY as the vendor to implement a commercial off-the-shelf software package that the client had selected, based on E&Y's recommendation, for its short and long-term business needs. E&Y made a number of representations to the client to induce the client to hire CGEY, and the court concluded that, without those representations, the client would probably have selected another IT service provider. E&Y reportedly represented that (1) CGEY was competent, experienced and qualified to implement the system selected by E&Y, and (2) CGEY's performance of services had already been "coordinated" with E&Y.

Existence of Fiduciary Duty

A fiduciary relationship existed between the accounting firm and its client for several reasons. First, the client had developed a relationship of trusting the accounting firm's judgment based on prior professional services. Second, the accounting firm offered to provide additional consulting services. Third, the medical and nutritional company was less sophisticated than the accounting firm in the "specialty" for which the accounting firm and the services firm were hired.

Potential Breach of Accountant's Fiduciary Duty

Thus, "when a fiduciary fails to disclose personal interests preliminary to contract, and/or represents the existence of a questionable competence and experience critical to the contract and procures a benefit such as that alleged to E&Y and the newly formed CGEY, the risk of liability for the negligent misrepresentations and a question of fraud is properly alleged." Atkins Nutritionals, Inc. v. Ernst & Young, LLP, NYLJ, Jan. 10, 2002. Accordingly, a fiduciary relationship arose and could have been breached if proven at trial.

Questions:

1. What you have observed about code of auditing standard followed in Cap Gemini and Ernst & Young deal?
2. What misrepresentations by accountants had been discovered?
3. Analyze the case in your own words necessitating the need of auditing?

Source: Outsourcing-law.com

1.9 Summary

- The word 'Audit' is originated from the Latin word 'audire' which means 'to hear'. In the earlier days, whenever there is suspected fraud in a business organization, the owner of the business would appoint a person to check the accounts and hear the explanations given by the person responsible for keeping the account and funds.
- Audit may be defined as an official inspection of an individual's or organization's accounts, typically by an independent body.
- The role of accountancy is to record the transaction in the book of accounts, extraction of trial balance, preparation of trading and Profit and Loss Account and balance sheet etc.
- On the other hand, auditing is the examination of books of account and checking the financial statement for the purpose of finding out the true and fair position and results of operation of a concern.

Notes

- For a better understanding we could classify the objective of audit as: 1. Primary Objectives; 2. Secondary Objectives.
- When accountings principles are violated in writing the books of account the error of principal occurs. For example, when wrong account head is chosen to record a transaction, error of principal occurs. When expenses of capital nature are debited to revenue or vice versa it is said that error of principal has occurred.
- There are following types of audit: Statutory Audit; Non-statutory Audit; External Audit; Internal audit; Final Audit; Social audit; Performance Audit, etc.

1.10 Keywords

Internal Audit: This is a review of operation carried out sometimes continuously specially assigned staff with in the client business.

Non Statutory audit: This are the audit not specially required by law this scope of the audit will be outline by the contract between the auditor and the clients.

Social Audit: Social audit is performed to know the corporate social responsibility.

Statutory audit: This is the audit governed by statute such as the Company's Act.

Subsidiary objects: The subsidiary object of auditing is to detect and prevent errors and frauds in the books of accounts.

1.11 Review Questions

1. Briefly explain the origin of audit.
2. Define audit. What is the difference between auditing and accounting?
3. What are the objectives of audit?
4. Write short notes on following:
   (a) Detection and prevention of errors
   (b) Detection and prevention of frauds
   (c) Errors of commission
   (d) Errors of omission
   (e) Compensating Errors.
   (f) Misappropriation of cash
   (g) Misappropriation of goods
   (h) Falsification or manipulation of accounts
   (i) Window dressing
   (j) Secret reserves
5. What are the advantages of auditing for different organizations?
6. What are the different types of audit? What is the difference between internal audit and statutory audit?

Notes

Answers: Self Assessment

1. Indian Companies Act, 1913
2. Institute of Chartered Accountants of India
3. an independent body
4. Books of a accounts; records of a business
5. Correspondence audits; office audits; field audits
6. preparation of accounts
7. prior existence of accounts
8. financial statement
9. Secondary
10. Errors of principle
11. Third party audit
12. Subsidiary or Secondary
13. Social
14. Compliance audit

1.12 Further Readings

Books

David Coderre, *Internal Audit: Efficiency through Automation*, John Wiley & Sons, 2009.

Emile Woolf, Moira Hindson, *Audit and Accountancy Pitfalls: A Casebook for Practising Accountants, Lawyers and Insurers*, John Wiley & Sons, 2011.

Iain Gray, Stuart Manson, *The Audit Process: Principles, Practice and Cases*, Cengage Learning EMEA, 2007.

Jeanette Franzel, *Single Audit: Opportunities exist to improve the Single Audit Process and Oversight*, DIANE Publishing, 2009.

Susan Switzer, *Internal Audit Reports Post Sarbanes-Oxley: A Guide to Process-Driven Reporting*, John Wiley & Sons, 2007.

Online links

www.asiatradehub.com/india/tr9.asp

www.auditservices.com/aevidence.html

www.investopedia.com/terms/a/auditing-evidence.asp#ixzz1x6PIvbTg

www.informationbible.com/article-auditing-in-depth-111904.html

www.cag.gov.in/html/rti.htm

Notes

Unit 2: Auditing Practices

CONTENTS

Objectives

After studying this unit, you will be able to:

- Define generally accepted auditing practices;
- Discuss about audit evidences;

Notes

- Know auditing in depth;
- Discuss about accounting/auditing statements.

Introduction

Audit plays a pivotal role in keeping proper legal check on those who carry on the business in a fiduciary capacity. Shareholders not being legal experts, the auditor acts as a link between the shareholders and the management. Statutory auditing, mandatory for all companies, is one of the regulatory mechanisms designed to check abuses and irregularities in the financial aspects of the companies. There are numerous provisions incorporated in the Companies Act, 1956 stipulating the norms and rules to be followed in maintaining the accounts of the company. All companies are statutorily required to prepare and maintain accounts which are then scrutinized by the auditor who certify their correctness. For company accounts to be credible they must be true and fair and this is more likely to happen if someone competent and independent of the company has vetted the accounts. An auditor has a fiduciary relationship with the company. The statutory auditors are often described as the watchdogs of the company. They have access to the book of accounts, vouchers and documents, which no member of the company has. At the same time a number of duties and responsibilities are cast upon them. While describing the position of the auditor Ramaswamy J. has opined, "*An audit is intended for the protection of the shareholders and the auditor is expected to examine the accounts maintained by the directors with a view to inform the shareholders of the true financial position of the company. The directors occupy a fiduciary position in relation to the shareholders and in auditing the accounts maintained by the directors the auditor acts in the interest of the shareholders who are in the position of beneficiaries. Thus, the auditor is like a trustee for the shareholders.*" The auditor may be an individual or a firm of many individuals wherein each one is qualified to be an "auditor" individually also. The Companies Act, 1956 envisages independence in the office of the auditor and therefore, elaborate provisions have been incorporated in the Companies Act to ensure the same. Sections 224 to 226 of the Companies Act, 1956 provides for the appointment, qualifications, disqualifications and payment of remuneration to the statutory auditor. Thus, the role of audit is to provide a moral check on those who are entrusted with the task of running the business and keeping and maintaining books of account of the company. Auditors are also regarded as the agents of the members appointed to carry on certain duties as laid down in the statute and the articles for the purposes of the audit. Of late, the role of the auditor has gained tremendous importance.

2.1 Importance of Audit

The present structure of a modern company has the shareholder as the focal point of the legal system governing them. This is evident in not only the present structures available but also the concerns for the future. The single largest concern at the moment seems to be corporate governance. The image of the company is of great concern to the company. Transparency in accounts and an audit that will enforce the financial discipline is the most crucial aspect of maintaining this public image. Audit is the examination of the financial accounts of the company. There is a belief that the presence of independent, competent and vigilant authority exercising strict audit control, ensuring that all the required disclosures have been made by the directors from time to time, and the funds of the company have not been siphoned off for extraneous purposes and so on. The aim is to get the company to present a true and fair view of the financial position. Thus, the Companies Act, 1956 has provided for appointment, remuneration, removal, etc. of the auditors. Also the listing agreements of various stock exchanges have made provisions to ensure independent auditing.

The annual audit is one of the cornerstones of corporate governance. Given the separation of ownership from management, the directors are required to report on their stewardship by

means of the annual report and financial statements sent to the shareholders. The audit provides an external and objective check on the way in which the financial statements have been prepared and presented, and it is an essential part of the checks and balances required. The question is not whether there should be an audit, but how to ensure its objectivity and effectiveness. Audits are a reassurance to everybody who has a financial interest in companies, quite apart from their value to Boards of Directors.

Caution The most direct method of ensuring that companies are accountable for their actions is through open disclosure by boards and through audits carried out against strict accounting standards.

Self Assessment

Fill in the blanks:

1. The present structure of a modern company has the ..... as the focal point of the legal system governing them.
2. The annual audit is one of the cornerstones of .....
3. The audit provides an ..... on the way in which the financial statements have been prepared and presented.

2.2 Generally Accepted Auditing Practices

2.2.1 Investor Considerations

Companies incorporated under the Companies Act, 1956 must keep proper books and records, sufficient to give a true and fair view of the company's affairs and to explain its transactions. Shareholders of such companies must appoint auditors at the annual general meeting. In practice, a firm of accountant whose partners would each qualify for appointment is usually appointed. Auditors must report to a company's shareholders on the accounts examined by them; their report must cover various matters and include whether in their opinion the accounts give a true and fair view of the state of affairs of the company and of its results.

Notes For all companies whose annual turnover exceeds a specified amount, a statutory audit under the Companies Act is required, along with a tax audit for certain matters prescribed under the Income tax Act. The Government may direct that a cost audit be carried out for a company required to maintain detailed cost accounting records.

2.2.2 Statutory Requirements

Books and Records

Every company is required to keep proper books of account with respect to the following:

1. All sums of money received and expanded by the company as well as the matters with respect to which the receipts and expenditures took place.

Notes

2. All sales and purchases of goods made by the company.
3. The assets and liabilities of the company.

Caution A company that belongs to a class of companies engaged in production, processing, manufacturing, or mining activities also must maintain such details of utilization of material, labor and other items of cost as may be prescribed by the Central Government for that class.

There is no provision in the Companies Act as to the form in which the books of account are to be maintained, but it is incumbent on a company to maintain such books on an accrual basis. Such books and vouchers as are relevant to any entry in the books of account must be maintained for a period of at least eight years after the end of any financial year.

The books of account must be kept at the company's registered office. In the case of a company with a branch office, the books of account relating to the branch transactions may be kept at the branch office. If the Board of Directors decides to keep the books at a place other than the registered office, it must inform the Registrar of Companies within seven days of its decision and given the address of the place where the books are located.

The books of account and other books and papers are open to inspection by any director the Registrar of Companies or authorized government officials during business hours. Except in the case of a winding-up of a company, the shareholders have no right to inspect the books of account.

In addition to the books of account mentioned above, a company is required to keep various registers, e.g., an investment (securities) register, a register of shareholders, a separate register of directors and their share holdings, and minute books of shareholders' and directors' meetings.

Notes The shareholders have the right of access to most of these registers, which must be kept at the registered office of the company.

Task On the basis of accounting standards make a checklist of various books of accounts that company need to maintain for compliance and auditing purpose.

2.2.3 Audited Financial Statements

At every annual general meeting of a company, the Board of Directors must lay before the shareholders financial statements consisting of a balance sheet and a profit and loss account (income statement). These financial statements must be accompanies by the auditor's report and the report of the company's Board of Directors. The auditor is required to report on a long list of matters prescribed either in the Companies Act or in the orders issued under the Act and on any deviation from the mandatory accounting standards issued by the Institute of Chartered Accountants of India (ICAI).

The period covered by the income statement should not end on a date that is more than six months before the date of the annual general meeting unless the date of the general meeting is extended by the Registrar of Companies. However, in the case of the first annual general meeting, the gap between the two dates may be none months. The financial year may be less or more than

a year, but it should not exceed 15 months. With special permission of the Registrar, however, this period may be extended to 18 months.

The audited financial statements, together with a report by the Board of Directors, must be sent to shareholders and trustees for debenture holders at least 21 days before the date of the annual general meeting. Quoted companies can no longer send an abridged set of accounts to the shareholders and trustees for debentures holders, according to a circular dated September 23, 1994 issued by the Securities and Exchange Board of Indian. This circular was issued to the stock exchanges to modify all listing agreements. Quoted companies are also required by their listing agreement to furnish the stock exchange with unaudited financial results and required details on a half-yearly basis within two months of the expiration of the period and also to advertise such details in at least one national-language and one English daily newspaper. Publication of the unaudited results for the second half-year is not obligatory if the company informs the stock exchange that it will publish audited results within three months of the closure of the accounting year. If the total of the two half years' unaudited results with respect to any items in the prescribed form varies by 20 percent or more when compared with the audited accounts for the full year, a listed company must explain the reasons to the stock exchange.

In addition to accounts showing its position as a separate entity, a company that has subsidiaries must submit for each subsidiary the financial statements, the board's report and the auditor's report, all of which must be prepared in accordance with the requirements of the Act. A statement must be attached that shows the extent of the holding company's interest in each subsidiary at the end of the subsidiary's financial year and the profits and losses not dealt with in the holding company's accounts. The time lag between the balance sheet dates of the holding company and of the subsidiaries should not exceed six months. When the financial years of the subsidiary and its holding company do not coincide, the following information must be shown for each subsidiary.

1. Whether during the interval there has been any change in the holding company's interest in the subsidiary and, if so, the extent thereof.
2. Details of any material change occurring during the same period in fixed assets, investments, and loans given or taken by the subsidiary. All listed companies whose financial year ends in March 1996 or thereafter will be required to, as per the amended listing agreements, give a cash flow statement along with the balance sheet and profit and loss account. Such a statement is to be prepared in accordance with the requirements prescribed by the Securities Exchange Board of India and duly certified by the statuette auditors.

Caution There is no need to prepare group accounts.

After the accounts have been laid before the company at the annual general meeting, three copies of these accounts, together with all the documents that are required to be attached thereto e.g. auditor's report, Board's report-must be filed with the Registrar of Companies within 30 days from the date of the annual general meeting. Under the tax laws a uniform accounting year, April 1 to March 31, is to be followed. However, the Companies Act does not stipulate any such uniform accounting year. As a result, companies having financial statements closing on a date other than March 31 are required to get their accounts audited for the year ended March 31 for tax purposes as well.

2.2.4 Appointment of Auditors

The Companies Act requires that only Chartered Accountants within the meaning of the Chartered Accountants Act, 1949 can qualify for appointment as auditors. The first auditor of a company is

Notes

usually appointed by the directors. Subsequently, except for appointments to fill casual vacancies, auditors are normally appointed by the shareholders at each annual general meeting by an ordinary resolution to hold office until the next general meeting by an ordinary resolution to hold office until the next annual general meeting. In the case of companies in which not less than 51 percent of the paid-up share capital is held by the Central or State Government or by government-owned companies/corporations or a combination thereof, the auditor is appointed or reappointed by the Central Government on the advice of the Comptroller and Auditor General of India. However, in the case of a company in which not less than 25 percent of the subscribed share capital is held singly or jointly by the Government a prescribed financial institution, a Government company, a nationalized bank, or an insurance company, the appointment or reappointment of an auditor at each annual general meeting must be made by a special resolution that must be passed by not less than 75 percent of the total votes.

Casual vacancies arising other than by the resignation of an auditor are filled by the board. A vacancy in the office of auditor arising from resignation may be filled only be filled only by the shareholders in a general meeting. The shareholders at an annual general meeting may pass a resolution appointing as auditor a person other than the retiring auditor. The intention of proposing such a resolution must be notified by a shareholder to the company at least 14 clear days before the date of the meeting. The company, in turn, must give notice of the resolution to its shareholders within seven days before the date of meeting. This procedures is designated to avoid the removal of an auditor without providing a reasonable opportunity for all the shareholders to attend the meeting and vote on the matter.

Caution Except for the first auditor, no auditor may be removed before the expiration of the period of appointment without the previous approval of the Government.

In practice, a firm of accountant whose partners all qualify for appointment is usually appointed as auditors. No officer or employee of the company and no corporate body can be appointed auditor of the company, no person who is a partner or in the employment of an officer or employee of the company can be appointed auditor of any company. The term "officer" is defined by the Companies Act to include the directors, the secretary and management personnel of the company. The Companies Act sets a limit on the number of company audits that may be undertaken by an auditor; the ceiling is 20 companies per partner of an audit firm, of which companies with paid-up shares capital above ₹ 2.5 million should not number more than ten.

The auditor has the right of access at all times to the accounting and other records of the company, as well as the right to require from the officers of the company such information and explanation as the auditor deems necessary for the audit.

Self Assessment

Fill in the blanks:

4. The books of account must be kept at the .....
5. The ..... have the right of access to most of the registers, kept at the registered office of the company.
6. At every annual general meeting of a company, the Board of Directors must lay before the shareholders financial statements consisting of a ..... and .....
7. The period covered by the income statement should not end on a date that is ..... before the date of the annual general meeting unless the date of the general meeting is extended by the Registrar of Companies.

Notes

8. The audited financial statements, together with a report by the Board of Directors, must be sent to shareholders and trustees for debenture holders at least ..... before the date of the annual general meeting.

9. There is no need to prepare ..... Accounts.

2.3 Tax Audit

Every company with a total sales turnover or gross receipts over ₹ 4 million must have its accounts audited in accordance with the Income tax Act. This audit is in addition to the statutory audit under the Companies Act and mainly involves verification and confirmation of certain facts, figures and information that are generally required by the Tax authorities in the course of assessment proceedings and that broadly relate to the following:

1. Books of account examined.
2. Methods of accounting employed and their consistency.
3. Methods of valuation and quantitative reconciliation of inventories.
4. Amounts of expenditure incurred under various headings that are not allowable in full or that result indirect benefits to directors or their relatives or officers.
5. Borrowings and repayments of certain types of loans.
6. Prior-period adjustments.
7. Deductions of tax at source and deposit thereof with appropriate authorities.

These particulars must be certified as true and correct based on the auditor's opinion land information and explanation received.

The tax audit requirements also apply to other types of business entities whose total sales turnover or gross receipts in business exceed ₹ 4 million and to entities carrying on a profession whose gross receipts in the profession exceed ₹ 1 million in any year.

Notes Every company with a total sales turnover or gross receipts over ₹ 4 million must have its accounts audited in accordance with the Income tax Act.

2.4 Cost Audit

Companies are required to maintain cost accounting records, and they may be directed by the Government to have a cost audit. Unlike the financial audit and tax audit, which are carried out from year to year, a cost audit is carried out only upon specific order of the Government. The cost auditor submits a report to the Company Law Boards of the Central Government and sends a copy to the company.

2.5 Accounting Profession

The bodies of accountants whose members are engaged in public practice in India and that are recognized by the Government are the Institute of Chartered Accountants of India and the Institute of Cost and Works Accountants of India. The memberships of the two bodies in 1995 were over 70,000 and 15,000 respectively. The financial audit and the tax audit of a company are conducted by members of the former body; the cost audit is performed by members of the latter body.

Notes

The Institute of Chartered Accountants of India has recognized the training and examinations of the Institute of Chartered Accountants in England and Wales, the Institute of Chartered Accountants of Scotland, and the Institute of Chartered Accountants in Ireland as being equivalent to the training and examination prescribed for its members. As a result, members of these three institutes are also eligible to become members of the Indian Institute, subject to their fulfilling certain conditions, and may consequently engage in practice in India.

The need for independence in mental attitude in an auditor is recognized. However, it is not considered improper for auditors to have a financial interest in a company on which they report. If, however, the auditor has a substantial interest in the company's finances, the Chartered Accountants Act 1949 requires that this be disclosed. The phrase "substantial interest" has been defined by the Act, as a holding of shares carrying not less than 20 percent of the voting power beneficially either by the member or jointly with relatives. Members of the Institute are also required to adhere to a code of professional ethics, failing which they are deemed guilty of professional misconduct and are subject to disciplinary action.

Did u know? Accounting and Auditing practice in India is derived largely from practice in the United Kingdom. However, with the introduction of the Manufacturing and Other Companies (Auditors' Report) Order, 1988 [see the sample Auditor's Report (Caselet)] various other enactments in the Companies Act and other legislation connected with such things as employee remuneration, auditing practice in India is gradually becoming more independent. And the demands made by the Government, the public and other agencies on the auditors are far greater than before. For the guidance of its members, the Indian Institute from time-to-time published briefs on various matters relating to auditing and accounting practices.

2.6 Auditing Standards

The Institute of Chartered Accountants of India (ICAI) is a member of the International Federation of Accountants (IFAC), and the Auditing Practices Committee (APC) of the Indian Institute is committed to giving due consideration to the auditing guidelines issued by the International Auditing Practices Committee of IFAC and integrating them to the extent possible with the Indian Auditing Standards being issued by APC, in the light of conditions and practices prevailing in India.

The Institute of Chartered Accountants of India was set up in 1949 to regulate the profession of chartered accountancy in India. Since its establishment, the Institute has taken numerous steps to ensure that its members discharge their duties with due professional care, competence and sincerity. One of the steps is the establishment of the Auditing Practices Committee, or the Auditing and Assurance Standards Board, as it is now known in September, 1982.

One of the main objectives of the Board is to issue auditing standards. Accordingly, the Board issues Statements on Standard Auditing Practices and Auditing and assurance Standards under the authority of the Council.

2.6.1 Underlying Principle of Auditing Standards

In simplest possible terms, auditing standards represent a codification of the best practices of the profession, which are already existing. Auditing standards help the members in proper and optimum discharge of their profession duties. Auditing standards also promote uniformity in practice as also comparability.

Notes

2.6.2 Auditing Standards-Setting in India

As mentioned earlier, the Auditing and Assurance Standards Board of the Institute formulates the auditing standards. Broadly, following is the procedure for formulating auditing standards:

1. The Auditing and Assurance Standards Board identifies the areas where auditing standards need to be formulated and the priority in regard to their selection.
2. In the preparation of the auditing standards, the Board is normally, assisted by study groups comprising of a cross section of members of the Institute.
3. On the basis of the work of the study groups, an exposure draft of the proposed auditing standard is prepared by the Board and issued for comments of the members.
4. After taking into the comments received, the draft of the proposed auditing standard is finalised by the Board and submitted to the Council of the Institute.
5. The Council considers the final draft of the proposed auditing standard and, if necessary, modifies the same in consultation with the Board. The auditing standard is then issued under the authority of the Council.

While formulating the auditing standards, the Board also takes into consideration the applicable laws, customs, usages and business environment in the country.

2.6.3 Compliance with Auditing Standards

While discharging their attest functions, it is the duty of the members of the Institute to ensure that the auditing standards are followed in the audit of financial information covered by their audit reports. If for any reason the member is unable to perform an audit in accordance with the generally accepted auditing standards, his report should draw attention to any material departures therefrom, failing which he would be held guilty of professional misconduct under clause 9 of Part 1 of the Second Schedule to the Chartered Accountants Act, 1949.

Table 2.1: Comparative Position of International Engagement Standards, issued by the International Auditing and Assurance Standard Board of the International Federation of Accountants vis-a-vis, Auditing and Assurance Standards (AASs) issued by ICAI (As on May 25, 2007)

Standards on Quality control				
Sl. No	**ISQC No.**	**Title of the ISQC**	**AAS No.**	**Title of the AAS**
01.	1	Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements		*The Draft of SQC 1 is under consideration of the Council.*
Standards on Auditing				
	ISA No.	**Title of the ISA**	**AAS No.**	**AAS/ Guidance Note**
02.	200	Objective and General Principles Governing an Audit of Financial Statements	01	Basic Principles Governing an Audit
			02	Objective and Scope of the Audit of Financial Statements.
03.	210	*Terms of Audit Engagements*	26	Terms of Audit Engagements

Contd...

Notes

04.	220	Quality Control for Audits of Historical Financial Information	17	Quality Control for Audit Work
05.	230	Audit Documentation	03	*(Documentation The Board has already undertaken the revision of AAS 3).*
06.	240	The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements	04	The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements
07.	250	Consideration of Laws and Regulations in an Audit of Financial Statements	21	Consideration of Laws and Regulations in an Audit of Financial Statements
08.	260	Communications of Audit Matters with those Charged with Governance	27	Communications of Audit Matters with those Charged with Governance
09.	300	Planning an Audit of Financial Statements	08	Audit Planning
	310	Knowledge of the Business *(Withdrawn pursuant to issuance of ISA 315 and 330)*	20	Knowledge of the Business
10.	315	Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement		*The Exposure Draft of the proposed AAS is under reconsideration of the Board*
11.	320	Audit Materiality	13	Audit Materiality
12.	330	The Auditor's Procedures in Response to Assessed Risks		The Exposure Draft of the proposed *AAS is under reconsideration of the Board*
	400	Risk Assessments and Internal Control *(Withdrawn pursuant to issuance of ISA 315 and 330)*	06	Risk Assessments and Internal Control
	401	Auditing in a Computer Information Systems Environment *(Withdrawn pursuant to issuance of ISA 315 and 330)*	29	Auditing in a Computer Information Systems Environment.
13.	402	Audit Considerations Relating to Entities using Service Organizations	24	Audit Considerations Relating to Entities using Service Organisations
14.	500	Audit Evidence	05	Audit Evidence
15.	501	Audit Evidence – Additional Considerations for Specific Items	34	Audit Evidence – Additional Considerations for Specific Items
16.	505	External Confirmations	30	External Confirmations
17.	510	Initial Engagements – Opening Balances	22	Initial Engagements – Opening Balances
18.	520	Analytical Procedures	14	Analytical Procedures
19.	530	Audit Sampling and other Means of Testing	15	Audit Sampling
20.	540	Audit of Accounting Estimates	18	Audit of Accounting Estimates
21.	545	Auditing Fair Value Measurements and Disclosures		*The Board has constituted a study group for the project..*

Contd...

Notes

22.	550	Related Parties	23	Related Parties
23.	560	Subsequent Events	19	Subsequent Events *The Board has already undertaken the revision of AAS 19.*
24.	570	Going Concern	16	Going Concern
25.	580	Management Representations	11	Representations by Management
26.	600	Using the Work of Another Auditor	10	Using the Work of Another Auditor
27.	610	Considering the Work of Internal Audit	07	Relying Upon the Work of Internal Auditor
28.	620	Using the Work of an Expert	09	Using the Work of an Expert
29.	700	The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements	28	The Auditor's Report on Financial Statements
30.	701	Modifications to the Independent Auditor's Report		*The Board has already undertaken the revision of AAS 28.*
31.	710	Comparatives	25	*Comparatives*
32.	720	Other Information in Documents Containing Audited Financial Statements		*The Board has decided to come out with the Guidance Note corresponding to ISA 720 initially.*
33.	800	The Auditor's Report on Special Purpose Audit Engagements		Guidance Note on Audit Reports and Certificates for Special Purposes *The Board has already undertaken a project to prepare an AAS corresponding to ISA 800.*
Standards on Review Engagements				
	ISRE No.	**Title of the ISRE**	**AAS No.**	**Title of the AAS**
34.	2400	Engagements to Review Financial Statements	33	Engagements to Review Financial Statements
35.	2410	Review of Interim Financial Information Performed by the Independent Auditor of the Entity		*The Board has already undertaken a project to prepare an AAS corresponding to ISRE 2410.*
Standards on Assurance Engagements				
	ISAE No.	**Title of the ISAE**	**AAS No.**	**Title of the AAS**
36.	3000	Assurance Engagements Other than Audits or Reviews of Historical Financial Information		*The Board is likely to consider the need to issue the AAS corresponding to ISAE 3000 shortly.*
37.	3400	The Examination of Prospective Financial Information	35	The Examination of Prospective Financial Information

Contd...

Notes

Standards on Related Services Engagements				
	ISRS No.	Title of the ISRS	AAS No.	Title of the AAS
38.	4400	Engagements to Perform Agreed-upon Procedures Regarding Financial Information	32	Engagements to Perform Agreed-upon Procedures Regarding Financial Information
39.	4410	Engagements to Compile Financial Information	31	Engagements to Compile Financial Information

Table 2.2: Reconciliation of the International Engagement Standards, issued by the International Federation of Accountants with the Auditing and Assurance Standards, issued by ICAI (as on May 25, 2007)

(A)	Number of International Engagement Standards issued by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants	39
	Total	**39**
(B)	Auditing and Assurance Standards (AASs) and other authoritative documents issued by the Institute of Chartered Accountants	
	(i) Number of Indian auditing standards issued by ICAI {Standards issued are 35 but since two Standards cover one ISA, therefore, one Standard is reduced from the total Standards issued, i.e., 35-1}	34
	(ii) ISA not relevant to the Indian legal environment 1. ISA 720, Other Information in Documents Containing Audited Financial Statements 2. ISA 545, Auditing Fair Value Measurements and Disclosures	02
	(iii) International Standards corresponding to which the drafts of Auditing Standards are under consideration of the Council 1. ISQC 1, Quality control for Firms that Perform Audits and Reviews of Historical Financial Information, and other Assurance and Related Services Engagements	01
	(iv) International Standards corresponding to which the drafts of Auditing Standards are under consideration of the AASB 1. ISA 315, Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement 2. ISA 330, The Auditor's Procedures in Response to Risks of Material Misstatements	02
	(v) International Standards yet to be considered by the Auditing and Assurance Standards Board of ICAI 1. ISA 701, Modifications to the Independent Auditor's Report 2. ISA 800, The Auditor's Report on Special Purpose Audit Engagements 3. ISRE 2410, Review of Interim Financial Information Performed by the Independent Auditor of the Entity 4. ISAE 3000, Assurance Engagements other than Audits or Reviews of Historical Financial Information	04
	(vi) AAS corresponding to which no International Standard has been issued 1. AAS 12, Responsibility of Joint Auditors	(01)
	(vii) AASs issued corresponding to ISAs withdrawn by IAASB 1. AAS 06, Risk Assessment and Internal Control 2. AAS 20, Knowledge of the Business 3. AAS 29, Auditing in a Computer Information Systems Environment	(03)
	Total	**39**

Notes

These standards are all mandatory and are in addition to the following statements on auditing already issued by the Institute, which are also mandatory.

1. Statements on Auditing Practices.
2. Statements of Qualifications in Auditor's Report.
3. Statement on the Responsibilities of Joint Auditors.
4. Statement on Payment to Auditors for other Services.
5. Statement on Manufacturing and other Companies (Auditor's Report) Order, 1988.

Besides the above, the following guidance notes have also been issued by ICAI. These are recommendations rather than rules.

1. Auditing of Accounts of Liquidators.
2. Maintenance of Unduly Heavy Cash Balances by Companies.
3. Auditor's Ditties.
4. Independence of Auditors.
5. Surprise Checks.
6. Coordination between the Internal Auditors and Statuary Auditors.
7. Audit Reports and Certificates for Special Purposes.
8. Audit of Accounts of Non-corporate Entities.
9. Reports in Company Prospectus.
10. Control on the Quality of Audit Work.
11. Revision/Rectification of Financial Statements.
12. Audit Engagement Letters.
13. Audit of Inventories, Investments, Debtors, Loans and Advances, Liabilities, Cash and Bank Balances, Fixed Assets.
14. Audit of Banks.
15. Audit of Miscellaneous Expenditure shown in Balance Sheet.
16. Audit of Accounts of Members of Stock Exchange.
17. Tax Audit under the Income tax Act.
18. Unqualified Auditor's Report.

A typical unqualified auditors' report on the accounts of manufacturing, service, trading, and/or finance company laid before the company at the annual general meeting is set out below. However, the applicability of individual clauses is based on the activities of the company in question.

Notes

Caselet

Auditors' Report to the Members of XYZ Limited

We report that we have audited the balance sheet of XYZ Limited as at 31st March 1996 signed by us under reference to this report, and the relative profit and loss account for the year ended on that date, which are in agreement with the books of account.

In our opinion and to the best of our information and according to the explanations given to us, the balance sheet and the profit and loss account together with the notes thereon given, in the prescribed manner, the information required by the Companies Act, 1956 and also give, respectively, a true and fair view of the state of the Company's affairs as at 31st March 1996 and its profit for the year ended on that date.

We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for our audit. In our opinion, proper books of account have been kept as required by law so far as appears from our examination of those books.

As required by the Manufacturing and other Companies (Auditors' Report) Order dated 7th September 1988 and issued by the Central Government and on the basis of such checks as we considered appropriate and according to the information and explanations given to us, we further report that

1. (a) The company has maintained proper records to show full particulars including quantitative details and situation of its fixed assets;

   (b) The fixed assets of the company have been physically verified during the year by the management and no material discrepancies between the book records and the physical inventory have been noticed.

2. The fixed assets of the company have not been revalued during the year.

3. The stocks of finished goods, stores, spares parts, and raw materials of the company at all its locations have been physically verified by the management during/at the end of the year.

4. In our opinion, the procedures of physical verification of stocks followed by the management are reasonable and adequate in relation to the size of the company and nature of its business.

5. The discrepancies between the physical stocks and the book stocks, which were not material, have been properly dealt with in the books of account.

6. In our opinion, the valuation of stocks of finished goods, stores, spare parts, and raw materials has been fair and proper in accordance with the normally accepted accounting principles and is on the same basis as in the earlier years.

7. The company has not taken any loans secured or unsecured from companies, firms or other parties listed in the register maintained under Section 301 of the Companies Act, 1956 and/or companies under the same management as defined under sub-section (1B) of Section 370 of the Companies Act, 1956.

8. The company has not granted any loans secured or unsecured to companies, firms or other parties listed in the register maintained under Section 301 of the Companies Act, 1956 and/or companies under the same management as defined under sub-section(1B) of Section 370 of the Companies Act, 1956.

Contd...

Notes

9. Interest free loans or advances in the nature of loans have been given to the employees only, who are repaying the principal amounts as stipulated.

10. In our opinion, there is an adequate internal control procedure commensurate with the size of the company and the nature of its business for purchase of stores, raw materials including components, plant and machinery, equipment and similar assets, and for the sale of goods.

11. In our opinion, purchase of goods and materials and sale of goods, materials and services, made in pursuance of contract or arrangements entered in the register maintained under Section 301 of the Companies Act, 1956 and aggregating during the year to ₹ 50,000 or more in value in respect of each party, have been made at prices which are reasonable having regard to the prevailing market prices for such goods, materials or services or the prices at which the transactions for similar goods or services have been made with other parties.

12. The company has a system of determining unserviceable or damaged stores, raw materials and finished goods on the basis of technical evaluation and on the aforesaid basis, in our opinion, adequate provision for the loss has been made in the accounts.

13. In the cases of public deposits received by the company, the directives issued by the Reserve Bank of India and the provision of Section 58A of the Companies Act, 1956 and the rules framed thereunder, where applicable, have been complied with.

14. In our opinion, reasonable records have been maintained by the company for the sale and disposal of production scrap. The company has no by-product.

15. In our opinion, the company's present internal audit system is commensurate with its size and nature of business.

16. 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.

17. The company has generally been regular during the year in depositing provident fund dues with the appropriate authorities. As informed to us, the company is at present not covered under the Employees' State Insurance Act, 1948.

18. At the last day of the year there were no amounts outstanding in respect of all undisputed income tax, wealth tax sales tax, customs duty, and duty which were due for more than six months from the date e they became payable.

19. During the course of our examination of the books of account carried out in accordance with the generally accepted auditing practices, we have not come across any personal expenses which have been charged to Profit and Loss Account, nor have we been informed of such case by the management.

20. The company is not a sick industrial company within the meaning of Clause (o) of Section 3(1) of the Sick Industrial Companies (Special Provisions) Act, 1985.

21. In respect of services rendered :

    (a) In our opinion, the company has a reasonable system of recording receipts, issues and consumption of materials and stores and allocating materials and stores consumed to the relative jobs commensurate with the size and nature of its business.

    (b) In our opinion, the company has a reasonable system of allocating man hours utilized to the relative jobs, commensurate with its size and nature of its business.

Contd...

Notes

(c) In our opinion, there is reasonable system of authorization at proper levels with necessary controls on the issue of stores and allocation of stores and labor to various job and the related system of internal control of the company is commensurate with the size of the company and the nature of its business.

22. In respect of trading activities there are no damaged goods in the possession of the company as on 31st March 1996.

2.7 Audit Evidence

Audit programs should take into consideration the audit evidence required/desired as well as the various data gathering techniques.

2.7.1 Definition of 'Auditing Evidence'

The information collected for review of a company's financial transactions, internal control practices, and other factors necessary for the certification of financial statements by a certified public accountant. The amount and type of auditing evidence considered varies considerably based on the type of firm being audited as well as the required scope of the audit.

The goal of any audit is to determine whether a company's financial statements comply with the generally accepted accounting principles applicable to the entity's jurisdiction. Publicly traded companies are generally required to present fully audited financial statements to shareholders periodically.

Rules/standards of audit evidence dictate that the evidence gathered during the audit be:

1. ***Persuasive:*** This requires the exercise of good professional judgement. Audit evidence from the most to least persuasive include: physical examination; externally prepared; observations; inquiries/testimonial.
2. ***Competent:*** Obtaining the best quality of evidence available.
3. ***Useful:*** Evidence supporting goals and objectives.
4. ***Relevant:*** Evidence needs to be logical and sensible relative to the audit finding.

The types of audit evidence include:

1. ***Analytical:*** Review of relationships.
2. ***Documentary:*** Evidence exists in some permanent form.
3. ***Physical:*** Evidence is obtained via direct observations.
4. ***Testimonial:*** Statements made by customers/management; typically needs to be corroborated.

Audit programs should also consider the source of information/evidence (has it been "tainted"?):

1. Internal (bank account reconciliation, for example)
2. Internal - External - Internal (check)
3. External - Internal (bank statement)
4. External (bank account confirmation returned directly to the auditor)

Various techniques are used to gather audit evidence:

1. Physical Examination
2. Confirmation
3. Observation

Notes

4. Recalculating
5. Reconciliation
6. Inquiry
7. Inspecting

2.7.2 Accumulating and Evaluating Evidence

Reviewing a function point count to insure counting guidelines were followed would be considered a compliance audit. The purpose of a compliance audit is to determine whether the function point counts follow specific procedures and guidelines set down for Counting Practices Committee. The results of a compliance audit are generally reported to someone within the organizational unit being audited rather than to a broad spectrum of users.

Evidence is defined as any information used by the auditor to determine whether the function point count being audited is in compliance. Evidence can take many different forms, the function point count, system documentation, conversations with developers and users, and interviews with individuals that conducted the original count. The auditor gathers evidence to draw conclusions.

Of course the function point count itself can be used as evidence, but using the function point count alone would be severely inadequate. It is impossible to determine the accuracy of a function point count without evaluating additional evidence.

Notes If an auditor was given the task of auditing a company with 500,000 function points it would be impossible to review every count. The auditor may select only 20 or 30 applications to actually audit. The actual sample size will vary from auditor to auditor and audit to audit. The decision of how many items to test must be made by the auditor for each audit procedure. There are several factors that determine the appropriate sample size in audits. The two most important ones are the auditors' expectations of the number of errors and the effectiveness of the clients internal function point counting procedures.

Additionally, the evidence must be pertain or be relevant to the audit. The auditor must be skilled at finding areas to test or review further. For example, the auditor may determine during conversations that there was some confusion about external inputs and external interface files. In this case, the auditor would review the actual system documentation and the function point count to insure that the all the external input and external interface file were treated correctly. Another example would be that the function point counter had never counted a GUI application. The auditor would review a series of screens and determine if the original counter had correctly counted such items as radio buttons, check boxes, and so on.

The evidence must be considered believable or worthy of trust. If evidence is considered highly trusty worthy, it is a great help in assisting the auditor with a function point audit. On the other hand, if the evidence is in question such as incomplete documentation (or old documentation) then the auditor would have to scrutinize these areas of the count more closely. Additionally, the auditor should make note in the final report of any evidence they requested and the client was not able to provide.

All evidence should be evaluated based upon valuation, completeness, classification, rating, mechanical accuracy, and analytical analysis.

1. ***Valuation:*** The objective deals with whether items included in the function point count should have been included. Perhaps the original function point count included additional transactions or files that should not have been included.

Notes

2. ***Completeness:*** The objective deals with including all transactions and files in the final function point count. It is important that the application team review the final function point count to insure all transactions and files have been included. The valuation and completeness objectives emphasize opposite audit concerns. Valuation deals with potential overstatement and completeness with unrecorded transactions and files.

3. ***Classification:*** Classification involves determining whether all transactions and files have been correctly classified. It is important to make sure the external input and external interface file have been classified correctly for example.

4. ***Rating:*** This objective deals with determining if the transactions and files were appropriately ranked as low, average or high. To complete this objective a detail examination of the data elements and files referenced.

5. ***Mechanical Accuracy:*** Testing the mechanical accuracy involves rechecking a sample of the computations and transfers of information from one document to the next. Rechecking of computations consists of testing the original function point counters arithmetical accuracy. This is most important if an automated tool was not used while counting function points.

6. ***Analytical Analysis:*** This procedure is another way that a function point count can be validated. For example, the ratio of external inputs, external output, external inquiry, internal logical file, and external interface file can be compared with other applications meeting similar business needs. Also, the general system characteristics can be reviewed and compared to similar applications. Analytical procedures should be performed early in the audit so to help the auditor determine areas that need to be more thoroughly investigated.

Self Assessment

Fill in the blanks:

10. All evidence should be evaluated based upon .....; .....; .....; .....; .....; ..... .

11. Testing the ..... involves rechecking a sample of the computations and transfers of information from one document to the next.

12. Auditors shall conduct the audit of the financial statements of an entity with .....; ..... and .....

2.8 Auditing in Depth

Audit in depth involves the examination of books of accounts in depth. Such a system of checking is adopted in big business houses, where detailed examination of all the records in not possible. This system of checking is undertaken with a view to check the incidence of errors or frauds in the books of accounts.

2.8.1 Base of Audit in Depth

The technique of audit in depth is based on test checking. It is very difficult for an auditor to make detailed examination of all the record of a big business house. Thus, the auditor has to verify about the reliability of internal check. Along this, he selects some items on the basis of random sampling. After that the auditor makes a detailed examination of all the records.

Notes

Example: If the auditor has selected the purchase of any costly machinery, then be has to follow the following procedure for its audit in depth:

1. To see the minutes of directors meetings to examine that the purchase of machine is authorized or not.
2. To inspect the copy of purchase order sent for the purchase of the machinery.
3. To check the invoice received from the seller.
4. To check and inspect the machinery purchases.
5. To verify the amount paid to the seller.
6. To verify the expenses incurred for the installation of machinery.
7. To examine the entries made in books of accounts and plant register.

2.8.2 Techniques of Audit in Depth

According to the Institute of Chartered Accountants, England, there are three stages of audit in depth; they are:

1. ***Ascertainment:*** To find out the efficiency of the system of internal check.
2. ***Testing:*** To examine the important transactions in detail.
3. ***Assessment:*** To determine the limit of verification on the above investigation.

2.8.3 Advantages of Audit in Depth

The main advantages of this technique are as follows:

1. ***Saving in Time and Energy:*** The technique of audit in depth saves time and energy of the auditor and enables him to devote more time and energy in important matters.
2. ***To Detect the Well-designed Frauds:*** The technique of audit in depth is helpful in detecting the well-designed frauds.
3. ***To Present the Success of Test Checking:*** This technique presents the success of test checking.
4. ***Moral Pressure:*** It puts a moral pressure on the employees.

Append below is some salient points on Depth Test and its objective(s):

2.9 Depth Test

1. Sometimes also known as "cradle-to-grave" tests.
2. Its involves taking a transaction or a number of transactions and following them through the accounting system from start to finish or vice versa

Purposes/Objectives

Generally, depth test is to provide audit evidence to assist the auditor in arriving at his opinion. There are also some specific purposes of using depth test:

1. To confirm the accuracy of his client's accounting system. It is also refer to as "walk-through checks." Such a depth test is likely to involve only a small number of transactions.

Notes

2. To perform compliance test. The auditor may use a number of transactions, testing the control in depth at each stage. Such tests will provide him with evidence as to whether or not he may rely upon that control in planning later audit work.
3. To provide evidence of a substantive nature. He may use such principles to check that transactions have been properly recorded in the accounting records or in the financial statements.

2.10 Audited Statement of Accounts

The annual statement of accounts is prepared in accordance with the requirements of the Local Government (Scotland) Act, 1973. The statement of accounts presents the financial position and performance of the Council and its related bodies. From 2010/2011 the main elements of the statements are:

1. Movement in Reserves Statement
2. Comprehensive Income and Expenditure Statement
3. Balance Sheet
4. Cash Flow Statement
5. Notes to the Financial Statements
6. Housing Revenue Account
7. Council Tax Income Account
8. Non-domestic Rates Income Account
9. Common Good Fund
10. Remuneration Report

Self Assessment

Fill in the blanks:

13. Except for..... , no auditor may be removed before the expiration of the period of appointment without the previous approval of the Government.
14. Every company with a total sales turnover or gross receipts over ₹ 4 million must have its accounts audited in accordance with the .....
15. ..... audit is carried out only upon specific order of the government.
16. The amount and type of auditing evidence considered varies considerably based on the ..... and .....

2.11 Summary

- There are numerous provisions incorporated in the Companies Act, 1956 stipulating the norms and rules to be followed in maintaining the accounts of the company.
- All companies are statutorily required to prepare and maintain accounts which are then scrutinized by the auditor who certify their correctness.
- For company accounts to be credible they must be true and fair and this is more likely to happen if someone competent and independent of the company has vetted the accounts.

Notes

- An auditor has a fiduciary relationship with the company. The statutory auditors are often described as the watchdogs of the company.
- Companies incorporated under the Companies Act, 1956 must keep proper books and records, sufficient to give a true and fair view of the company's affairs and to explain its transactions. Shareholders of such companies must appoint auditors at the annual general meeting.
- There is no provision in the Companies Act as to the form in which the books of account are to be maintained, but it is incumbent on a company to maintain such books on an accrual basis.
- Such books and vouchers as are relevant to any entry in the books of account must be maintained for a period of at least eight years after the end of any financial year.
- At every annual general meeting of a company, the Board of Directors must lay before the shareholders financial statements consisting of a balance sheet and a profit and loss account (income statement).
- The Companies Act requires that only Chartered Accountants within the meaning of the Chartered Accountants Act, 1949 can qualify for appointment as auditors. The first auditor of a company is usually appointed by the directors.
- Subsequently, except for appointments to fill casual vacancies, auditors are normally appointed by the shareholders at each annual general meeting by an ordinary resolution to hold office until the next general meeting by an ordinary resolution to hold office until the next annual general meeting.
- Every company with a total sales turnover or gross receipts over ₹ 4 million must have its accounts audited in accordance with the Income tax Act.
- The cost auditor submits a report to the Company Law Boards of the Central Government and sends a copy to the company.
- The Institute of Chartered Accountants of India (ICAI) is a member of the International Federation of Accountants (IFAC), and the Auditing Practices Committee (APC) of the Indian Institute is committed to giving due consideration to the auditing guidelines issued by the International Auditing Practices Committee of IFAC and integrating them to the extent possible with the Indian Auditing Standards being issued by APC, in the light of conditions and practices prevailing in India.
- Audit programs should take into consideration the audit evidence required/desired as well as the various data gathering techniques.
- The technique of audit in depth is based on test checking. It is very difficult for an auditor to make detailed examination of all the record of a big business house. Thus, the auditor has to verify about the reliability of internal check.

2.12 Keywords

Depth auditing: This system of checking is undertaken with a view to check the incidence of errors or frauds in the books of accounts.

Depth Test: It involves taking a transaction or a number of transactions and following them through the accounting system from start to finish or vice versa.

Tax Audit: This audit in addition to the statutory audit under the Companies Act and mainly involves verification and confirmation of certain facts, figures and information that are generally required by the Tax authorities in the course of assessment proceedings.

Notes

2.13 Review Questions

1. Identify generally accepted auditing practices.
2. Why investor's considerations are important in formulating and executing auditing practices?
3. Elaborate the importance of auditing in current situations and prevalent company practices.
4. What are the various statutory requirements in carrying out various auditing practices?
5. What do you understand by audit evidence? What factors constitute auditing evidences?
6. What do you understand by word "Auditing in depth?" What are the key methods of performing in depth audit?
7. What are the key implications of accounting/auditing financial statements?
8. Write short notes on:
   (a) Cost audit
   (b) Tax audit
   (c) Accounting profession

Answers: Self Assessment

1. Shareholder
2. Corporate governance
3. External and objective check
4. Company's registered office
5. Shareholders
6. Balance sheet; a profit and loss account (income statement)
7. More than six months
8. 21 days
9. Group
10. Valuation, completeness, classification, rating, mechanical accuracy, and analytical analysis
11. Mechanical accuracy
12. Integrity; objectivity; independence
13. the first auditor
14. Income Tax Act
15. Cost
16. type of firm being audited; scope of the audit

2.14 Further Readings

Notes

Books

David Coderre, *Internal Audit: Efficiency through Automation* John Wiley & Sons, 2009.

Emile Woolf, Moira Hindson, *Audit and Accountancy Pitfalls: A Casebook for Practising Accountants, Lawyers and Insurers*, John Wiley & Sons, 2011.

Iain Gray, Stuart Manson, *The Audit Process: Principles, Practice and Cases*, Cengage Learning EMEA, 2007.

Jeanette Franzel, *Single Audit: Opportunities exist to improve the Single Audit Process and Oversight*, DIANE Publishing, 2009.

Susan Switzer, *Internal Audit Reports Post Sarbanes-Oxley: A Guide to Process-Driven Reporting*, John Wiley & Sons, 2007.

Online links

www.asiatradehub.com/india/tr9.asp

www.auditservices.com/aevidence.html

www.investopedia.com/terms/a/auditing-evidence.asp#ixzz1x6PIvbTg

www.informationbible.com/article-auditing-in-depth-111904.html

Notes

Unit 3: Roles and Independence of Auditor

CONTENTS

Objectives

After studying this unit, you will be able to:

- Identify audit functions of an auditor;
- Know the concepts of integrity, objectivity and independence of an auditor;
- Discuss the roles and responsibility of controller and Auditor-General of India.

Introduction

The very term auditor and audit makes many of us feel uncomfortable. Many industries have independent inspectors and auditors. As function points become more widely used and become a more important part of decision making, those using the function point counts will want them independently reviewed and audited. Auditing is the process by which a competent, independent person accumulates and evaluates evidence about quantifiable information related to a specific entity for the purpose of determining and reporting on the degree of correspondence between the quantifiable information and established criteria.

To do an audit of any kind, there must be information in a verifiable form and some standard by which the auditor can evaluate the information. The auditor may go to the business premises to examine records and obtain information about the reliability of the function point counts. On

Notes

the other hand, there may be adequate information that can be sent to the function point auditor that can be reviewed off site.

3.1 Auditor

The auditor must be a qualified to understand the criteria used and competent to know the types and amount of evidence to accumulate to reach the proper conclusion after the evidence has been examined. The auditor also must have an independent mental attitude. It does little good to have a competent person who is biased performing the audit. Independence cannot be absolute by any means, but it must be a goal.

Example: Even though an auditor may be paid a fee by a company they may still be sufficiently independent to conduct audits that can be relied upon by users. Auditors may not be sufficiently independent if they are also company employees.

Auditors shall conduct the audit of the financial statements of an entity with integrity, objectivity and independence.

3.1.1 Integrity

Integrity is a prerequisite for all those who act in the public interest. It is essential that auditors act, and are seen to act, with integrity, which requires not only honesty but a broad range of related qualities such as fairness, candor, courage, intellectual honesty and confidentiality. It is important that the directors and management of an audited entity can rely on the auditor to treat the information obtained during an audit as confidential, unless they have authorised its disclosure, unless it is already known to third parties or unless the auditor has a legal right or duty to disclose it. Without this, there is a danger that the directors and management will fail to disclose such information to the auditor and that the effectiveness of the audit will thereby be impaired.

3.1.2 Objectivity

Objectivity is a state of mind that excludes bias, prejudice and compromise and that gives fair and impartial consideration to all matters that are relevant to the task in hand, disregarding those that are not. Objectivity requires that the auditor's judgment is not affected by conflicts of interest. Like integrity, objectivity is a fundamental ethical principle.

The need for auditors to be objective arises from the fact that many of the important issues involved in the preparation of financial statements do not relate to questions of fact but rather to questions of judgment.

For example, there are choices to be made by the board of directors in deciding on the accounting policies to be adopted by the entity: the directors have to select the ones that they consider most appropriate and this decision can have a material impact on the financial statements. Furthermore, many items included in the financial statements cannot be measured with absolute precision and certainty. In many cases, estimates have to be made and the directors may have to choose one value from a range of possible outcomes. When exercising discretion in these areas, the directors have regard to the applicable financial reporting framework. If the directors, whether deliberately or inadvertently, make a biased judgment or an otherwise inappropriate decision, the financial statements may be misstated or misleading.

It is against this background that the auditor is required to express an opinion on the financial statements. The audit involves considering the process followed and the choices made by the

Notes

directors in preparing the financial statements and concluding whether the result gives a true and fair view. The auditor's objectivity requires that an impartial opinion is expressed in the light of all the available audit evidence and the auditor's professional judgment. Objectivity also requires that the auditor adopts a rigorous and robust approach and is prepared to disagree, where necessary, with the directors' judgments.

3.1.3 Independence

Independence is freedom from situations and relationships which make it probable that a reasonable and informed third party would conclude that objectivity either is impaired or could be impaired. Independence is related to and underpins objectivity. However, whereas objectivity is a personal behavioral characteristic concerning the auditor's state of mind, independence relates to the circumstances surrounding the audit, including the financial, employment, business and personal relationships between the auditor and the audited entity. The need for independence arises because, in most cases, users of the financial statements and other third parties do not have all the information necessary for judging whether the auditor is, in fact, objective. Although the auditor may be satisfied that its objectivity is not impaired by a particular situation, a third party may reach a different conclusion. For example, if a third party were aware that the auditor had certain financial, employment, business or personal relationships with the audited entity, that individual might reasonably conclude that the auditor could be subject to undue influence from the directors or would not be impartial or unbiased. Public confidence in the auditor's objectivity could therefore suffer as a result of this perception, irrespective of whether there is any actual impairment. Accordingly, in evaluating the likely consequences of such situations and relationships, the test to be applied is not whether the auditor considers that the auditor's objectivity is impaired but whether it is probable that a reasonable and informed third party would conclude that the auditor's objectivity either is impaired or is likely to be impaired. There are inherent threats to the level of independence (both actual and perceived) that the auditor can achieve as a result of the influence that the board of directors and management have over the appointment and remuneration of the auditor. The audit engagement partner considers the application of safeguards where there are threats to auditor independence (both actual and perceived).

In Brief

Keeping What Works

Several articles on the subject of audit independence have appeared in the CPA Journal. In the December 1998 issue, Robert K. Elliott and Peter D. Jacobson presented their versions of the objective, definition, and principles of audit independence. The author presents contrary views on the following points raised by Elliott and Jacobson:

1. The objective of an audit,
2. The effect of appearance of independence on information risk,
3. The appropriateness of regulating the appearance of independence, and
4. The wisdom of viewing integrity, objectivity, and independence as mutually exclusive qualities.

At the close of "Audit Independence Concepts," Robert K. Elliott and Peter D. Jacobson throw out a challenge to those unwilling to engage in wholesale abandonment of existing concepts of audit independence. They state: It is unlikely that a conceptual framework worthy of the profession's heritage will emerge without a frank admission that past independence concepts—to the extent they existed at all—left much to be desired. Those who revere the profession's

Notes

history may find the admission difficult, but it would be in the best traditions of independence. While reexamination of historically held views on any topic is usually necessary for progress, it is important to make sure those views are understood before considering discarding them. To that end, I accept Elliott and Jacobson's challenge on behalf of all those who do revere the profession's history.

Elliott and Jacobson assert that there has never been an official definition of the term independence and that there has never been a conceptual framework for audit independence. There has been an official definition of audit independence since Generally Accepted Auditing Standards were first proposed in 1947 (Tentative Statement of Auditing Standards—Their Generally Accepted Significance and Scope). Essentially the same definition exists today in AU section 220 of the AICPA's codification of auditing standards. The second general standard on independence requires that the auditor

"*must be without bias with respect to the client since otherwise he [or she] would lack that impartiality necessary for the dependability of his [or her] findings, however excellent his [or her] technical proficiency may be." AU section 220 also states that independence requires "intellectual honesty*" and a

"*judicial impartiality that recognizes an obligation for fairness not only to management and owners of a business but also to creditors and those who may otherwise rely (in part, at least) upon the independent auditor's report, as in the case of prospective owners or creditors.*"

The official definition of audit independence equates the term with an attitude and approach of objectivity (being unbiased, fair, and impartial) and integrity (being intellectually honest). There has also been an excellent foundation, at least for a conceptual framework, for several decades.

The Audit should enhance Credibility of Financial Information

Elliott and Jacobson assert that the immediate objective of the audit is to improve the reliability of information. They make passing mention of credibility, but relegate it to the periphery (not the core contribution). A key distinction between credibility and reliability is whether the focus is on the financial information or the user of that information. Financial information is made more reliable by preventing, or detecting and correcting, material misstatements or omissions in it. Financial information is made more credible by increasing users' confidence that the information is reliable.

Caution Independence is an essential auditing standard because the opinion of the independent accountant is furnished for the purpose of adding justified credibility to financial statements, which are primarily the representations of management.

The auditor can add justified credibility to financial statements even when no material misstatements or omissions are detected by validating their absence. Reliability is a characteristic of the financial information. The audit of the financial information adds significant assurance that the information is reliable and thereby enhances its credibility.

No matter which view is taken, the audit objective is to improve the quality of the information. The answer is found in the implication concerning the importance attached to the appearance of independence. If the objective of an audit is merely to improve reliability, then the perceptions of users about the independence of auditors can be regarded as irrelevant, or at least insignificant, within a conceptual framework and principles of independence. Viewing the auditor's role as adding credibility increases the legitimacy of treating the appearance of independence as a separate, self-sufficient cause for regulation.

Notes

Auditor independence can be defined as a reference to the independence of internal or external auditors from parties that might have a financial interest in the business being audited.

3.2 Independence Needs

1. ***Independence of mind:*** The state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism.
2. ***Independence in appearance:*** The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firms, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised.

The use of the word "independence" on its own may create misunderstandings. Standing alone, the word may lead observers to suppose that a person exercising professional judgment ought to be free from all economic, financial and other relationships. This is impossible, as every member of society has relationships with others. Therefore, the significance of economic, financial and other relationships should also be evaluated in the light of what a reasonable and informed third party having knowledge of all relevant information would reasonably conclude to be unacceptable.

3.2.1 Appearance of Independence does affect Perceived Information Risk

Elliott and Jacobson assert that "appearance of independence does not, at least in any way that has been identified, affect ... information risk." This assertion is very important to the concepts of independence that they propose because they acknowledge that "the information risk perceived by investors and creditors is reflected in the cost of capital to the corporation," and they propose that "the purpose of audit independence is to improve the cost-effectiveness of the capital markets." The link between audit independence and the effectiveness of the capital markets is at the heart of their analysis.

The relationship between the appearance of independence and the effectiveness of capital markets is not at all difficult to identify. In very simple terms, if investors and creditors believe that auditors are advocates for their clients and lacking in objectivity and integrity, then the information risk perceived by investors and creditors will increase and negatively impact the cost of capital. The cost of capital will increase for corporations generally and for new and relatively unknown companies especially. This would undermine the effectiveness of capital markets and, at the least, seriously diminish the value of the audit function.

3.2.2 Appearance of Independence is an Appropriate Subject of Regulation

Elliott and Jacobson suggest that the appearance of independence, apart from the fact of independence, is not a separate, self-sufficient cause for regulation. They argued in an earlier article (The CPA Journal, April 1998) that investors do not suffer damages from a specific engagement when there is an appearance of lacking independence. Investors in this circumstance simply do not rely upon the auditor. If the auditor is not independent in both appearance and fact, then lack of reliance is the proper response. If the auditor is actually independent in fact, but not appearance, then the auditor suffers, but the investor does not. Thus, regulation of the appearance of independence is not justifiable, they argue, because only the person pursuing the activity is harmed.

Notes

This position runs head-on into the official description of the importance of the appearance of independence stated as follows in AU section 220.03:

It is of utmost importance to the profession that the general public maintains confidence in the independence of independent auditors. Public confidence would be impaired by evidence that independence was actually lacking, and it might also be impaired by the existence of circumstances which reasonable people might believe likely to influence independence. To be independent, the auditor must be intellectually honest; to be recognized as independent, he [or she] must be free from any obligation to or interest in the client, its management, or its owners.

This rationale for the importance of the appearance of independence has been part of the official description of audit independence since at least 1963, when Statements on Auditing Procedure were codified with auditing standards. However, in the spirit of Elliott and Jacobson's challenge to look afresh at even historically revered notions, let's examine this description more closely. Does the concept of appearance of independence belong in a conceptual framework of auditing and audit independence?

A highly regarded previous attempt to develop a conceptual framework for auditing is found in R. K. Mautz and H. A. Sharaf's 'The Philosophy of Auditing'. Mautz and Sharaf develop a concept of independence with two components: practitioner-independence and profession-independence. Practitioner-independence is a state of mind and equates to the notion of the integrity and objectivity of the individual auditor. Profession-independence is the apparent independence of auditors, as a professional group, to the public.

The appearance of independence can be evaluated at two levels—the user's perception of the individual auditor's ability to be independent in particular unique circumstances and the general public's view toward public accountants as a professional group. Both levels exist in the authoritative auditing literature, but auditing standards attach the greatest significance to profession-independence. "It is of utmost importance to the profession that the general public maintains confidence in the independence of independent auditors". This reference is clearly to auditors as a professional group.

The logic of Elliott and Jacobson works only at the individual auditor level. If users are aware of all of an auditor's relationships and interests with respect to an audit client and believe there is something that creates an appearance of lack of independence, the situation can be avoided. They can "walk away," as financial analysts generally say they do, at any sign of an independence problem.

The same logic does not work at the profession level. If investors and creditors begin to view auditors as a professional group as lacking in independence, if they are viewed as client advocates, then as the U.S. Supreme Court concluded (in *United States v. Arthur Young*), "The value of the audit function itself might well be lost."

For this reason, the appearance of independence is an appropriate subject for regulation. Appearance of independence can, as described earlier, affect perceived information risk and thereby reduce the cost-effectiveness of the capital markets.

3.2.3 Integrity, Objectivity and Independence are not Mutually Exclusive

Elliott and Jacobson put forward a view of integrity, objectivity, and independence that makes them distinct, mutually exclusive concepts rather than interdependent qualities. In their formulation, the only requirements for a quality audit are for the auditor to be competent and objective. As they state the relationships, "Objectivity can result from perfect integrity (despite

Notes

impaired independence), perfect independence (despite impaired integrity), or some adequate combination of reasonable independence and integrity."

As explained earlier, the current official definition of independence at the individual auditor level equates independence in fact with integrity and objectivity. At the individual level, no significant purpose is served by trying to parse integrity, objectivity, and independence. If the auditor knowingly gives an unqualified opinion on financial statements that are materially and intentionally misstated, whether the cause is intellectual dishonesty, bias favoring the client's management or some other cause of lack of impartiality is unimportant and usually not determinable with any degree of certainty.

Did u know? The historical reason for the prohibitions against a direct financial interest in the client and against serving the client in the capacity of management or employee has been a quest for external signs by which a lack of independence might be recognized. Because members not in public practice could not meet these stringent requirements, a separate rule on integrity and objectivity was adopted and made applicable to all AICPA members. This occurred in the 1973 code. However, the existence of two rules in the code does not mean that the qualities of integrity and objectivity should be viewed separately from the quality of independence at the individual public auditor level.

3.2.4 The Independence of Auditors as a Profession must be Preserved

The interests, relationships, and transactions that create a presumption of lack of independence were adopted into existing requirements because of value judgments made about their potential effect at both the practitioner and profession level. The longevity of those requirements should not deter a searching reexamination of the underlying value judgments. However, any conceptual framework worthy of the profession's heritage cannot ignore the importance of the public's perception of auditors as a professional group. To do so would risk far more than reverence for that heritage.

Self Assessment

Fill in the blanks:

1. Audit independence equates the term with an attitude and approach of objectivity by ..... and integrity by.....
2. Financial statements are often audited by ..... for the purpose of enhancing confidence in their reliability.
3. ..... is an essential auditing standard because it added justified credibility to financial statements.

3.3 Duties and Powers of the Comptroller and Auditor-General of India

The duties and powers of the Comptroller and Auditor-General of India are enshrined in Chapter V of Part V of the Constitution of India in Articles 148 to 151 and elaborated under CAG's (Duties, Powers and Conditions of Service) Act, 1971.

Notes

1. ***Audit Functions:*** The duties of Comptroller and Auditor-General includes audit of:

   a. All expenditure from the Consolidated Fund of India of Union, of each State and of each Union Territory having a Legislative Assembly with the objective to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it;

   b. All transactions of the Union and of the States/Union Territory having a Legislature relating to Contingency Funds and Public Accounts;

   c. All trading, manufacturing, profit and loss accounts and balance-sheets and other subsidiary accounts kept in any department of the Union or of a State and in each case, to report on the expenditure, transactions or accounts so audited by him;

   d. Receipts and expenditure of bodies or authorities substantially financed from Union or State revenues;

   e. Grants or loans given to other authorities or bodies;

   f. Revenue of the Union and of the State Governments;

   g. Accounts of stores and stock;

   h. Government Companies and Corporations under the Company's Act, 1956 read with CAG's (DPC) Act, 1971 ; and

   i. Accounts of other authorities or bodies as per their statute or upon request by the Governor of a State or the Administrator of a Union Territory having a Legislative Assembly.

2. ***Accounting Functions:*** The Accounts Offices are responsible for:

   a. Compilation of accounts of the State Government;

   b. Preparation of the annual accounts of the States Governments and Union Territories having a Legislative Assembly; and

   c. Rendering accounting information and assistance to the State Governments.

3.4 Audit Reports

CAG presents a number of Audit Reports on the basis of audit of the Union Government and the State Governments to the Parliament and State Legislature respectively under Article 151 of the Constitution of India. In addition, CAG certifies the Appropriation Accounts and Finance Accounts of the Union Government and of the State Governments and forwards them to the President/Governors of States for being laid on the Table of Parliament and State Legislature respectively. CAG also submits Separate Audit Reports on all statutory corporations and autonomous bodies, for which he is the sole auditor.

The sectors under which CAG presents one or more volumes of his Audit Reports to Parliament are:

1. Civil;

2. Autonomous Bodies;

Notes

3. Scientific Departments;
4. Defence Services;
5. Railways;
6. Direct Taxes;
7. Indirect Taxes; and
8. Commercial.

CAG presents the following reports to State Legislature and Union Territories with Legislative Assemblies in one or more volumes:

1. Civil;
2. Revenue; and
3. Commercial.

Figure 3.1 : Organisation Structure

Task Read audit report carefully and identify main points included in such reports by carefully examining the role played by auditor in preparing such reports.

Self Assessment

Notes

Fill in the blanks:

4. The appearance of independence can be evaluated at ..... and .....
5. Duties and powers of the comptroller and Auditor-General of India can be divided into ..... and .....
6. CAG also submits separate audit reports on all ..... and....., for which he is the sole auditor.

3.5 Summary

- In almost every sophisticated industry there are auditors and inspectors function point analysis should not be any different.
- There is no need to fear audits or auditors. If they are done appropriately they should provide valuable feedback on the function point counting process.
- Auditing is the process by which a competent, independent person accumulates and evaluates evidence about quantifiable information related to a specific entity for the purpose of determining and reporting on the degree of correspondence between the quantifiable information and established criteria.
- Evidence can take many different forms, the function point count, system documentation, conversations with developers and users, and interviews with individuals that conducted the original count.
- Additionally, the evidence must be pertain or be relevant to the audit. The auditor must be skilled at finding areas to test or review further.
- All evidence should be evaluated based upon valuation, completeness, classification, rating, mechanical accuracy, and analytical analysis.
- The auditor must be a qualified to understand the criteria used and competent to know the types and amount of evidence to accumulate to reach the proper conclusion after the evidence has been examined.
- Auditors shall conduct the audit of the financial statements of an entity with integrity, objectivity and independence.
- The official definition of audit independence equates the term with an attitude and approach of objectivity (being unbiased, fair, and impartial) and integrity (being intellectually honest).
- Independence is an essential auditing standard because the opinion of the independent accountant is furnished for the purpose of adding justified credibility to financial statements, which are primarily the representations of management.
- The audit report may allow you to correct any incorrect function point counts, and re-evaluate the decisions you have made to date.

3.6 Keywords

Audit plays a pivotal role in keeping proper legal check on those who carry on the business in a fiduciary capacity. Shareholders not being legal experts.

Auditor Independence can be defined as a reference to the independence of internal or external auditors from parties that might have a financial interest in the business being audited.

Notes

Auditor: The auditor acts as a link between the shareholders and the management.

Independence in Appearance: The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firms, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised.

Independence of Mind: The state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism.

Statutory auditing, mandatory for all companies, is one of the regulatory mechanisms designed to check abuses and irregularities in the financial aspects of the companies.

3.7 Review Questions

1. Why does the distinction between improving reliability and adding credibility (enhancing confidence in reliability) matters?
2. Why independence of an auditor is important?
3. How appearance of independence affects perceived information risk?
4. "Appearance of independence is an appropriate subject of regulation". Justify.
5. "Objectivity can result from perfect integrity (despite impaired independence), perfect independence (despite impaired integrity), or some adequate combination of reasonable independence and integrity." Elaborate the statement.
6. Why the independence of auditors as a profession must be preserved?
7. What are the duties and powers of the Comptroller and Auditor-General of India?
8. Why integrity, objectivity and independence are not mutually exclusive? Elaborate.

Answers: Self Assessment

1. Being unbiased, fair, and impartial; being intellectually honest
2. independent accountants
3. Independence
4. the user's perception of the individual auditor's ability to be independent in particular unique circumstances; the general public's view toward public accountants as a professional group
5. Audit; accounting functions
6. statutory corporations; autonomous bodies

3.8 Further Readings

Books

David Coderre, *Internal Audit: Efficiency through Automation*, John Wiley & Sons, 2009.

Emile Woolf, Moira Hindson, *Audit and Accountancy Pitfalls: A Casebook for Practising Accountants, Lawyers and Insurers*, John Wiley & Sons, 2011.

Notes

Iain Gray, Stuart Manson, *The Audit Process: Principles, Practice and Cases*, Cengage Learning EMEA, 2007.

Jeanette Franzel, *Single Audit: Opportunities exist to improve the Single Audit Process and Oversight*, DIANE Publishing, 2009.

Susan Switzer, *Internal Audit Reports Post Sarbanes-Oxley: A Guide to Process-Driven Reporting*, John Wiley & Sons, 2007.

Online links

www.asiatradehub.com/india/tr9.asp

www.auditservices.com/aevidence.html

www.investopedia.com/terms/a/auditing-evidence.asp#ixzz1x6PIvbTg

www.informationbible.com/article-auditing-in-depth-111904.html

www.cag.gov.in/html/rti.htm

Notes

Unit 4: Section 226, 314 and Code of Ethics

CONTENTS

Notes

Objectives

After studying this unit, you will be able to:

- Know qualifications of auditors as per Section 226;
- Discuss about disqualifications of auditors as per Section 226;
- Explain Section 314;
- Identify auditor's code of ethics.

Introduction

The qualifications and disqualifications of auditors are provided in Section 226 of the Companies Act. The main purpose of this section is to ensure that only qualified person possessing the requisite knowledge and technical skill acts as the auditor of the company so that he may discharge his duties effectively. This is to ensure that the auditor is independent in carrying out his work so that he is able to give an unbiased opinion based on the objective assessment of the facts.

Auditors' Qualifications: Sub-sections (1) and (2) of Section 226 enumerate the qualifications required to be an auditor. A person who is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949 and holds a certificate of practice, or a partnership firm whereof all the partners are Chartered Accountants holding certificates of practice may be appointed as auditor, of a company. In the latter case, the appointment of an auditor may be made in the firm name and any of its partners may act in the name of the firm. Sub-section (2) provides for recognition of certain persons though not Chartered Accountants or possessed of similar qualifications, for appointment as auditors, if they have been functioning as such in the erstwhile Part 'B' States, or in Jammu and Kashmir, subject to the Rules framed in this behalf.

Auditors' Disqualifications: Sub-section (3) of Section 226 enumerates the categories of persons who are disqualified for appointment as auditors. The object of these disqualifications is to make the position of auditors as independent as possible from the affairs if the companies whose affairs they handle. Also, if under the Chartered Accountants Act any other disqualifications are added, they shall also apply. None of the following persons are qualified for appointment as auditor of a company:

1. a body corporate;
2. an officer or employee of the company;
3. a person who is a partner, or who is in employment of an officer or employee of the company;
4. a person indebted to the company for an amount exceeding one thousand rupees, or who has given any guarantee or provided any security in connection with indebtedness of any third person to the company for an amount exceeding one thousand rupees;
5. a person who is director or member of a private company, or a partner of a firm, which is the managing agent or the secretaries and treasurers of the company;
6. a person holding any security of that company after a period of one year from the date of commencement of the Companies (Amendment) Act, 2000.

Further, a person disqualified for appointment as auditor under the above disqualifications of any other body corporate which is that company's subsidiary or holding company or a subsidiary of that company's holding company, or would be disqualified if that body corporate were a company Section 226(5) further provides that "*if an auditor becomes subject, after his appointment, to any of the disqualifications, he shall be deemed to have vacated his office*".

Notes

Notes Apart from the disqualifications laid down in Section 226, the Institute of Chartered Accountants of India has prepared its own code of ethics which is mandatory for its members.

In order to ensure independence of the auditors and also to prevent conflict of interest and duty, the Council has decided not to permit a Chartered Accountant in employment to certify the financial statements of the concern in which he is employed, or of a concern under the same management as the concern in which he is employed, even though he is holding a certificate of practice and even though such certification can be done by any chartered accountant in practice. This restriction does not apply where the certification is permitted by any law. Further, it has also been decided that a chartered accountant should not by himself or in his firm name:–

1. Accept the auditorship of a college, if he is working as a part-time lecturer in the college.
2. Accept the auditorship of a trust where his partner is either an employee or a trustee of the trust.

4.1 Qualifications and Disqualifications of Auditors [Section 226]

Only individual, possessing the requisite knowledge and skill, can be appointed as auditor of the company. The auditor should be independent in carrying out his work so that he is able to give an unbiased opinion based on an objective assessment of facts. Thus, he should have no interest, financial or otherwise and whether directly or indirectly, in the company and/or its management.

A person, who is Chartered Accountant within the meaning of Chartered Accountants Act, 1949 and holds a certificate of practice, or a partnership firm where of all the partners are Chartered Accountants holding certificates of practice, may be appointed as auditor of a company. However, in the latter case, the appointment as an auditor may be made in the firm name and any of its partners may act in the name of the firm.

The following persons cannot be appointed as auditor of a company:

1. An officer or employee of the company;
2. A person who is partner with an employee of the company or employee of an employee of the company;
3. Any person who is indebted to a company for a sum exceeding ₹ 1,000/- or who have guaranteed to the company on behalf of another person for a sum exceeding ₹ 1,000/-.
4. A person who is holding any security of that company, after a period of one year from the date of commencement of Companies (Amendment) Act, 2000.

Caution If an auditor, after his appointment, becomes subject to any disqualification mentioned above, he shall be deemed to have vacated as such.

Central Government Act Section 226 in the Companies Act, 1956

1. A person shall not be qualified for appointment as auditor of a company unless he is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949 (48 of 1949)

Notes

2. (a) Notwithstanding anything contained in sub- section (1) but subject to the provisions of any rules made under clause (b), the holder of a certificate granted under a law in force in the whole or any portion of a Part B State immediately before the commencement of the Part B States (Laws) Act, 1951 (3 of 1951 .) [or of the Jammu and Kashmir (Extension of Laws) Act, 1956, (62 of 1956 .) as the case may be,] entitling him to act as an auditor of companies [in the territories which, immediately before the 1st November, 1956 , were comprised in that State] or any portion thereof, shall be entitled to be appointed to act as an auditor of companies registered anywhere in [India].

   (b) The Central Government may, by notification in the Official Gazette, make rules providing for the grant, renewal, suspension or cancellation of auditors' certificates to persons in 4[the territories which, immediately before the 1st November, 1956 , were comprised in Part- B States] for the purposes of clause (a), and prescribing conditions and restrictions for such grant, renewal, suspension or cancellation.

3. None of the following persons shall be qualified for appointment as auditor of a company-

   (a) a body corporate;

   (b) an officer or employee of the company;

   (c) a person who is a partner, or who is in the employment, of an officer or 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;

   (e) a person who is a director or member of a private company, or a partner of a firm, which is the managing agent or the secretaries and treasurers of the company;

   (f) a person who is a director or the holder of shares exceeding five per cent.

   Capital, of anybody corporate which is the managing agent or the secretaries and treasurers, of the company: Provided that any shares held by such person as nominee or trustee for any third person and in which the holder has no beneficial interest shall be excluded in computing the percentage of shares held by him for the purpose of this clause. Explanation.- References in this sub-section to an officer or employee shall be construed as not including references to an auditor.

4. A person shall also not be qualified for appointment as auditor of a company if he is, by virtue of sub-section (3), disqualified for appointment as auditor of any other body corporate which is that company's subsidiary or holding company or a subsidiary of that company's holding company, or would be so disqualified if the body corporate were a company.

5. If an auditor becomes subject, after his appointment, to any of the disqualifications specified in sub-sections (3) and (4), he shall be deemed to have vacated his office as such.

Self Assessment

Fill in the blanks:

1. Auditor is ..... in carrying out his work so that he is able to give an unbiased opinion based on the objective assessment of the facts.

2. Apart from the disqualifications laid down in Section 226, the Institute of Chartered Accountants of India has prepared its ..... which is mandatory for its members.

Notes

3. ..... means an office, which brings to the person holding it some pecuniary gain or advantage or benefit.

4. A person is said to hold an office or Place of Profit if there is between him and the company ..... in due discharge of his duties.

4.2 Central Government Act Section 314 in the Companies Act, 1956

4.2.1 Meaning

In ordinary parlance, an office or place of profit means an office or profit or position, which brings to the person holding it some pecuniary gain or advantage or benefit. It will be an office or place of profit if it carries some remuneration, pecuniary advantage, benefit etc. The amount of such profit is immaterial. Section 314 of the Companies Act, 1956 regulates the provisions relating to appointment of a director or any relative, firm, body corporate to an office or place of profit. The underlying object of this section is to ensure that those who occupy a fiduciary position in the company do not misuse, directly or indirectly, except with the permission of the shareholders or Central Government in certain cases. The provisions of this section are applicable to both public and private companies.

An Office or Place of Profit can be deemed to be an Office or Place of Profit

1. Where the office is held by a director, If the director holding it obtains from the company anything by way of remuneration over and above the remuneration to which he is entitled as such director, whether as salary, fees, commission, perquisites, the right to occupy free of rent any premises as a place of residence, or otherwise;

2. If the office or place is held by an individual other than a director or by any firm, private company or other body corporate, If the individual, firm, private company or body corporate holding it obtains from the company anything by way of remuneration whether as salary, fees, commission, perquisites, the right to occupy free of rent any premises as a place of residence, or otherwise.

A mere contractual arrangement entered into between a company and the persons listed in the section under which some monetary benefit flows to such person does not per se amount to holding an office or place of Profit, by such other person.

A person is said to hold an office or Place of Profit if there is between him and the company a relationship of employer and employee or such other person performs for and on behalf of the company certain acts under the control, direction or supervision of the company and also he is in receipt of consideration in due discharge of his duties. It is pertinent to note that this section prohibits a director of a company from holding an office or Place of Profit under the company or subsidiary. It, however, does not prohibit a director of a subsidiary company from holding an office or Place of Profit under the holding company.

4.2.2 Approval of Shareholders in General Meeting

In terms of Section 314(1), approval of shareholders by passing a special resolution in general meeting will be required for appointment of any of the following persons to an office or place of profit:

1. ***Any director:*** This section will be attracted even if the director receives an additional one rupee towards discharge of service in a capacity other than a director.

Notes

2. Partner in a firm in which a director is a partner
3. Relative of such director

   The Madras High Court in *A R Sundarasanam v Madras PHJS Nidhi Limited*, (1985) Comp Cas 776 (Mad) held that the office or place of profit held by a relative of a director is attracted by this section only if the director himself holds an office or place of profit. The words "such director' in sub-section (1)(b) referred to the director already holding the office of profit and not to any other director. This lacuna in law is proposed to be plugged by the Companies (Amendment) Bill, 2003 as the article 'a' has substituted the words 'such' before the word director.
4. A firm in which such director or relative is a partner
5. Any private company of which a director is a director or member
6. Any director or manager of such a private company

The object of this section is to prohibit a director and any person connected with him from holding any office or Place of Profit of such sum as may be prescribed unless the company approves it by means of a special resolution. The consent of the Board of Directors and the subsequent approval by the general meeting is no substitute for a special resolution. [*Gobind Pritamdas Malkani v Amarendranath Sircar*, (1980) 50 Com Cases 219, 233 (Cal)]

The provisions of this section will be attracted if any of the entities referred to in (b) to (f) receive monthly remuneration of ₹ 10,000 or more but less than ₹ 50,000 per month. The Delhi High Court in *Ravinder Kumar Sangal v Auto Lamps Ltd*. (1984) 55 Comp Cas 742 (Del). Held that the word "monthly" necessarily connotes anything taking place once a month, relating to a month, payable every month, based on a month, having a duration of one month, occurring, appearing or being done or acted upon every month or once a month. No other implication has been stressed.

Considered in this context, the payment of bonus, reimbursement in lieu of privilege leave not availed, employer's contribution to provident fund, reimbursement of medical expenses, etc., cannot be treated as events of monthly regularity of occurrence. They are dependent upon certain events happening during the course of the entire year, and as and when they take place.

Any office or place of profit held by the following persons shall be excluded from the rigors of this section:

1. Managing Director,
2. Manager,
3. Banker, or
4. Trustee for the debenture holder. This office may be held by them under the company or under any subsidiary of the company. This sub-section has been retained in the Companies (Amendment) Bill, 2003 also.

The section does not envisage prior approval of shareholders in general meeting. The person(s) referred to in sub-section (1) of Section 314 of the Act may hold office and that the special resolution may be passed by shareholders at the general meeting held for the first time after the holding of an office or place of profit. However, consent of the company shall be obtained in the general meeting or within a period of three months of the appointment whichever is later if either the relative of a director or a firm in which such relative is a partner is appointed to an office or place of profit without the knowledge of the director. Approval of shareholders in general meeting will not be required if the relative of a director or a firm in which the relative is a partner holds any office or place of profit under the company before the appointment of such

Notes

director as a director of the company. It is pertinent to note that this relaxation is available only in cases where either a relative of a director or a firm in which such relative of a director is a partner.

4.2.3 Prior Approval of Shareholders and Central Government

Sub-section (1B) of Section 314 lists persons who shall not hold office or place of profit carrying such remuneration as has been prescribed except with the prior approval of shareholders in general meeting and approval of Central Government. These persons include :

1. Partner in a firm in which a director of the company is a partner.
2. Relative of a director
3. Firm in which such director or his relative is a partner.
4. Firm in which such manager or relative is a partner.
5. Private company in which such director or his relative is a director or member.
6. Private company in which the manager or relative is a member.

Sub-section (1B) does not cover a director holding an office or place of profit and also a director or manager of a private company in which the director is a director or member. It also does not exclude the offices exempted under sub-section (1) i.e. Managing Director, manager, banker or trustee for the debenture holder. However, the Dept. of Company Affairs has clarified that the provisions of sub-section (1A) shall apply to cases falling under sub-section (1B) of the Act. A director receiving only sitting fee for attending meetings is not holding an 'office or Place of profit' [(*A. R. Sudarasanan v Madras Pursawalkam Hindu Janokara Saswatha Nidhi Ltd.*, (1985) 57 Comp. Cas. 776 (Mad)].

The Director's Relatives (Office or Place of Profit) Rules, 2003 provides that approval of Central Government shall now be required for cases where the remuneration exceeds ₹ 50,000 p.m. The application shall be made in form 24B to the secretary, Government of India, Department of Company Affairs accompanied by treasury challan for the payment of the requisite fee. Form 23 together with a certified true copy of the special resolution will be filed with the Registrar of Companies with in thirty days of the general meeting.

The Companies (Amendment) Bill, 2003 has omitted the provisions of sub-section (1B). It has, however, inserted a clause providing that the appointment of a relative of a director holding more than two percent of the equity of the company shall require the approval of Central Government if the remuneration exceeds such sums or percentage of profits or turn over as may be prescribed.

4.2.4 Vacation of Office

The office or Place of Profit held in contravention of the provisions of this section will become vacant and the director, partner, relative, firm, private company or the manager concerned, shall be deemed to have vacated his office as such on and from the date next following the general meeting and shall be liable to refund to the company any remuneration received or the monetary equivalent or advantage taken in respect of the office or place of profit.

Did u know? A question has been raised whether a special resolution under section 314(1B) is necessary for the appointment of managerial persons who may be relatives of directors and whose appointments are already regulated by section 269, etc. of the Act.

Notes

This query arises with reference to public companies to which the said section 269 applies and, strictly, will have to be answered in the affirmative. But in the interests of administrative convenience, it has been decided that the approval of the Central Government once again, under section 314(1B) will not be necessary in the cases where the Central Government's approval has already been taken under sections 198, 269, 309, 310 and 311, as the case may be. Irrespective of the question of Central Government's approval, the special resolution required under section 314(1B) will have to be passed whether by a public company or a private company.

Another question raised is whether approval of the general meeting and of the Central Government is necessary for an employee drawing salary exceeding ₹ 3,000 per month who is a relative of an existing director but the appointment of such employee was made before his relative became a director i.e. whether the exemption under section 314(1A) ensures under section 314(1B) as well. It is considered that sub-section (1) and sub-section (1A) should be read together before applying sub-section (1B) and inasmuch as there is nothing in sub-section (1B) to affect the operation of the principle underlying sub-section (1A), the exemption under sub-section (1A), continues to apply even with reference to a case concurrently falling under sub-section (1B).

In the case of a private company (not governed by section 269, etc. of the Companies Act, 1956) a question has arisen whether the appointment of a person as a Managing Director who is related to a director of the company will attract the provisions of section 314(1B) where the remuneration payable to such managing director is in excess of the limit envisaged in sub-section (1B). This question is answered in the affirmative. The circumstances that for the purpose of sub-section (1), which deals with appointments to an office of profit carrying less than a total monthly remuneration of ₹ 500 or more (i.e. up to ₹ 3,000), an exception is made in respect of an appointment of managing director or manager is not considered relevant because sub-section (1B) expressly overrides sub-section (1) and call for the exercise of a greater vigilance against the likelihood of the abuse of patronage in a case where the remuneration proposed is of the order of ₹ 3,000 per month and more.

A question has also been raised whether provisions of section 314(1B) are applicable where a company proposes to appoint a firm of solicitors and advocates, etc. to help the company in its work. It is considered that an advocate or solicitor appears in a court of law as an officer of the court in pleading the cause of justice and hence, such appearance and receiving fees of that account cannot lead to an inference of an offence or place of profit in or under the company under section 314 of the Act. However, if such a solicitor/advocate, etc. is appointed on a regular retainer basis from rendering legal advice other than appearance in courts, the provisions of section 314 will be applicable.

A question has also been raised whether provisions of section 314(1B) will be applicable to selling arrangements entered into by the company with a partner or relative of directors or with private companies of which such a partner or relative is a director or member. It is considered that these arrangements represent contracts, which fall under section 297 and so far as selling arrangements are concerned they may also attract section 294AA if the conditions for its operation are attracted; but section 314(1B) is not attracted.

Few cases of appointment of relatives of directors as statutory auditors of the company managed by such directors have come to the notice of the Department. It is conceded that there is no legal bar to such appointments so long as the provisions of section 314 and those relating to appointment of auditor are complied with the appointments are to be regarded as legally valid. It is, however, felt that it would be in the large interests of the profession, if the auditors were to avoid any conflict between their duties as statutory auditors of companies and their personal interest in

Notes

the management of such companies. As a matter of general principle, a Chartered Accountant, who was a near relation of a director of a company or a partner of a firm in which such director is a partner, should refrain from accepting the appointment of auditor of the company. As regards other categories or relatives of directors, a healthy convention should be established by such persons should not audit or sign the balance sheets of companies managed by their relatives or associates, even though the firms of which they were partners happened to be the auditors of these companies.

4.2.5 Circumstances under which a Special Resolution is required to be Passed

As per section 314(1) certain persons as given below cannot hold office or place of profit carrying the remuneration of ₹ 10,000 p.m. or more in the company, unless a special resolution to that effect has been passed in the general meeting of the company:—

1. Any partner of the firm in which director of the company is also a partner;
2. Any relative of a director of the company;
3. Any firm in which a director or his relatives or both are partner;
4. Any private company in which director of the company is holding office of director or member;
5. Any director/manager of a private company in which director of the company is holding office of director or member.

For computing the limit of ₹ 10,000 per month, bonus, leave encashment, reimbursement of medical expenses, etc., which are not events of monthly regularity or occurrence cannot be taken into account.

Where relative of any director or any of the person mentioned above is or appointed to an office or place of profit without the knowledge of director of the company, such appointment shall require the approval of the members in the general meeting by way of special resolution within 3 months of the date of appointment.

4.2.6 Consent of members may be taken subsequently

The appointment of such person under section 314 may be made by the Board at its meeting and may take consent of the company by passing special resolution in a general meeting held for the first time after the said appointment.

However, if the remuneration is more than ₹ 50,000 p.m. (Limit raised from ₹ 20,000 by the Director's Relatives (Office or Place of Profit) Rules, 2003 notified on 5-2-2003) prior approval of members by way of special resolution and the Central Government is required.

4.2.7 Increase in the Remuneration of a Person Appointed in the Office or Place of Profit

If the remuneration of a person appointed in the office or place of profit needs to be increased than the approval of the members of the company by passing special resolution in the general meeting is to be taken, for each time the remuneration is so increased. However, if the appointment is made under time scale in the first instance, there will be no need for further approval of members.

Notes

Relative of director or firm in which such relative is a partner, appointed to office or place of profit before a person hold the office of director in a company.

As per section 314(1A) if a relative of a director or firm in which such relative is partner is appointed to office or place of profit in a company before the appointment of such person as a director in the company, it will not affect the continuance of the holding of an office or place of profit by a relative of such director or by a firm in which such a relative is a partner.

4.2.8 Circumstances u/s. 314(1) under which Special Resolution is not Applicable

Under the following circumstances, the special resolution shall not be required for appointment of a person on the office or place of profit:

1. If the monthly remuneration is less than ₹ 10,000 p.m.;
2. If the office or place of profit held by such person(s) in the capacity of managing director/ whole-time director/manager/banker/debenture holder trustee;
3. If relative of director has been appointed before becoming director in the company;
4. If director of subsidiary company hold office or place of profit in holding company;
5. If such person is rendering professional advice to the company including director who is consulted or who gives his professional advice to the company occasionally and receive remuneration for such service;
6. If a company purchases or sell materials from or to a director of the company or any of the persons mentioned above to which section 297 will apply. Any person appointed to an office of agent for the sale of the output of the company will be deemed to be holding an office or place of profit under section 314(1).

4.2.9 Circumstances where Section 314(1B) is Applicable

As per section 314(1B) certain persons as given below cannot hold office or place of profit carrying the remuneration of ₹ 50,000 p.m. or more in the company, unless special resolution to that effect has been passed in the general meeting of the company and prior approval of the Central Government has been obtained:

1. any partner of the firm in which director of the company is also a partner;
2. any relative of a director of the company;
3. any firm in which a director or his relative or both are partner;
4. any private company in which director of the company is holding office of director or member;
5. any director/manager of a private company in which director of the company is holding office of director or member.

Caution Provision of section 314(1B) shall not apply to any appointment of firm of solicitors/advocates, if they are appointed to give advice and are consulted by the company in its work on case to case basis. Therefore, any remuneration or fee received by a professional director as advocates/solicitors for appearing in a Court of Law or Company Law Board/Tribunal in pleading on behalf of the company will not come under the provisions of the section as mentioned above.

Notes

4.2.10 Procedure for Appointment on Office or Place of Profit, where CG approval required

If a company appoint a director or concerned persons on office or place of profit on a total monthly remuneration of ₹ 50,000 or more, it has to obtain consent of the members of the company by way of special resolution in GM and with the prior approval of the Central Govt. for the first time after the holding of such office. The following procedure has to be complied with:

1. Hold a Board meeting & consider appointment u/s. 314 and approve notice for convening general meeting for passing special resolution by the members. Explanatory statement with full particulars has to be sent to the members with the notice of the meeting;
2. Obtain approval of selection committee (as per rules) for appointment of relative to office or place of profit before getting approval of members in general meeting;
3. Hold a general meeting and pass a special resolution for getting approval to the appointment under section 314(1) or (1B);
4. Particulars of such appointment shall be filed with the Registrar of Companies within thirty days of the passing of special resolution in the e-Form 23 u/s. 192 along with the copy of such resolution and prescribed fees;
5. Prepare and file an application to the Central Government for its approval in the e-Form 24B along with prescribed fee;
6. The Central Government may vary the terms and conditions of appointment while according its approval. On obtaining approval from the Central Government, the company should enter into a contract with the concerned person.

Task Does the appointment of director to the office of secretary also require CG approval?

4.2.11 Documents and Particulars to be Furnished in the Application to the Central Government

The following information shall be given in the application:

1. An undertaking from the appointee that he/she will be in the exclusive employment of the company and will not hold a place of profit in any other company.
2. The monetary value of all allowances and perquisites and of total remuneration package (monthly/annually) proposed to be paid to the appointee and details of the services that will be rendered by him to the company.
3. Shareholding pattern particularly the shareholding of the directors along with his/her/their relatives, the public holding, institutional holding (each institution separately).
4. The educational qualification/experience, pay scale, allowances and other benefits of similarly placed executives. In case of the appointment of a relative, then, an undertaking from the director/Company Secretary of the company that the similarly placed employees are getting the comparable salary shall also be enclosed along with the application.
5. List/Particulars of all the employees who are in receipt of remuneration of ₹ 50,000 or more per month.

Notes

6. The total number of relatives of all the directors either appointed as Managing/Whole-time director, Manager or in any other position in the company; the total remuneration paid to each relative and the total remuneration paid to them altogether as a percentage of profits as calculated for the purpose of section 198 of the Companies Act, 1956.

7. The selection and appointment of a relative of a director for holding office or place of profit in the company shall be approved by adopting the same procedure applicable to non-relatives. However, in the case of public companies, the selection of a relative of director for holding place of office or profit in the company shall have to be also approved by a Selection Committee.

4.2.12 Declaration by a Person who is Appointed to an Office or Place of Profit

When a person is proposed to be appointed to an office or place of profit, he is required to file a declaration in writing of his connection, if any, with the director of the company as prescribed in section 314(1)/(1B). No declaration needs to be filed if the person so appointed is connected to the manager in the company.

4.2.13 Consequences on Non-complying with the Provisions of Section 314

If any office or place of profit is held by certain persons which is not as per the provisions of the section mentioned above then any appointment made under contravention of the section will be held invalid from the date next following the date of holding the general meeting in which the special resolution is passed or from the date of expiry of three months referred to in the second provision under. Any remuneration received by such persons who were holding the office or place of profit as such shall pay back the remuneration received by them from the company.

The company is not under an obligation to waive the refund of any amount unless the Central Government, on application, waives such refund.

Director's Relatives (Office or Place of Profit) Rules, 2003

1. ***Short title and commencement:***

   (a) These rules may be called Director's Relatives (Office or Place of Profit) Rules, 2003.

   (b) They shall come into force on the date of their publication in the Official Gazette.

2. ***Applicability:*** These rules shall apply to all companies registered under the Companies Act, 1956 except as provided in these rules.

3. ***Approval of the Central Government in case of appointment of relatives etc. of directors:*** No appointment for an office or place of profit in a company shall take effect unless approved by the Central Government on an application, in respect of—

   (a) Partner or relative of a director or manager; or

   (b) Firm in which such director or manager, or relative of either is a partner; or

   (c) Private company of which such director or manager or relative of either is a director or member, which carries a monthly remuneration exceeding ₹ 50,000 p.m.

Notes

4. ***Procedure of examination of applications:*** The application under rule 3 shall be examined with respect to the following, in addition to all other requirements under the Companies Act, 1956:

   (a) An undertaking from the appointee that he/she will be in the exclusive employment of the company and will not hold a place of profit in any other company.

   (b) The monetary value of all allowances and perquisites and of total remuneration package (monthly/ annually) proposed to be paid to the appointee and details of the services that will be rendered by him to the company.

   (c) Shareholding pattern particularly the shareholding of the directors along with his/her/their relatives, the public holding, institutional holding (each institution separately).

   (d) The educational qualification/experience, pay scale, allowances and other benefits of similarly placed executives. In case of the appointment of a relative, then, an undertaking from the director/Company Secretary of the company that the similarly placed employees are getting the comparable salary shall also be enclosed along with the application.

   (e) List/Particulars of the employees who are in receipt of remuneration of ₹ 50,000 or more per month.

   (f) The total number of relatives of all the directors either appointed as Managing/ Whole time director, Manager or in any other position in the company; the total remuneration paid to each relative and the total remuneration paid to them altogether as a percentage of profits as calculated for the purpose of section 198 of the Companies Act, 1956.

   (g) The selection and appointment of a relative of a director for holding office or place of profit in the company shall be approved by adopting the same procedure applicable to non-relatives. However, in the case of public companies, the selection of a relative of director for holding place of office or profit in the company shall have also to be approved by a Selection Committee.

Notes For the purposes of sub-rule (7) of rule 4, the expression "Selection Committee" means a committee, the majority of which shall consist of independent directors and an expert in the respective field from outside the company.

4.2.14 Conclusion

The Amendment Bill has simplified this otherwise complicated provision and proposes to do away with central Government approval except in case where a relative of a director has been appointed and he holds more than two percent stake. In the company and draws remuneration more than such sums as may be prescribed.

Self Assessment

Fill in the blanks:

5. Only individual, possessing the requisite..... can be appointed as auditor of the company.

Notes

6. In terms of Section 314(1), approval of shareholders by passing a special resolution in general meeting will be required for appointment of .....; ..... and .....

7. Any office or place of Profit held by the following persons shall be excluded from the rigors of section 314 .....; .....; ..... and .....

4.3 Auditor's Code of Ethics

An auditor is a professional who is responsible for evaluating some aspects of a project, business, or individuals. Auditors often are employed for the task of determining the level of efficiency present in the production process of a business, the efficient use of labor and other resources associated with the business, and the veracity of the financial records of the business. Along with evaluating a project or aspect of a company, an auditor is often expected to make recommendations regarding the correction of negative conditions that currently impact the organization. Auditors are also to conduct themselves in a manner consistent with the promotion of co-operation and good relations between auditors and the sector.

As promulgated by Auditors, Auditing should adopt and uphold the Code of Ethics. The Code of Ethics states principles and expectations governing behavior of individuals and organizations in the conduct of auditing. It describes the minimum requirements for conduct, and behavioral expectations rather than specific activities.

Auditors' Code of Ethics is a system or code of behavior based on moral responsibility and obligation to explain how an auditor must behave. Auditors' Code of Ethic was enacted as a guide for all audit personnel to enhance the performance and professionalism. Auditor's General report helps to improve public management efficiency and effectiveness.

Caution It is utmost important that the audits produced followed a prescribed standard based on high work code of ethics to acquire the confidence from the public.

Financial statements of an enterprise depict the wholesome financial situation of the enterprise for a particular period/at a particular date. The information in these statements are of vital importance for a large section of the society, which deal with that enterprise. It may be suppliers of material, customers, investors, Banks, Financial Institutions, Insurers, Government, Tax Authorities, employees, collaborators and even their competitors.

Keeping in view the importance of these statements and the large section of the society who use these statements for taking many vital decisions, it is necessary that these statements are attested by some person who is expert in this field so that the objectivity, integrity, reliability and credibility of the information is assured to a large extent. This function of attestation is done by professional accountants, who are Chartered Accountants in our country.

It has been however, observed that there have been a number of cases in banks and financial institutions wherein due to the erroneous/ambiguous advice tendered by the respective Chartered Accountants, borrowal accounts have had to face quick mortality resulting in loss for the bank. Many a time this has also resulted in vigilance cases being initiated with the allegations of connivance/malafide/gross negligence being attributed to the concerned Bank officials.

For the success of the profession of accountancy a self-imposed Code of Ethics is essential to command the respect and confidence of the general public. Chartered Accountants in the service of the affairs of others have responsibilities and obligations to those who rely on their work.

Notes

A client, before engaging the services of a professional requires to be assured, (i) that he has the required competence and (ii) that he is a person of character and integrity. As regards the first, evidence is available to the client in the form of a certificate that the Chartered Accountant has undergone the training and passed the appropriate examination in accountancy and as regards the second, he would have an assurance only if the professional body to which he belongs has adopted a code of professional ethics for its members.

The International Federation of Accountants (IFAC), in its guidelines on Professional Ethics for the Accountancy Profession, has stated :-

"*Persons who pursue a vocation in which they offer their knowledge and skills in the service of the affairs of others have responsibilities and obligations to those who rely on their work. An essential pre-requisite for any group of such persons is the acceptance and observance of professional ethical standards regulating their relationship with clients, employers, employees, fellow members of the group and the public generally*."

IFAC in its Code of Ethics for Professional Accountants has also stated as under:-

The Public Interest: A distinguishing mark of a profession is acceptance of its responsibility to the public. The accountancy profession's public consists of clients, credit grantors, governments, employers, employees, investors, the business and financial community and others who rely on the objectivity and integrity of professional accountants to maintain the orderly functioning of commerce. This reliance imposes a public interest responsibility on the accountancy profession. The public interest is defined as the collective well-being of the community of people and institutions the professional accountant serves.

A professional accountant's responsibility is not exclusively to satisfy the needs of an individual client or employer. The standards of the accountancy profession are heavily determined by the public interest, for example :-

1. Independent auditors help to maintain the integrity and efficiency of the financial statements presented to financial institutions in partial support for loans and to stockholders for obtaining capital;
2. Financial executives serve in various financial management capacities in organizations and contribute to the efficient and effective use of the organization's resources;
3. Internal auditors provide assurance about a sound internal control system which enhances the reliability of the external financial information of the employer;
4. Tax experts help to establish confidence and efficiency in, and the fair application of, the tax system; and
5. Management consultants have a responsibility towards the public interest in advocating sound management decision-making.

Professional accountants have an important role in society. Investors, creditors, employers and other sections of the business community, as well as the government and the public at large rely on professional accountants for sound financial accounting and reporting, effective financial management and competent advice on a variety of business and taxation matters. The attitude and behaviour of professional accountants in providing such services have an impact on the economic well-being of their community and country.

Professional accountants can remain in this advantageous position only by continuing to provide the public with these unique services at a level which demonstrates that the public confidence is firmly founded. It is in the best interest of the worldwide accountancy profession to make known to users of the services provided by professional accountants that they are executed at the highest level of performance and in accordance with ethical requirements that strive to ensure

Notes

such performance. In formulating their national code of ethics, member bodies should therefore consider the public service and user expectations of the ethical standards of professional accountants and take their views into account. By doing so, any existing "expectation gap" between the standards expected and those prescribed can be addressed or explained.

4.3.1 Objectives

The Code recognizes that the objectives of the accountancy profession are to work to the highest standards of professionalism, to attain the highest levels of performance and generally to meet the public interest requirement set out above. These objectives require four basic needs to be met:-

1. ***Credibility:*** In the whole of society there is a need for credibility in information and information systems.
2. ***Professionalism:*** There is a need for individuals who can be clearly identified by clients, employers and other interested parties as professional persons in the accountancy field.
3. ***Quality of Services:*** There is a need for assurance that all services obtained from a professional accountant are carried out to the highest standards of performance.
4. ***Confidence:*** Users of the services of professional accountants should be able to feel confident that there exists a framework of professional ethics which governs the provision of those services.

4.3.2 Fundamental Principles

In order to achieve the objectives of the accountancy profession, professional accountants have to observe a number of prerequisites or fundamental principles. The fundamental principles are:-

Integrity: A professional accountant should be straightforward and honest in performing professional services.

Objectivity: A professional accountant should be fair and should not allow prejudice or bias, conflict of interest or influence of others to override objectivity.

Professional Competence and Due Care: A professional accountant should perform professional services with due care, competence and diligence and has a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives the advantage of competent professional service based on up-to-date developments in practice, legislation and techniques.

Confidentiality: A professional accountant should respect the confidentiality of information acquired during the course of performing professional services and should not use or disclose any such information without proper and specific authority or unless there is a legal or professional right or duty to disclose.

Professional Behaviour: A professional accountant should act in a manner consistent with the good reputation of the profession and refrain from any conduct which might bring discredit to the profession. The obligation to refrain from any conduct which might bring discredit to the profession requires IFAC member bodies to consider, when developing ethical requirements, the responsibilities of a professional accountant to clients, third parties, other members of the accountancy profession, staff, employers and the general public.

Technical Standards: A professional accountant should carry out professional services in accordance with the relevant technical and professional standards. Professional accountants

Notes

have a duty to carry out with care and skill, the instructions of the client or employer in-so-far as they are compatible with the requirements of integrity, objectivity and in the case of professional accountants in public practice, independence. In addition they should confirm with the technical and professional standards promulgated by:-

1. IFAC (e.g. International Standards on Auditing);
2. International Accounting Standards Board;
3. The Member's professional body or other regulatory body; and
4. Relevant legislation.

Independence

When in public practice, an accountant should both be, and appear to be, free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity.

The overriding motto has been 'pride of service in preference to personal gain'. A code of professional conduct may have the force of law, as is the case in this country in some matters, as well as the result of discipline and conventions voluntarily established by the members, any breach whereof would result in the person being disentitled to continue as a member of the professional body. In any event, it has a great deal of practical value in so far as it proclaims to the public that the members of the profession will discharge their duties and responsibilities, having regard to the public interest. This, in turn, will give an assurance to the public that in the event of a member straying away from the path of duty, he would be suitably dealt with by the professional body.

"Other Misconduct"

In this background, the Chartered Accountants Act, 1949 (as amended up to date), was formulated to regulate the profession of Chartered Accountancy. This Act is being administered through the Institute of Chartered Accountants of India; which functions and discharges its duty through a 'Council'. To ensure discipline in the profession, The Chartered Accountants Act along with its schedules sets out different forms of behaviour, which constitute misconduct under the law. The definition of misconduct in the Act is only an inclusive one and is not exhaustive. Over and above this, the council of the institution (ICAI) has also been given powers under the law to enquire into the conduct of any member of the Institute other than those specified in the Act, which may in the view of the COUNCIL be not desirable and/or expected of a Chartered Accountant. This kind of misconduct is known as 'other misconduct'. The 'other misconduct' may not necessarily arise out of professional work. With a view to bring harmony in presentation of the financial statements and an identical treatment in a particular situation, the ICAI has brought out various Statements, Auditing and Assurance Standards, Accounting Standards and Guidance Notes, which are mandatory for a practicing Chartered Accountant to be adhered to while discharging his professional duty of attestation of financial statements. These sets of documents necessitate that financial statements are depicted in a definite manner, and give the required information in the desired manner, which are professionally verified by applying scientific audit techniques to ensure material correctness to a large extent. The objectivity and integrity of the financial statements attested by a Chartered Accountant following these sets of documents, are of a very high degree, and which enhance the credibility and reliability of these statements to the user. A Chartered Accountant who does not follow these sets of documents in

Notes

discharging his professional duty of attestation, is guilty of professional misconduct, and thereby liable for disciplinary action and punishment under the Act, which may be;

(i) Reprimanding the member, or

(ii) Removing his name from the Register of members for such period not exceeding five years, or

(iii) Forwarding the case to the High Court with its recommendations where the council opines for removal of name for a period exceeding five years, or

(iv) If the misconduct is of a nature, which as per the Chartered Accountants Act requires action by the High Court, reference to the High Court with recommendations of the council. The procedure of enquiry in respect of disciplinary action against a Chartered Accountant is not only lengthy but rigorous also. Barring a few exceptions, the Chartered Accountant, who has to face action would feel so humiliated that his enthusiasm and working capacity comes to the lowest level. Removal of name as a punishment further nails him with a severe economic blow.

Still there are instances when it is noticed that the report of Chartered Accountants either misses vital information which must be there, or gives incomplete information or gives information in a misleading manner or at times gives completely wrong information. It is pertinently noticed by bank officials in dispensation of credit and monitoring of some financed cases, that information in the financial statements does not help in taking a right and judicious decision. Though it is difficult to substantiate by tangible evidences, but circumstantial evidences in certain cases, do point out that the intention of all concerned has not been *bona fide*, rather it is *mala fide* and is done with some ulterior motive.

Some of the common points where reports of Chartered Accountants have not been of desirable level are:-

1. Valuation of stocks including work-in-progress.
2. Transactions with related parties.
3. Valuation of investments
4. Valuation and status of other assets.
5. Status of Sundry Debtors
6. Status of Creditors
7. Status of loans
8. Provision in respect of all the known liabilities.

All these issues have a considerable impact on profit and the real financial health of an enterprise, failure of which would prevent taking of a well informed, correct decision by banks and financial institutions. Here it may not be out of place to mention that banks and financial institutions are heavily relying on Chartered Accountants in discharging their work in judicious manner. For this the banks get various type of reports and certificates which the banks have devised after much deliberations. If these certificates give the required information in the right perspective, the loan assets of the banks to a large extent may be saved from becoming bad.

These certificates and reports in general are:-

1. Annual Audit Report on the Accounts of Borrower CAs have to be transparent and absolutely honest while certifying the following items:

   (a) *Valuation of inventory:* Stock, work-in-progress, finished goods, etc. (It may be observed that variations in the sale of the stocks declared by the companies in their

Notes

stock statement for the year ending position in March and the value of stocks declared in the annual accounts subsequently are on account of this.)

(b) *Dealing with group accounts:* Normally this is where diversion of funds take place. CAs also should comment whether transactions are at par with commercial transactions done with other parties. CAs also should comment whether investments in group companies are safe and sound.

(c) It should also be commented whether any bad debt is included under Sundry Debtors, whether loans and advances to group companies are camouflaged under sundry debtors to avail book debt finance, whether any fictitious debt is created to avail finance from banks (like fertilizer subsidy financed against by banks).

(d) Whether any fictitious sales are booked to inflate sales/profit.

2. ***Stock Audit of Borrowal accounts:*** CAs should bear in mind that based on their certificate, the banks value the security. Any false certificate will affect the security of the bank and jeopardize their funds. The valuation of stocks should be judged correctly. The valuation of especially work-in-progress should be studied in depth. The sundry creditors position should be analyzed to see whether paid for stocks is adequate. The sundry debtors position should be analyzed to ensure that:

   - The debts are good and realizable;
   - No bad debt is included;
   - In case of debts relating to group company, they are reflecting genuine commercial transaction;
   - No fictitious debt is created.

   Regarding specific certificates/tasks, sometimes, in order to comply with the terms of sanction in a hurry, banks get these certificates from any CA. The purpose of the banks will be served better, if they insist that the 'statutory auditors' to the company should give these certificates.

3. Specific certificate with respect to infusion of capital or family loans.
4. Monitoring of accounts with a specific objective.
5. Certification of utilization of funds for the desired end-use.

However the plight is that these certificates and reports do not give the required information in the required manner and therefore fail to serve the desired purpose. Besides the large number of disclaimers made lessen the authenticity of the Report made by the Chartered Accountant. At times CAs also function as directors of companies on their Boards.

What is to be Code of Conduct for them is well defined in Naresh Chandra Committee Report and should be implemented? If these certificates and reports are objectively prepared keeping in view the statements, standards and guidance notes issued by ICAI, it is believed that the required information in the required manner will be available to a large extent. In short, the essence of the whole issue is that the rigorous disciplinary action of ICAI also seems to be ineffective to some extent in deterring some of the Chartered Accountants from resorting to undesirable practices. The reason for this, seems to be that many a time undesirable practices are not caught and only sparingly CA(s) get punished for their intentional misdeeds; which again is a time taking process.

It is suggested that the following be mandated as a Policy:-

(a) Banks and financial institutions have independent assessment of the work of Chartered Accountants and a list of Chartered Accountants, who work objectively, may be evolved

Notes

and simultaneously the list of Chartered Accountants, whose work is undesirable, can also be evolved. Such lists may be shared by nationalized banks amongst themselves. Further, if it is found that the Chartered Accountant has not adequately reported nonadherence of the laid down Statements Standards and/or Guidance Notes in preparing his reports, the concerned banks should report the matter to the Institute of Chartered Accountants of India, who should take the required action against the concerned Chartered Accountant within a specific time schedule.

(b) It could be made mandatory that companies should change their 'statutory auditors' every 3 years. Periodic changes will be healthy.

4.3.3 Purpose of Code of Ethics

The purpose of Code of Ethics is to promote an ethical culture in the profession of auditing and provides guidance to Auditors serving others. Auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

Caselet

KPMG Canada: Lack of Independence

In June 2005, the Securities and Exchange Commission entered into a settlement, in an enforcement action, with KPMG LLP (KPMG Canada), a Canadian audit firm, and two of its partners, Gary Bentham, the audit engagement partner, and John Gordon, the concurring and SEC reviewing partner. The SEC asserted that KPMG Canada, Bentham and Gordon lacked independence when they audited the 1999 through 2002 financial statements of Southwestern Water Exploration Co. (Southwestern), a now-bankrupt Colorado corporation.

The SEC claimed that KPMG Canada provided bookkeeping services to Southwestern and then audited its own work. Specifically, after KPMG Canada prepared certain of Southwestern's basic accounting records and financial statements, it issued purportedly independent audit reports on those financial statements. KPMG Canada's audit reports were included in Southwestern's annual reports that were filed with the Commission.

The SEC found that KPMG Canada, Bentham and Gordon engaged in "improper professional conduct" within the meaning of Rule 102(e) of the SEC's Rules of Practice by virtue of their violations of the auditor independence requirements imposed by the Commission's rules and guidance and by generally accepted auditing standards in the United States.

4.3.4 Importance of the Code of Ethics

A code of ethics is necessary and appropriate for the auditing profession. Founded as it is on the trust placed in its objective assurance about risk management, control, and governance.

The Code of Ethics extends beyond the definition of auditing to include two essential components:

1. Principles that is relevant to the profession and practice of auditing;
2. The Rules of Conduct describe behavior norms expected of auditors. These rules are an aid to interpreting the Principles into practical applications and are intended to guide the ethical conduct of auditors. Below they are set out together with the principle they interpret.

Notes

4.3.5 Applicability and Enforcement

This Code of Ethics is directed to internal, external auditors, as well as all other individuals working on a company audit. For association members, breaches of the Code of Ethics will be evaluated and administered according to Disciplinary Procedures. The fact that a particular conduct is not mentioned in the Rules of Conduct does not prevent it from being unacceptable or discreditable, and therefore, the member liable to disciplinary action.

4.3.6 Rules of Conduct

1. ***Integrity:*** Auditors shall:
   a. follow high standards of fairness, integrity and ethical conduct;
   b. achieve their work with honesty, diligence, and responsibility;
   c. observe the law and make disclosures expected by the law and the profession;
   d. not knowingly be a party to any illegal activity, or engage in acts that are discreditable to the profession of auditing or to the organization;
   e. respect the integrity of other auditors, recognizing their different experiences and areas of expertise, and contribute to the legitimate and ethical objectives of the organization; and
   f. not represent themselves as employees or contractors for the Construction Safety Network at any time.
2. ***Objectivity:*** Auditors shall:
   a. conduct the audit as instructed by the Audit Protocol without bias, prejudice, variance or compromise;
   b. not participate in any activity or relationship that may impair or be presumed to impair their unbiased assessment. This participation includes those activities or relationships that may be in conflict with the interest of the organization;
   c. remain free of any influence, interest or relationship that impairs professional judgment, independence or objectivity while providing auditing services;
   d. auditors must not market their services at anytime during the audit process;
   e. reveal any potential personal or perceived conflict of interest during initial contact or communication with a client;
   f. auditors must avoid conflicts of interest at all times;
   g. auditors must not conduct two consecutive audits for a company;
   h. protect their independence and not accept any gifts of gratuities which could influence, compromise or threaten the ability of the auditor to act and be seen to be acting independently; and
   i. uphold both the actual and perceived political neutrality in order to discharge their duties and responsibilities in an impartial way.
3. ***Confidentiality:*** Auditors shall:
   a. sustain the confidentiality of information received during the audit;
   b. be prudent in the use and protection of information acquired in the course of their duties;
   c. not use audit information for any personal gain or in any manner that would be contrary to the law or detrimental to the legitimate and ethical objectives of the organization; and

Notes

d. take all reasonable steps to protect the confidentiality of the audit results, data collected and the anonymity of interviewees.

4. ***Competency:*** Auditors shall:

   a. engage only in those services for which they have the necessary knowledge, skills, and experience, and not assign or subcontract any obligation of the audit program;

   b. continually improve their proficiency and the effectiveness and quality of their skills;

   c. be consistent and accurate in their evaluations of data obtained through documentation, interviews and observation;

   d. strive to be complete in their evaluations and avoid any omissions;

   e. separate fact from opinion clearly and concisely in their evaluations. Support for auditor opinions must be derived from quantitative, measurable data;

   f. serve the client in a conscientious, diligent, respectful and efficient manner;

   g. assist clients with any post audit questions, such as recommendations or explanations of results;

   h. commit to honest, thorough and straightforward communication in the performance of audit activities; and

   i. willingly and openly share their collective knowledge and always be in the pursuit of the truth and enhancement of health and safety in the construction sector.

4.3.7 Auditor Violation and Disciplinary Process

During the audit process, the Code of Ethics is the accepted practices that surround the auditor. Violations of these are considered to be serious in nature, and will result in swift intervention by the Company. In particular, the following sanctions may be administered to the auditor for violations of the Code depending on the situation:

1. Formal letter advising the auditor of the violation, a restatement of the required standard, and a stipulation to not have this reoccur,
2. A requirement to have retraining undertaken by the auditor,
3. Suspension of the auditor's certification, and
4. Permanent removal of the auditor's certification.

All sanctions against an auditor will involve a full investigation before any actions are taken. The Company is not required to apply progressive discipline in situations which are serious in nature and warrant severe penalties up to and including permanent removal of certification. As part of the Code of Ethics, auditors will cooperate fully with an inquiry in the event of a breach of this Code of Ethics.

Self Assessment

Choose the appropriate answers:

8. The most difficult type of misstatement to detect fraud is based on:

   (a) Related party purchases

   (b) Related party sales

   (c) The restatement of sales

   (d) Omission of a sales transaction from being recorded.

Notes

9. Which of the following statements is correct concerning the required documentation in working papers of fraud risk assessment undertaken by the auditor?
   (a) All risk factors as mentioned in AAS4, should be considered and documented along with response to them.
   (b) Document the identification of fraud risk factors along with response to them.
   (c) Document material fraud, risk factors and response to them.
   (d) No documentation in required.
10. Which of the following is the most appropriate potential reaction of the auditor to his assessment that the risk of material misstatement due to fraud is high in relation to existence of inventory?
   (a) Visit location on surprise basis to observe test counts
   (b) Request inventory count at a date close to year end
   (c) Vouch goods sent on approval very carefully
   (d) Perform analytical procedures.
11. Which of the following is not likely to be a fraud risk factor relating to management's characteristics?
   (a) Tax evasion
   (b) Failure to correct known weakness in internal control system
   (c) Adoption of conservative accounting principles
   (d) High management turnover
12. Professional skepticism requires that the auditor assume that management is
   (a) reasonably honest
   (b) neither honest nor dishonest
   (c) not necessarily honest
   (d) dishonest unless proved otherwise
13. An auditor who accepts an audit but does not possess the industry expertise of the business entity should
   (a) engage experts
   (b) obtain knowledge of matters that relate to the nature of entity's business
   (c) inform management about it
   (d) take help of other auditors
14. An auditor obtains knowledge about a new client's business and its industry to
   (a) Make constructive suggestions concerning improvements to the client's internal control system.
   (b) Evaluate the appropriateness of audit evidence obtained
   (c) Under stand the events and transactions that may have an effect on client's financial statements.
   (d) All of the above

Notes

15. Which of the following sections deal with qualifications of the auditor ?
    (a) Section 226 (1) and section 226(2)
    (b) Section 224 (1) and section 224 (2)
    (c) Section 226 (3) and section 226(4)
    (d) Section 224(3) & Sec. 224
16. The sequence of steps in the auditor's consideration of internal control is as follows -
    (a) Obtain an understanding, design substantive test, perform tests of control, make a preliminary assessment of control risk
    (b) Design substantive tests, obtain an understanding, perform tests of control, make a preliminary assessment of control risk
    (c) Obtain an understanding, make a preliminary assessment of control risk, perform tests of control, design substantive procedures.
    (d) Perform tests of control, obtain and understanding, make a preliminary assessment of control risk, design
17. Which of the following is not an inherent limitation of internal control system?
    (a) Management override
    (b) Collusion among employees
    (c) Inefficiency of internal auditor
    (d) Abuse of authority
18. An auditor should study and evaluate internal controls to
    (a) determine whether assets are safeguarded
    (b) suggest improvements in internal control
    (c) plan audit procedures
    (d) express and opinion
19. XYZ Ltd. conducts quarterly review of operations. It discovers that unrest in a south east Asian country may affect the supply of raw materials to it the next quarter. This is an example of :
    (a) risk assessment
    (b) control procedure
    (c) supervision
    (d) control environment

Did u know? Some Rules of Ethics for Auditors: The Sarbanes-Oxley Act sets new standards of independence for auditors.

Public Companies

Such standards created such friction between public companies and their auditors that decisional gridlock set in. On May 16, 2005, the Public Company Accounting Oversight Board (established under the Sarbanes-Oxley Act, to oversee the auditors of public

Notes

companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports) issued a policy statement on its Auditing Standard No. 2. The PCAOB's Policy Statement sought to give ensure some level of reasonableness and flexibility in the conduct of audits.

As it noted, In particular, the staff questions and answers seek to correct the misimpression that certain provisions of Auditing Standard No. 2 need to be applied in a rigid manner that discourages auditors from exercising the judgment necessary to conduct an internal control audit in a manner that is both effective and cost-efficient. The Policy Statement expresses the Board's view that, to properly plan and perform an effective audit under Auditing Standard No. 2, auditors should-integrate their audits of internal control with their audits of the client's financial statements, so that evidence gathered and tests conducted in the context of either audit contribute to completion of both audits; exercise judgment to tailor their audit plans to the risks facing individual audit clients, instead of using standardized "checklists" that may not reflect an allocation of audit work weighted toward high-risk areas (and weighted against unnecessary audit focus in low-risk areas); use a top-down approach that begins with company-level controls, to identify for further testing only those accounts and processes that are, in fact, relevant to internal control over financial reporting, and use the risk assessment required by the standard to eliminate from further consideration those accounts that have only a remote likelihood of containing a material misstatement; take advantage of the significant flexibility that the standard allows to use the work of others; and engage in direct and timely communication with audit clients when those clients seek auditors' views on accounting or internal control issues before those clients make their own decisions on such issues, implement internal control processes under consideration, or finalize financial reports.

Private Companies

Where the audit client is a privately owned business (such as a private enterprise customer or a private service provider), auditor independence rules still apply. The auditors could probably have avoided the claims of breached fiduciary duty if they had made suitable disclosures and had remedied, or caused their consulting affiliate, to remedy a failed software installation. In that case, the auditors should:

1. disclose their conflict of interest to the client and obtain waivers (similar to the waivers obtained from medical patients undergoing surgery);
2. remedy the flaws in the selection of off-the-shelf software, the systems integrator, and the systems integrator's lack of skills to cure the defects impeding software performance; and
3. learn from similar client-relationship mistakes that had been subject to prior, unrelated litigation.

The court's ruling is based under existing rules governing independence of auditors.

4.4 Summary

- Sub-sections (1) and (2) of Section 226 enumerate the qualifications required to be an auditor.
- A person who is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949 and holds a certificate of practice, or a partnership firm whereof all the partners are Chartered Accountants holding certificates of practice may be appointed as auditor, of a company.

Notes

- Sub-section (3) of Section 226 enumerates the categories of persons who are disqualified for appointment as auditors. The object of these disqualifications is to make the position of auditors as independent as possible from the affairs if the companies whose affairs they handle.
- Also, if under the Chartered Accountants Act any other disqualifications are added, they shall also apply. None of the following persons are qualified for appointment as auditor of a company: a body corporate; an officer or employee of the company; a person who is a partner, or who is in employment of an officer or employee of the company; a person indebted to the company for an amount exceeding one thousand rupees, or who has given any guarantee or provided any security in connection with indebtedness of any third person to the company for an amount exceeding one thousand rupees; a person who is director or member of a private company, or a partner of a firm, which is the managing agent or the secretaries and treasurers of the company; a person holding any security of that company after a period of one year from the date of commencement of the Companies (Amendment) Act, 2000.
- A person disqualified for appointment as auditor under the above disqualifications of any other body corporate which is that company's subsidiary or holding company or a subsidiary of that company's holding company, or would be disqualified if that body corporate were a company Section 226(5) further provides that, "if an auditor becomes subject, after his appointment, to any of the disqualifications, he shall be deemed to have vacated his office".
- Apart from the disqualifications laid down in Section 226, the Institute of Chartered Accountants of India has prepared its own code of ethics which is mandatory for its members.
- In order to ensure independence of the auditors and also to prevent conflict of interest and duty, the Council has decided not to permit a Chartered Accountant in employment to certify the financial statements of the concern in which he is employed, or of a concern under the same management as the concern in which he is employed, even though he is holding a certificate of practice and even though such certification can be done by any chartered accountant in practice. This restriction does not apply where the certification is permitted by any law.
- It has also been decided that a chartered accountant should not by himself or in his firm name: accept the auditorship of a collage, if he is working as a part-time lecturer in the college; accept the auditorship of a trust where his partner is either an employee or a trustee of the trust.
- Auditors' Code of Ethics is a system or code of behavior based on moral responsibility and obligation to explain how an auditor must behave.
- Auditors are expected to apply and uphold the following principles: integrity; objectivity; and confidentiality competency.

4.5 Keywords

Auditors' Code of Ethics is a system or code of behavior based on moral responsibility and obligation to explain how an auditor must behave.

Competency: Auditors must apply the knowledge, skills, and experience needed in the performance of auditing services.

Confidentiality: Auditors must do not disclose information without appropriate authority unless there is a legal or professional obligation to do so.

Notes

Integrity: Integrity of auditors establishes trust and thus provides the basis for reliance on their judgment.

Objectivity: It includes making a balanced assessment of all the relevant circumstances and not to be unduly influenced by their own interests or by others in forming judgments.

4.6 Review Questions

1. What are the qualifications of auditors as per section 226?
2. Identify disqualification criteria for auditors as per section 226.
3. Briefly explain different proponents of Section 314.
4. What do you understand by auditor's code of ethics?
5. Under what circumstances as per section 314 a special resolution is required to be passed?
6. Identify various circumstances where section 314 is applicable.
7. What is the purpose of having code of ethics for working of an auditor?
8. What is the importance of the code of ethics for proper execution of duties by auditors?
9. What are the applicability and enforcement criteria for auditor's code of ethics?
10. Auditors are expected to apply and uphold on what principles?
11. Identify various rules of conduct for an auditor based on different principles.
12. What are the implications of an auditor's violation and disciplinary process?

Answers: Self Assessment

1. Independent
2. Own code of ethics
3. An office or place of profit
4. Knowledge and skill
5. A relationship of employer and employee; or such other person performs for and on behalf of the company certain acts under the control, direction or supervision of the company; also he is in receipt of consideration
6. Any director; Partner in a firm in which a director is a partner; Relative of such director
7. Managing Director; Manager; Banker; Trustee for the debenture holder

8.	(d)	9.	(b)	10.	(a)
11.	(c)	12.	(b)	13.	(b)
14.	(c)	15.	(a)	16.	(c)
17.	(c)	18.	(c)	19.	(a)

4.7 Further Readings

Books

David Coderre, *Internal Audit: Efficiency through Automation*, John Wiley & Sons, 2009.

Emile Woolf, Moira Hindson, *Audit and Accountancy Pitfalls: A Casebook for Practising Accountants, Lawyers and Insurers*, John Wiley & Sons, 2011.

Notes

Iain Gray, Stuart Manson, *The Audit Process: Principles, Practice and Cases*, Cengage Learning EMEA, 2007.

Jeanette Franzel, *Single Audit: Opportunities exist to improve the Single Audit Process and Oversight*, DIANE Publishing, 2009.

Susan Switzer, *Internal Audit Reports Post Sarbanes-Oxley: A Guide to Process-Driven Reporting*, John Wiley & Sons, 2007.

Online links

www.asiatradehub.com/india/tr9.asp

www.auditservices.com/aevidence.html

www.investopedia.com/terms/a/auditing-evidence.asp#ixzz1x6PIvbTg

www.informationbible.com/article-auditing-in-depth-111904.html

www.caclubindia.com

indiankanoon.org/doc/780853/

Notes

Unit 5: Audit Planning

CONTENTS

Objectives

After studying this unit, you will be able to:

- Define audit planning;
- Describe the purpose and methodology of audit planning;
- Know factors affecting audit planning;
- Find about audit programming;
- Discuss quality control for audit.

Notes

Introduction

This unit gives an introduction to audit planning, including: purpose and methodology of audit planning; client acceptance and continuance; obtain knowledge of client's industry and business; assess client business risk and analytical procedures.

5.1 Purpose and Methodology of Audit Planning

There are three main benefits from planning audits: it helps the auditor obtain sufficient appropriate evidence for the circumstances, helps keep audit costs at a reasonable level, and helps avoid misunderstandings with the client. ISA 300 Planning an Audit of Financial Statements requires that, "the planning stage of the audit should be used to establish an overall strategy for the audit, develop an audit plan, and reduce audit risk to an acceptably low level". The standard also requires that: Auditors should plan the audit work so that the engagement is performed in an effective manner. It is important to clarify what are meant by the terms "overall audit strategy" and "audit plan" as per ISA 300. The overall "audit strategy" describes in general terms how the audit is to be carried out and the "audit plan" details the specific procedures to be carried out to implement the strategy and complete the audit. It is also important for students to understand the precise meaning of the risk terms: "audit risk" and "inherent risk" as both risks influence how the audit is carried out and the costs involved. The auditor will spend quite a bit of time at the early planning stages obtaining information to assess these risks so that "the engagement is performed in an effective manner". "Audit risk" is the risk that an auditor may give an inappropriate audit opinion on financial statements that are materially misstated. To reduce the audit risk to an acceptably low level means the auditor needs to be more than certain that the financial statements are not materially misstated. This is reiterated by ISA 200, which states, "*The auditor should plan and perform the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit.*" "Inherent Risk" as per ISA 400 is "*the susceptibility of an account balance or class of transactions to misstatements that could be material, individually or when aggregated with misstatements in other balances or classes, assuming that there are no related internal controls*".

Assessing audit risk and inherent risk is an essential part of audit planning because it determines the quantity and quality of evidence that will need to be gathered and the staff that need to be assigned to the particular audit. If for example there were valuation issues with property inherent risk would then be assessed as high, therefore meaning more evidence would have to be gathered and staff that are more experienced assigned to perform testing on this account.

Notes ISA 300 Planning an Audit of Financial Statements requires that the planning stage of the audit should be used to establish an overall strategy for the audit, develop an audit plan, and reduce audit risk to an acceptably low level.

5.2 Accept Client and Perform Initial Audit Planning

ISA 300 states that the auditor should:

1. Perform procedures regarding the continuance of the client relationship and the specific audit engagement;
2. Evaluate compliance with ethical requirements, including independence (also refer to ISA 220 Quality Control); and

Notes

3. Establish an understanding of the terms of the engagement (also refer to ISA 210 Terms of Audit Engagement).

5.3 Client Acceptance and Continuance

Client acceptance and continuance encompasses both deciding on acquiring a new client or continuation of relationship with an existing one and the type and amount of staff required. ISQC 1 states that audit firms should establish policies and procedures for the acceptance and continuance of client relationships. Typical policies and procedures involved in this process are:

1. Evaluate the client's background;
2. Determine whether the auditor is able to meet the ethical requirements regarding the client;
3. Communicate with the previous auditor;
4. Determine need for other experts;
5. Select staff to perform the audit and;
6. Obtain an engagement letter.

5.4 New Client

Prior to accepting a new client, the auditor should investigate the client before accepting them. The auditor should evaluate the client's standing in the business community, financial stability, and relations with its previous auditor. The main purpose of investigating a new client is to ascertain the integrity of the client and the possibility of fraud. The auditor should be especially concerned with the possibility of fraudulent financial reporting since it is difficult to uncover. The auditor does not want to expose him or herself to the possibility of legal liability for failure to detect fraud. If the client has been audited previously, under ISA 300 the new auditor should contact the previous auditor, in compliance with relevant ethical requirements, in order to evaluate whether to accept the engagement. Both the new auditor and the previous auditor must obtain permission from the client before communication can be made because of the confidentiality requirement in the Auditors Code. The new auditor should be wary of accepting the client if the client does not give permission for this communication to the new auditor and/ or the previous auditor. The previous auditor in compliance with relevant ethical requirements is required to respond to the new auditor's request for information if given permission by the client. Even when a potential client has been audited previously, the auditor may make other.

Caution The auditor should evaluate the client's standing in the business community, financial stability, and relations with its previous auditor.

Notes Enquiries done by collecting information from bankers, legal representatives, and background searches of relevant databases.

5.5 Continuing Clients

Past arguments over the scope of the audit, the type of opinion issued, fees , etc. may give the auditor pause to reconsider the association with the particular client. The auditor may also

Notes

decide to discontinue the relationship if the client is deemed to lack integrity. Under the Ethical Standards the auditor may have to discontinue association if there are ethical issues (if the client is involved in litigation against the auditor, there are unpaid fees, independence issues etc.). The auditor may also decide the particular engagement is too high risk. Client acceptance and continuance is an important part of determining audit risk.

Self Assessment

Fill in the blanks:

1. Main benefits from planning audits are .....; ..... and .....
2. ..... is an important part of determining audit risk.
3. ..... states that audit firms should establish policies and procedures for the acceptance and continuance of client relationships

5.6 Obtaining an Understanding with the Client

A clear understanding of the terms of the engagement should exist between the client and the auditor. ISA 210 describes the contents of an engagement letter. Although the standard does not require use of an engagement letter, the guidance is provided in a manner that presumes use of an engagement letter. According to ISA 210, "*the auditor and the client should agree on the terms of the engagement*."

ISA 210 states that, "*the auditor should ensure that the engagement letter or other form of suitable contract documents and confirms the auditor's acceptance of the appointment and includes a summary of the responsibilities of those charged with governance and of the auditor*."

The terms of the engagement include consideration of what is to be done (the objective, scope, and report of the audit) by who (the staff) and for how much (the fee). The agreed terms would need to be recorded in an audit engagement letter or other suitable form of contract. The engagement letter may also include an agreement to provide other services such as tax returns.

Did u know? It should also state any assistance to be provided by the client personnel in obtaining books and records, and schedules to be prepared for the auditor. It will outline the auditor's responsibilities in relation indictable offences and money laundering. It also serves the purpose of informing the client that the auditor cannot guarantee that all fraud will be detected.

5.7 Develop Overall Audit Strategy

ISA 300 necessitates that the overall audit strategy should be established at the beginning, and updated and amended as required during the course of the audit. The auditor may need to revise his Overall Audit Strategy and Overall Audit Plan (and thereby the planned nature, extent and timing of further audit procedures) when unexpected events, changed conditions or the audit evidence achieved from audit procedures lead to information that is significantly different from information available to the auditor when he first planned his audit.

The purpose of the overall audit strategy is to develop an effective response to the risk of material misstatement. The auditor considers what they found in preliminary planning activities such as client acceptance, ethical position of the audit firm and their understanding of the entity and its environment, including its internal control, to develop an effective and efficient overall

Notes

audit strategy that will appropriately respond to assessed risks. The overall audit strategy includes consideration of planned audit responses to specific risks through the development of the audit plan. The overall audit strategy also helps the auditor determine the resources required for the engagement, including engagement staffing. Therefore, at a minimum the following matters should be included in the overall audit strategy:

1. Relevant characteristics of the audit engagement, such as the reporting framework used in order to set the scope of the engagement;
2. Key dates for reporting and other communications;
3. Setting of materiality;
4. Preliminary risk assessment and whether internal controls are to be tested; and
5. Consideration of resources available and how they are to be used.

Self Assessment

Fill in the blanks:

4. ISA 210 describes the contents of an .....
5. The terms of the engagement include consideration of .....
6. The purpose of the overall audit strategy is to develop an effective response to the.....

5.8 Select Staff for Engagement

Appropriate staff, knowledgeable about the client's industry, must be assigned to the engagement. In order that they may effectively carry out their work, the assigned engagement staff should have the following capabilities and competencies:

1. An understanding of, and practical experience with, audit engagements of similar nature and complexity through appropriate training and participation.
2. Appropriate technical knowledge, including knowledge of relevant information technology.
3. Knowledge of relevant industry in which the client operates.
4. Ability to apply professional judgment.
5. An understanding of the firms quality control policies and procedures.
6. An understanding of professional standards and regulatory and legal requirements.

For existing clients there may also be a need for continuity from year to year. In addition, ISA 300 states that "*the auditor should plan the nature, timing, and extent of direction and supervision of engagement team members and review of their work*." In reviewing the work of engagement team members, it should be ensured that:

1. the work has been performed in accordance with professional standards and regulatory and legal requirements;
2. the work performed supports the conclusions reached;
3. the work performed is appropriately documented;
4. the evidence obtained is sufficient and appropriate to support the auditor's report;
5. the objectives of the engagement have achieved;

Notes

6. any need to revise the nature, timing and extent of audit work performed has been identified;
7. significant matters have been raised for further consultation; and
8. appropriate consultations have taken place and the resulting conclusion have been documented and implemented.

The engagement team will usually consist of a partner, manager, audit senior and junior.

5.9 Evaluate Need for Outside Experts

ISA 620 defines an expert as a person or firm possessing special skill, knowledge, and experience in a particular field other than accounting and auditing. The auditor must have an understanding of the clients business sufficient to identify whether an expert is needed e.g. where inventory is highly specialized and is material to the financial statements independent valuation by an expert may be necessary. Where an expert's work is needed as audit evidence, the auditor should evaluate the expert's skills and competence by considering professional qualifications, experience, and reputation. The expert's objectivity should be considered.

Task Identify different skills and qualifications of an expert.

5.10 Understand the Client's Business and Industry

ISA 310 requires a reasonable understanding of the clients business and industry. The nature of the clients business and industry affects client business risk and the risk of material misstatement in the financial statements. Auditors use the knowledge of these risks to determine the appropriate amount of audit evidence to gather. Auditors have been exposed to problems resulting from the auditor's failure to understand comprehensively the nature of transactions in clients industry. The auditor must also have an understanding of the client's external environment, including economic conditions, impact of competition, reporting obligations, legal and regulatory requirements. The auditor should source this information by reading industry trade publications, and regulatory requirements.

The auditor should identify factors such as major sources of income, key customers and suppliers, sources of finance, related parties and transactions with related parties requiring disclosure that may be high-risk areas within the client. The auditor should make inquiries of management and others within the entity in relation to the above. Visiting the client's premises is also useful in this regard because it gives an opportunity to observe operations firsthand and to meet key employees.

Transactions with related parties are important to auditors because the International Accounting Standards require that such transactions be disclosed in the financial statements if they are material. As management are pivotal in establishing an entities strategies and business processes the auditor should consider managements philosophy and operating style and its ability to identify and respond to risks as this significantly affects the risk of material misstatement in the financial statements. In this regard, the auditor should read the memorandum and articles of association, read minutes of board of directors and shareholders, and inquire of management. The auditor should understand the clients objectives related to reliability of financial reporting; effectiveness and efficiency of operations; and compliance with laws and regulations.

Auditors need knowledge about operations to assess client business risk and inherent risk in the financial statements. The auditor should make inquiries of management; review prior year

Notes

working papers; inspect legal documents (such as share options and pension plans), minutes of meetings and significant contracts. The auditor needs also to consider to clients performance measurement system. Inherent risk may be increased if the client has set unreasonable objectives or if the performance measurement systems encourage manipulation of amounts in the financial statements. The auditor should read financial statements, perform ratio analysis, and inquire of management about key performance indicators that management uses to measure progress toward its objectives.

Notes The auditor should understand the clients objectives related to reliability of financial reporting; effectiveness and efficiency of operations; and compliance with laws and regulations.

5.11 Assess Client Business Risk

The auditor uses knowledge gained from the strategic understanding of the client business and industry to assess client business risk, the risk that client will fail to achieve its objectives. It is managements responsibility to identify the business risks facing the company and respond accordingly to those risks. The auditor's main concern is the risk of material misstatement in the financial statements due to client business risk. It is important to note that not all business risks will turn into risks leading to material misstatement in the financial statements. ISA 315 stresses the importance of all members of the audit team understanding the potential risk of misstatements in each client's financial statements. In particular, the standard introduces the concept that the auditor is required to obtain an understanding of business risks and significant risks to the extent that they are relevant to the financial statements. ISA 315 requires the audit team to discuss risk factors as part of the audit planning process.

5.12 Perform Preliminary Analytical Procedures

Analytical procedures applied at the planning stage can assist the auditor in gaining an understanding of the clients business and in assessing client business risk. ISA 520 states, "*the auditor should apply analytical procedures at the planning and overall review stages of the audit*." ISA 520 Analytical Procedures states that analytical procedures include the consideration of comparisons of the entity's financial information with, for example:

1. Comparable information for prior periods,
2. Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimate for depreciation, and
3. Similar industry information, such as comparison of the entity's ratio of sales to receivables with industry averages or with other entities of comparable size in the same industry.

Application of analytical procedures may indicate aspects of the business of which the auditor was unaware. In order to gain a better understanding of the client's business and industry, the auditor will calculate typical ratios and compare the company ratios to those of the industry. Analytical procedures identify significant deviation from predicted amounts, which show the auditor where to increase procedures to obtain corroborative evidence. ISA 315 paragraph 10 contains additional guidance on applying analytical procedures as risk assessment procedures.

Notes

5.13 Additional Parts of Audit Planning

Other areas in relation to audit planning include:

1. Setting materiality and assessing audit risk and inherent risk.
2. Understanding internal control and assessing control risk.
3. Gathering information to assess fraud risks.
4. Developing an audit plan.

5.14 Audit Programming

The following are the features of audit programming

1. Most of the time audit is conducted by a team instead of just an individual. If business is small or if there is not much to be done then it might be possible to conduct the whole engagement easily by an individual. But usually amount of work, time constraints and other factors require the audit engagement to be conducted by more than one person.
2. Depending on the audit, audit team can have different number of members. Usually the team is structured in a Partner, Manager and Assistants which may further be divided into senior assistants and juniors.
3. In order to properly assign work to each individual and what is required to be done by whom there must be some kind of an instructions set otherwise, more than one members might be auditing the same area or in other case some areas are left completely unaudited.
4. To ensure efficient and effective conduct of audit assignment, audit programmes or audit programs are used.
5. Audit programme contains step by step instructions to be carried out by team members i.e. it is simply a list of audit procedures to be executed by team members.
6. Even though audit programme sets out the whole agenda for every member of the team but the main users are juniors for whom it acts as a dictation to be followed. The main purpose of audit programme is that every material area has been audited appropriately and sufficient appropriate audit evidence has been obtained in respect of every important areas of audit.
7. Audit programmes are prepared on the basis of audit plan usually by the auditor – who in the audit team is either partner or manager. But sometimes, audit firms have a basic audit programme and the same is used by the auditor after making some modifications to it to make it according the audit engagement in hand.
8. Mostly it is in the form of a checklist which can be used by the juniors to make sure every required procedure has been implemented. This can also help in monitoring the work of juniors in specific or assistants in general.
9. Audit programmes may be laid down in advance for the whole year for some aspects of the audit which auditor expects to be auditing after regular intervals of time or when needed. For understandability and convenience, audit programmes are written for each audit area separately and then assigned to specific team members.
10. What procedures shall be part of audit programme is to be decided by the auditor and depends on the auditor's judgement.

Notes

Sample audit programme is as follows:

Table 5.1: Audit Programme: Purchases

Procedures	Check List
Check purchase requisition for serial numbering	
Check whether purchase requisitions were signed by (name or the person authorized)	
(and other procedures for this area)	
Were quotations called by (name of the person authorized)?	
Obtain evidence of comparative statement prepared by (name of the persons authorized)	
(and other procedures for this area)	

Notes Audit program or audit program is not a name of any computer program. Also it has nothing to do with computer programming in any way. However, audit programs can be made using computer software in computer assisted auditing environment.

5.15 Quality Control for Audit

General

Any audit institution should seek to carry out its audit work at a consistently high level of quality in the following dimensions:

1. Significance and value of matters addressed in its audits;
2. Objectiveness and fairness in the basis of assessments made and opinions given;
3. Scope and completeness in the planning and performance of audits carried out;
4. Reliability and validity of the opinions, or findings and conclusions, appropriateness of the recommendations and relevance of other matters presented in its audit reports and other products;
5. Timeliness of the issue of audit reports and other products in relation to statutory deadlines and the needs of anticipated users;
6. Clarity in the presentation of audit reports and other products;
7. Efficiency in the performance of audits and audit-related work; and
8. Effectiveness in terms of results and impacts achieved.

In pursuit of this goal, an audit institution should establish policies, systems and procedures that will encourage actions leading to high quality and discourage or prevent actions that might impair quality. These quality controls should be developed and implemented with respect to all phases of the audit process, including:

1. Selecting matters for audit;
2. Deciding the timing of the audit;

Notes

3. Planning the audit;
4. Executing the audit;
5. Reporting the audit results; and
6. Follow-up and evaluation of audit findings, conclusions and recommendations.

Audit institution with a strong reputation for the consistently high quality of their work exhibits certain characteristics in common, regardless of their organizational structure. Among these, there is the commitment to quality throughout the organization, coupled with a clear understanding, based on education, training and experience, of what is required to achieve that goal. Developing this institutional environment of quality is a long-term process that is addressed in a later sub-section of these guidelines.

This sub-section of the guidelines, together with the forthcoming sub-sections, are addressed to the more immediate need to establish procedures to control the quality of individual audits undertaken by an audit team. However, because of the diversity in form and structure of an audit institution as well as the different types of audits they perform, there is no single set of detailed procedures that will accomplish the goal of quality in all circumstances. For example, audit procedures that are appropriate for attesting the reliability of a set of financial statements are unlikely to be entirely appropriate for a performance audit. Review procedures that work well in some "audit offices" simply do not fit the structure of some "courts of audit". Nevertheless, there are attributes that are applicable to all audit institutions and to all audits. Among these are the characteristics of quality and the phases of the audit process. Decisions and actions taken by the audit institutions or its components and by the audit staff during each of the phases of the audit largely determine the ultimate quality of the audit.

Ensuing sub-sections of these guidelines set out the basic principles that should guide decisions and actions in each phase of the audit process. It is up to each SAI to determine how best to implement these principles in the context of its own organization structure and the particular types of audits that it performs.

In audit institutions with a highly decentralized organization, while setting up the guidelines is a central management responsibility, implementing these guidelines rests almost entirely on the component units or chambers.

Special attention is needed to the problems and potential advantages of computerization. Auditing requires special skills when the auditee operates in a computerized environment. The auditors in these circumstances must have not only a basic understanding of computers, but must have or quickly acquire knowledge of the systems used by the auditee.

At the same time, computerized audit tools and programmes – when properly employed – can greatly increase the efficiency of the audit process. Audit institutions may need to introduce appropriate training to develop these skills.

Modern audit systems that make extensive use of computers to render audits largely paperless, including the related working papers and documentation, should contain in-built controls and safeguards. In such systems all or most stages of the audit could be processed and stored in electronic format. An automated quality control system should incorporate a strictly defined set of authorization and approved criteria, as well as features that ensure that standard documents and checklists (which may be electronically readily available to all team members) are used and compiled in all cases. With such systems some parts of the work of supervisors and reviewers are electronically supported on a real time basis. The principles of quality control remain intrinsically the same as those in a non-automated audit process.

Although an audit requires different layers of quality control measures and criteria, the auditors carrying out the audit fieldwork should be left with a degree of professional judgement. This

Notes

depends upon the audit task in hand, problems encountered that need to be addressed immediately, as well as, most importantly, to the degree of direction, supervision and/or review, that is required on the auditors. The degree of professional judgement also depends upon the auditor's competence, expertise, professional qualifications, aptitude and level in the hierarchy.

General quality control policies and procedures should be communicated to its personnel in a manner that provides reasonable assurance that the policies are understood and implemented. Quality control requires a clear understanding of where responsibility lies for particular decisions. It should be the responsibility of everyone involved in the audit to fully identify and understand his or her responsibility.

Quality control processes should be carried out in a prescribed way and be documented. These processes may be supported by questionnaires and checklists in prescribed forms.

Self Assessment

Fill in the blanks:

7. ..... defines an expert as a person or firm possessing special skill, knowledge, and experience in a particular field other than accounting and auditing.
8. ..... affects client business risk and the risk of material misstatement in the financial statements.
9. External environment of a client including .....; .....; ..... and .....
10. ..... stresses the importance of all members of the audit team understanding the potential risk of misstatements in each client's financial statements.
11. To ensure efficient and effective conduct of audit assignment ..... are used.

Case Study

Internal Auditing Planning

Background

An external audit firm is conducting internal audit in an engineering company since the last two years. The audit committee chairman had a one to one meeting with the partner–in-charge for a review of the present internal audit reports and the internal audit process. During the discussions, the chairman asked the internal auditor to present an annual internal audit plan that takes into account the bigger picture rather than smaller issues and really adds value to the business. Based on recent corporate events and the Board's responsibilities in the matter of Transparency and Control, the Audit Committee Chairperson enquired with the – Chief Audit Executive – CAE, the status of implementation of Standards of Internal Audit of ICAI.

The CAE highlighted that a Risk Based Audit Planning process is being currently followed. However, the process has not been benchmarked against the Standards. The CAE affirmed that the entire activity will be aligned with Indian Standards and a report presented in the next Audit Committee.

Methodology

The internal audit function has a five member team. The internal auditor therefore has to select projects (areas) with high risk to the organization and direct the limited resources

Contd...

Notes

towards such projects. Frequency of high risk areas needs to be high – maybe twice a year whereas in cases of low risk or almost zero risk areas, the frequency may be once in three years and so on.

A benchmark against the standard was carried out by the team to identify further areas for improvement.

Opportunities for Improvement

Overall, the standard sought to address audit planning from two dimensions –

1. Overall Annual Audit Plan
2. Audit engagement or each specific audit project

For the Overall Annual Audit Plan, the areas identified were -

1. The existing Audit Charter adequately explained the 'purpose, authority and responsibility' of the Internal Audit function. The Audit Charter designed earlier had not been reviewed and revised for the last two years. During the last two years, the auditee had implemented an ERP and adopted a Balanced Scorecard strategy for evaluating performance. Efforts of Cost Reduction have rationalised middle level management.

   (a) The CAE and the team felt that the focus of audit needed to be revised through use of Audit Tools and the possibility of taking on a leading role in implementing Continuous Auditing.

   (b) One of the overall objectives that the standard expects the Internal Audit to achieve is to "strengthen overall governance, particularly strategic risk management". The Audit Charter had not mentioned any specific responsibility for this objective. The audit team appreciated the following fact however with this objective that:

      (i) When strategic risks are taken, there is no audit involvement.

      (ii) The operating management does not perceive any specific role of the internal auditors in strategic risk management.

      (iii) The Internal Auditor is expected not to be a part of the decision. In this way, he/she retains their independence. If he is a part of this process, it may be a barrier to his independence at a later date, when the decision might not achieve the desired objectives. The Internal Auditor's role as an assurance provider may get compromised if the internal auditor is involved in decision making.

   One of the internal audit team members pointed out however that if he gets additional information at a later date, should he not then advise review of the decision rather than wait for issuance of the report?

   This change was therefore sought to be introduced and highlighted specifically for discussion. The CAE took a stand that while the Internal Auditor could be a part of the Strategic Risk Management process, it should be seen as a 'facilitator role' and not as member of the decision making team.

2. While the Audit Plan was provided to the Audit Committee for approval, there was hardly any debate on the same and it was approved. The CAE thought that in the current practice, they were not really benefiting from the experience and knowledge of the Audit Committee Members. He therefore thought it fit to arrange for meetings

Contd...

Notes

with each of the Audit Committee Members to gain individual input prior to the next Audit Committee Meeting, where his first report would be presented. These meetings helped the CAE improve the audit plan.

3. The Risk Based Audit Planning process as currently implemented (Refer article of BCAJ IAS article in March/April, 2003) was generally found to be robust. The process included the following:

   (a) Identify the Audit Universe (comprehensive list of Audit Areas),

   (b) Established weights and ranks for criteria which will form the basis of ranking the audit areas and cut off score,

   (c) Applying criteria to the various audit areas,

   (d) Arrive at scores for each area, and

   (e) Applying the Cut off criteria and shortlisting the areas of audit for the year. This forms a part of the Annual Audit Plan.

4. The revised Annual Audit Plan was also reviewed along with the first report. In order to ensure continuing relevance of the audit plan, a process of a half yearly review of the audit plan with the Audit Committee was suggested and approved.

For the Audit Engagement or each specific Audit Project –

A brainstorming on the issues and difficulties faced by the Audit Team Members in Audit Engagements was undertaken. A few of the difficulties that came up from all members was:

1. the general appreciation of raising the right business issues in the audit reports.

2. the adequacy of time for performance of the audit – at times, key areas of audit were left out given the demands of completing the report.

3. the team members voiced their concern that the response that the CAE gets from officials was not the same as that received by them. They felt that the auditor's employees did not give the required efforts and seriousness, which resulted in avoidable delays.

The team thought of the options that the Standard provided towards overcoming these difficulties. The following were the guidelines that they felt could overcome the difficulties:

1. ***Preliminary Review:*** A visit by the CAE along with the audit team members of the audit area was planned to be conducted 15 days prior to the actual start date. This audit visit was to understand the business process area and operational realities within which the team performs, the expectations of the auditee and the auditor are discussed and firmed up, the data and time requirements from the auditees are discussed and the JOINT objectives of the audit process are laid down. The auditee's person-in-charge is made aware of the audit objectives, methodology and the ways that risk and control needs to be looked at within the Risk Management Framework implemented. Apprehensions of the Auditee team are laid to rest in these interactions. This meeting is also sought to be used as a means to improve auditee's person-in-charge responses.

2. ***Audit Engagement Planning:*** The Preliminary Review meeting was also to be used to study past reports . The larger participation of all team members in identification of potential risk and control focus in each area was scheduled for at least once a fortnight in such a way that no area is taken up without the inputs received from all team members.

Contd...

Notes

These measures would also ensure that the issues that are relevant to the organisation and the auditee team are addressed. This will also ensure that there is an ongoing value addition out of the audit process.

3. The CAE decided to improve the following areas:

   (a) *Resource allocation in line with the scope:* The knowledge and skills required for each audit was sought to be formally identified and matched with the ability of the team members. In case there was a mismatch, the CAE considered the option of training a team member in the area in advance and also involving an outside professional for the specific aspect of audit as part of the on the job training for the team. The option of including a guest auditor from within the organisation also was considered.

   (b) *Detailed Audit Programme with specific priority for audit checks:* Normally the Audit Programmes were packed with all possible tests to be conducted during an audit for all identified risks and controls. The team decided to identify which controls significantly mitigate the risk (Key Control). Single control mitigating multiple risks were also sought to be specifically identified in a list of controls. The audit priority was focused on key controls. This focus improved audit effectiveness.

Conclusions

These measures were implemented in the quarter and some significant improvements were observed. The gaps identified vis a vis the standard and the measures already taken and thus impact were shared with the Audit Committee. The initiatives taken were highly appreciated by the Audit Committee members.

All the action of CAE were based on Internal audit standard issued by the Institute of Chartered Accountant of India.

Exhibit 1: Standards of Internal Audit – 1 of The Institute of Chartered Accountants of India

The internal auditor should, in consultation with those charged with governance, including the audit committee, develop and document a plan for each internal audit engagement to help him conduct the engagement in an efficient and timely manner.

The internal audit plan should be comprehensive enough to ensure that it helps in achieving of the above overall objectives of an internal audit. The internal audit plan should, generally, also be consistent with the goals and objectives of the internal audit function as listed out in the internal audit charter as well as the goals and objectives of the organisation. An internal audit charter is an important document defining the position of the internal audit vis a vis the organisation. The internal audit charter also outlines the scope of internal audit as well as the duties, responsibilities and powers of the internal auditor(s). In case the entire internal audit or the particular internal audit engagement has been outsourced, the internal auditor should also ensure that the plan is consistent with the terms of engagement.

A plan once prepared should be continuously reviewed by the internal auditor to identify any modifications required to bring the same in line with the changes, if any, in the audit environment. However, any major modification to the internal audit plan should be done in consultation with those charged with governance. Further, the internal auditor should also document the changes to the internal audit plan.

Contd...

Notes

Internal audit plan should cover areas such as:

1. Obtaining the knowledge of the legal and regulatory framework within which the entity operates.
2. Obtaining the knowledge of the entity's accounting and internal control systems and policies.
3. Determining the effectiveness of the internal control procedures adopted by the entity.
4. Determining the nature, timing and extent of procedures to be performed.
5. Identifying the activities warranting special focus based on the materiality and criticality of such activities, and their overall effect on operations of the entity.
6. Identifying and allocating staff to the different activities to be undertaken.
7. Setting the time budget for each of the activities.
8. Identifying the reporting responsibilities.

The internal audit plan should also identify the benchmarks against which the actual results of the activities, the actual time spent, the cost incurred would be measured.

The internal auditor should obtain a level of knowledge of the entity sufficient to enable him to identify events, transactions, policies and practices that may have a significant effect on the financial information.

The audit universe and the related audit plan should also reflect changes in the management's course of action, corporate objectives, etc. The internal auditor should periodically, say half yearly, review the audit universe to identify any changes therein and make necessary amendments, to make the audit plan responsive to those changes.

The establishment of such objectives should be based on the auditor's knowledge of the client's business, especially a preliminary understanding and review of the risks and controls associated with the activities forming the subject matter of the internal audit engagement.

The internal auditor should also document the results of his preliminary review so conducted.

For this purpose, the internal auditor should prepare an audit work schedule, detailing aspects such as:

1. Activities/procedures to be performed;
2. Engagement team responsible for performing these activities/procedures; and
3. Time allocated to each of these activities/procedures.

While preparing the work schedule, the internal auditor should have regard to aspects such as:

1. Any significant changes to the entity's missions and objectives, business processes, and management's strategies to counter these changes, for example, changes in the entity's controls structure or changes in the risk assessment and management structures
2. Any changes or proposed changes to the governance structure of the entity. The engagement work schedule should, however, be flexible enough to accommodate

Contd...

Notes

any unanticipated changes as well as professional judgment of the engagement team in the components of the audit universe as discussed above. The work schedule should also reflect the internal auditor's assessment of risks associated with various areas covered by the particular internal audit engagement and the priority attached thereto.

The internal auditor should also prepare a formal internal audit programme listing the procedures essential for meeting the objective of the internal audit plan. Though the form and content of the audit programme and the extent of its details would vary with the circumstances of each case, yet the internal audit programme should be so designed as to achieve the objectives of the engagement and also provide assurance that the internal audit is carried out in accordance with the Standards on Internal Audit.

Questions:

1. Analyze the case and find out different methods employed in planning internal audit
2. What were the main areas identified for overall annual audit plan?

Source: bcasonline.org

5.16 Summary

- There are three main benefits from planning audits: it helps the auditor obtain sufficient appropriate evidence for the circumstances, helps keep audit costs at a reasonable level, and helps avoid misunderstandings with the client.
- The overall "audit strategy" describes in general terms how the audit is to be carried out and the "audit plan" details the specific procedures to be carried out to implement the strategy and complete the audit.
- It is also important for students to understand the precise meaning of the risk terms: "audit risk" and "inherent risk" as both risks influence how the audit is carried out and the costs involved.
- ISA 210 describes the contents of an engagement letter. Although the standard does not require use of an engagement letter, the guidance is provided in a manner that presumes use of an engagement letter.
- The overall audit strategy includes consideration of planned audit responses to specific risks through the development of the audit plan. The overall audit strategy also helps the auditor determine the resources required for the engagement, including engagement staffing.
- For existing clients there may also be a need for continuity from year to year. In addition, ISA 300 states that, the auditor should plan the nature, timing, and extent of direction and supervision of engagement team members and review of their work.
- The auditor must have an understanding of the clients business sufficient to identify whether an expert is needed e.g. where inventory is highly specialized and is material to the financial statements independent valuation by an expert may be necessary.
- Auditors need knowledge about operations to assess client business risk and inherent risk in the financial statements.
- ISA 520 Analytical Procedures states that analytical procedures include the consideration of comparisons of the entity's financial information.

Notes

- Other areas in relation to audit planning include: Setting materiality and assessing audit risk and inherent risk; Understanding internal control and assessing control risk; Gathering information to assess fraud risks; and Developing an audit plan
- To ensure efficient and effective conduct of audit assignment, audit programmes or audit programs are used. Audit programme contains step by step instructions to be carried out by team members i.e. it is simply a list of audit procedures to be executed by team members.
- In pursuit of this goal, an audit institution should establish policies, systems and procedures that will encourage actions leading to high quality and discourage or prevent actions that might impair quality.

5.17 Keywords

Audit Planning is developing an overall strategy for the audit. The nature, extent, and timing of planning vary with size and complexity of the entity, experience with the entity, and knowledge of the entity's business.

Audit program contains step by step instructions to be carried out by team members i.e. it is simply a list of audit procedures to be executed by team members.

Audit risk is the risk that an auditor may give an inappropriate audit opinion on financial statements that are materially misstated.

5.18 Review Questions

1. What do you understand by audit planning? What is the purpose and methodology of audit planning?
2. What do you understand by obtaining an understanding with the client?
3. What factors are considered by an auditor in understanding client's business and industry?
4. Why transactions with related parties are important to auditors? Write its implications.
5. Why assessing audit risk and inherent risk is an essential part of audit planning? Elaborate with suitable example.
6. Identify different factors affecting audit planning.
7. What is audit programming? What is its importance in developing audit planning strategies?
8. What do you understand by quality control for audit? Why quality is considered on higher priority basis for any prime audit institution?

Answers: Self Assessment

1. Helps the auditor obtain sufficient appropriate evidence for the circumstances; keep audit costs at a reasonable level; avoid misunderstandings with the client
2. Client acceptance and continuance
3. ISQC 1
4. Engagement letter
5. The objective, scope, and report of the audit) by who (the staff) and for how much (the fee)

Notes

6. Risk of material misstatement
7. ISA 620
8. The nature of the clients business and industry
9. Economic conditions; impact of competition; reporting obligations; legal and regulatory requirements
10. ISA 315
11. Audit programs

5.19 Further Readings

Books

David Coderre, *Internal Audit: Efficiency through Automation*, John Wiley & Sons, 2009.

Emile Woolf, Moira Hindson, *Audit and Accountancy Pitfalls: A Casebook for Practising Accountants, Lawyers and Insurers*, John Wiley & Sons, 2011.

Iain Gray, Stuart Manson, *The Audit Process: Principles, Practice and Cases*, Cengage Learning EMEA, 2007.

Jeanette Franzel, *Single Audit: Opportunities exist to improve the Single Audit Process and Oversight*, DIANE Publishing, 2009.

Susan Switzer, *Internal Audit Reports Post Sarbanes-Oxley: A Guide to Process-Driven Reporting*, John Wiley & Sons, 2007.

Online links

www.asiatradehub.com/india/tr9.asp

www.auditservices.com/aevidence.html

www.investopedia.com/terms/a/auditing-evidence.asp#ixzz1x6PIvbTg

www.informationbible.com/article-auditing-in-depth-111904.html

Notes

Unit 6: Laws and Regulations in Audit

CONTENTS

Notes

Objectives

After studying this unit, you will be able to:

- Discuss considerations of laws and regulations in an audit of financial statements;
- Know about responsibility for compliance with laws and regulations;
- State procedures when non-compliance is discovered;
- Know about law and regulation for auditing procedures;
- Communicate/report about non-compliance.

Introduction

The Audit operation refers to an examination of auditing records undertaken with a view to establishing the correctness or otherwise of the transactions reflected therein. It involves an intelligent scrutiny of the books of account of a company, with reference to documents, vouchers and other relevant records to ensure that the entries made therein give a true picture of the business conducted during that period, that every transaction has been properly authorized by the appropriate authority and that the effect of all the entries in the books of account has been reflected in the final accounts. The role of regulators and inspectors such as auditors has been brought into prominence with the sweeping changes that liberalization has brought in, along with recent instances of embezzlement, which have shaken investor confidence.

When planning and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognize that non-compliance by the entity with the laws and regulations may materially affect the financial statements. However, an audit cannot be expected to detect non-compliance with all laws and regulations. Detection of non-compliance, regardless of materiality, requires consideration of the implications for the integrity of management or employees and the possible effect on other aspects of the audit.

The term "non-compliance" as used in the SAP refers to acts of omission or commission by the entity being audited, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of, the entity or on its behalf by its management or employees. For the purpose of this SAP, non-compliance does not include personal misconduct (unrelated to the business activities of the entity) by the entity's management or employees.

Whether an act constitutes non-compliance is a legal determination that is ordinarily beyond the auditor's professional competence. The auditor's training, experience and understanding of the entity and its industry may provide a basis for recognition that some acts coming to the auditor's attention may constitute non-compliance is generally based on the advice of an informed expert qualified to practice law but ultimately can only be determined by a court of law.

Laws and regulations vary considerably in their relation to the financial statements. Some laws or regulations determine the form or content of an entity's financial statements or the amounts to be recorded or disclosures to be made in financial statements. Other laws or regulations are to be complied with by management or prescribe the provisions under which entity is allowed to conduct its business. Some entities operate in heavily regulated industries (such as banks, sugar and pharmaceuticals industries). Others are only subject to the many laws and regulations that generally relate to the operating aspects of the business (such as those related to occupational safety and health). Non-compliance with laws and regulations could result in financial

Notes

consequences for the entity such as fines, litigations, etc. Generally, the further removed non-compliance is from the events and transactions ordinarily reflected in financial statements, the less likely the auditor are to become aware of it or recognize its possible non-compliance. This SAP applies to audits of financial statements and does not apply to other engagements in which the auditor is specifically engaged to test and report separately on compliance with specific laws or regulations.

Financial statements are prepared to summarize the end-result of all the business activities by an enterprise during an accounting period in monetary terms. These business activities vary from one enterprise to other. To compare the financial statements of various reporting enterprises poses some difficulties because of the divergence in the methods and principles adopted by these enterprises in preparing their financial statements. In order to make these methods and principles uniform and comparable to the extent possible – standards are evolved.

Did u know? The auditor's responsibility to consider fraud and errors in an audit of financial statements is provided in SAP 4, "Fraud and Error."

6.1 Considerations of Laws and Regulations in an Audit of Financial Statements

6.1.1 Scope

1. Addresses the auditor's responsibility to consider laws and regulations in an audit of financial statements.
2. Does not apply to other assurance engagements in which the auditor is specifically engaged to test and report separately on compliance with specific laws or regulations.

6.1.2 Effect of Laws and Regulations

1. The impact of laws and regulations on financial statements varies considerably.
2. The applicable laws and regulations constitute the legal and regulatory framework of the entity.
3. Some laws or regulations have provisions with a direct effect on the financial statements because they determine the reported amounts and disclosures required in an entity's financial statements.
4. Other laws or regulations are to be complied with by management, or set the provisions under which the entity is allowed to conduct its business, but do not have a direct effect on an entity's financial statements.
5. Some entities operate in heavily regulated industries (such as banks and chemical companies) while others are subject only to the many laws and regulations that relate generally to the operating aspects of the business (such as those related to occupational safety and health and equal employment opportunity).
6. Non-compliance with laws and regulations may result in fines, litigation, or other consequences for the entity that may have a material effect on the financial statements.

Self Assessment

Notes

State whether the following statements are true or false:

1. An audit is expected to detect non-compliance with all laws and regulations.
2. Non-compliance refers to acts of omission or commission by the entity being audited, either intentional or unintentional, which are contrary to the prevailing laws or regulations.
3. Consideration of laws and regulations does not apply to other assurance engagements in which the auditor is specifically engaged to test and report separately on compliance with specific laws or regulations.

6.2 Responsibility for Compliance with Laws and Regulations

6.2.1 Responsibility of Management for the Compliance with Laws and Regulations

Management's responsibility, with the oversight of those charged with governance, is to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements. It is management's responsibility to ensure that the entity's operations are conducted in accordance with laws and regulations. The responsibility for the prevention and detection of non-compliance rests with management.

The following policies and procedures, among others, may assist management in discharging its responsibilities for the prevention and detection of non-compliance with laws and regulations:

1. Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements.
2. Instituting and operating appropriate systems of internal control.
3. Developing, publicizing and following a Code of Conduct.
4. Ensuring employees are properly trained and understand the Code of Conduct.
5. Monitoring compliance with the Code of Conduct and acting appropriately to discipline employees who fail to comply with it.
6. Establishing a legal department and/or engaging legal advisors to assist in monitoring legal requirements.
7. Maintaining a register of significant laws with which the entity has to comply within its particular industry and a record of complaints in respect of non-compliance.
8. In larger entities, these policies and procedures may be supplemented by assigning responsibilities to:
   (a) An internal audit function.
   (b) An audit committee.

Caution Compliance with the provisions of laws and regulations determine the reported amounts and disclosures in an entity's financial statements.

Notes

6.2.2 Responsibility of the Auditor

1. The requirements in SAS are designed to assist the auditor in identifying material misstatement of the financial statements due to non-compliance with laws and regulations.
2. The auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations.
3. The auditor is responsible for obtaining reasonable assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error.
4. The auditor is responsible for taking into account the applicable legal and regulatory framework during the planning and execution of the audit procedures.
5. In the context of laws and regulations, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for the following reasons:
   (a) Many laws and regulations (relating principally to the operating aspects of an entity) typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.
   (b) Non-compliance may involve acts designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, management override of controls, or intentional misrepresentations made to the auditor.
   (c) Whether an act constitutes noncompliance is ultimately a matter for legal determination, such as by a court of law.

Given below are the auditor's responsibilities in relation to compliance with the following two categories of laws and regulations that may have a material effect on the financial statements of the company:

1. The provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements, such as tax and pension laws and regulations.
2. The provisions of other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements but compliance with which may be:
   (a) Fundamental to the operating aspects of the business,
   (b) Fundamental to an entity's ability to continue its business, or necessary for the entity to avoid material penalties (for example, compliance with the terms of an operating license, regulatory solvency requirements, or environmental regulations).

6.2.3 Differing Requirements are specified for each of the previously mentioned Categories of Laws and Regulations

1. Auditor's responsibility to obtain sufficient appropriate audit evidence regarding material amounts and disclosures in the financial statements that are determined by the provisions of those laws and regulations.
2. Auditor's responsibility is limited to performing specified audit procedures that may identify noncompliance with those laws and regulations that may have a material effect on the financial statements.
3. The auditor is required to remain alert to the possibility that other audit procedures applied for the purpose of forming an opinion on financial statements may bring instances

of identified or suspected non-compliance with laws and regulations to the auditor's attention.

6.2.4 The Auditor's Consideration of Compliance with Laws and Regulations

The auditor is not, and cannot be held responsible for preventing non-compliance. The fact that an audit is carried out may, however, act as a deterrent.

An audit is subject to the unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with SAPs and other generally accepted audit procedures. This risk is higher with regard to material misstatements resulting from non-compliance with laws and regulations due to factors such as:

1. Existence of laws and regulations, relating to the operating aspects of the entity that do not have a material effect on the financial statements and are not captured by the accounting and internal control systems.
2. The inherent limitations of the accounting and internal control systems and the testing procedures.
3. Persuasive rather than conclusive nature of audit evidence, in general.
4. Deliberate designs, such as collusion, forgery, deliberate failure to record transactions, senior management override of controls or intentional misrepresentations being made to the auditor, to conceal non-compliance.

The auditor should plan and perform the audit recognizing that the audit may reveal conditions or events that would lead to questioning whether an entity is complying with laws and regulations.

In accordance with specific statutory requirements, the auditor may be specifically required to report as part of the audit of the financial statements whether the entity complies with certain provisions of laws or regulations. In these circumstances, the auditor would plan to test for compliance with these provisions of the laws and regulations.

In order to plan the audit, the auditor should obtain a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.

In obtaining this general understanding, the auditor would particularly recognize that non-compliance of some laws and regulations may have a fundamental effect on the operations of the entity and may even cause the entity to cease operations, or call into question the entity's continuance as a going concern.

Example: A Non-banking Financial Company might have to cease to carry on the business of a non-banking financial institution if it fails to obtain a certificate of registration issued under Chapter IIIB of the Reserve Bank of India Act, 1934 and if its Net Owned Funds are less than the amount specified by the RBI in this regard.

To obtain the general understanding of laws and regulations, the auditor would ordinarily: Use the existing knowledge of the entity's industry and business.

1. Inquire of management as to the laws and regulations that may be expected to have a fundamental effect on the operations of the entity.

Notes

2. Inquire of management concerning the entity's policies and procedures regarding compliance with laws and regulations.

3. Discuss with management the policies or procedures adopted for identifying, evaluating and accounting for litigation claims and assessments.

After obtaining the general understanding, the auditor should perform procedures to identify instances of non-compliance with these laws and regulations where non-compliance should be considered when preparing financial statements, specifically:

1. Inquiring of management as to whether the entity is in compliance with such laws and regulations.

2. Inspecting correspondence with the relevant licensing or regulatory authorities

Further, the auditor should obtain sufficient appropriate audit evidence about compliance with those laws and regulations generally recognized by the auditor to have an effect on the determination of material amounts and disclosures in financial statements. The auditor should have a sufficient understanding of these laws and regulations in order to consider them when auditing the assertions related to the determination of the amounts to be recorded and the disclosures to be made.

Such laws and regulations would be well established and known to the entity and within the industry; they would be considered on a recurring basis each time financial statements are issued. These laws and regulations may relate, for example, to the form and content of financial statements, including industry specific requirements or the accrual or recognition of expenses for retirement benefits etc.

Other than as described in paragraphs 17, 18, and 19, the auditor need not test or perform other procedures on the entity's compliance with laws and regulations since this would be outside the scope of an audit of financial statements.

The auditor should be conscious that procedures applied for the purpose of forming an opinion on the financial statements may bring instances of possible non-compliance with laws and regulations to the auditor's attention. For example, such procedures include reading minutes; inquiring of the entity's management and legal counsel concerning litigation, claims and assessments; and performing substantive tests of details of transactions or balances.

The auditor should obtain written representations that management has disclosed to the auditor all known actual or possible non-compliance with laws and regulations whose effects should be considered when preparing financial statements.

In absence of evidence to the contrary, the auditor is entitled to assume the entity is in compliance with these laws and regulations.

Caution The auditor is not, and cannot be held responsible for preventing non-compliance. The fact that an audit is carried out may, however, act as a deterrent.

Self Assessment

Fill in the blanks:

4. Management's responsibility is to ensure that ..... are conducted in accordance with the provisions of laws and regulations.

5. The auditor is responsible for obtaining assurance that the financial statements are free from..... caused by fraud or error.

Notes

6. Non-compliance may involve acts designed to conceal it, such as .....; .....; .....; .....; .....

6.3 Laws and Regulations for Auditing Procedures

Non-compliance means acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Non-compliance does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management or employees of the entity.

Auditor's Duty

Following are the Duties as per SA 250

1. ***Duty to understand the entities Environment and to obtain general understanding about:***
   (a) The legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates; and
   (b) How the entity is complying with that framework?
2. ***Duty to obtain sufficient appropriate audit evidence:*** The auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements.
3. ***Duty to execute procedures:*** The auditor shall perform the following audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements:
   (a) Inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and
   (b) Inspecting correspondence, if any, with the relevant licensing or regulatory authorities.

   The auditor shall remain alert to the possibility that other audit procedures applied may bring instances or suspected of non-compliance with laws and regulations to the auditor's attention.
4. ***Duty to get Representations by Management:*** The auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements have been disclosed to the auditor.

Notes Audit Procedures necessary to applied by the auditor when Non-compliance is identified or suspected are: (a) An understanding of the nature of the act and the circumstances in which it has occurred; and (b) Further information to evaluate the possible effect on the financial statements.

If the auditor suspects there may be non-compliance, the auditor shall discuss the matter with management and, where appropriate, those charged with governance. If management or, as appropriate, those charged with governance do not provide sufficient information that supports that the entity is in compliance with laws and regulations and, in the auditor's judgment, the

Notes

effect of the suspected non-compliance may be material to the financial statements, the auditor shall consider the need to obtain legal advice. If sufficient information about suspected non-compliance cannot be obtained, the auditor shall evaluate the effect of the lack of sufficient appropriate audit evidence on the auditor's opinion.

Task Find out and explain with examples factors that cause non-compliance in a financial statement.

6.4 Procedures when Non-compliance is Discovered

SAP sets out examples of the type of information that might come to the auditor's attention that may indicate non-compliance.

When the auditor becomes aware of information concerning a possible instances of non-compliance, the auditor should obtain an understanding of the nature of the act and the circumstances in which it has occurred, and sufficient other information to evaluate the possible effect on the financial statements.

When evaluating the possible effect on the financial statements, the auditor considers:

1. The potential financial consequences, such as fines, penalties, damages, litigation, threat of expropriation of assets and enforced discontinuation of operations, including vitiation of going concern assumption.
2. Whether the potential financial consequences require disclosure.
3. Whether the potential financial consequences are so serious as to call into question the true and fair view given by the financial statements.

When the auditor believes there may be non-compliance, the auditor should document the findings and discuss them with management. Documentation of findings would include copies of records and documents and making minutes of conversations, if appropriate.

If management does not provide satisfactory information that it is in fact in compliance, the auditor would consult with the entity's lawyer about application of the laws and regulations to the circumstances and the possible effects on the financial statements. When it is not considered appropriate to consult with the entity's lawyer or when the auditor is not satisfied with the opinion, the auditor would consider consulting some other lawyer as to whether a violation of a laws and regulations is involved, the possible legal consequences and what further action, if any, the auditor would take.

When adequate information about the suspected non-compliance cannot be obtained, the auditor should consider the effect of the lack of audit evidence on the auditor's report.

The auditor should consider the implications of non-compliance in relation to other aspects of the audit, particularly the reliability of management representations. In this regard, the auditor reconsiders the risk assessment and the validity of management representations, in case of non-compliance not detected by internal controls or not included in management representations. The implications of particular instances of non-compliance discovered by the auditor will depend on the relationship of the perpetration and concealment, if any, of the act to specific control procedures and the level of management or employees involved.

Notes

6.4.1 Reporting Responsibility of the Auditor for Non-compliance with the Laws and Regulations by the Entity under Audit

In case where those charged with governance are not directly involved in the management of the business auditor shall communicate with those charged with governance matters involving non-compliance with laws and regulations that come to the auditor's attention during the course of the audit. If, Auditor finds that non-compliance is believed to be intentional and material, the auditor shall communicate the matter to those charged with governance as soon as practicable. If the auditor suspects that management or those charged with governance are involved in non-compliance, the auditor shall communicate the matter to the next higher level of authority at the entity, if it exists, such as an audit committee or supervisory board. Where no higher authority exists, or if the auditor believes that the communication may not be acted upon or is unsure as to the person to whom to report, the auditor shall consider the need to obtain legal advice.

6.4.2 Non-compliance on Auditor's Report

1. ***When Auditor has Sufficient and Appropriate Audit evidence that non-compliance exist:*** If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall, in accordance SA-700 express a qualified or adverse opinion on the financial statements.
2. ***When auditor has limitations on scope of Audit:*** If the auditor is prohibited by management or those charged with governance from obtaining sufficient appropriate audit evidence regarding non-compliance the auditor shall express a qualified opinion or disclaim an opinion on the financial statements on the basis of a limitation on the scope of the audit in accordance with SA-700.

Further, if the auditor has identified or suspects non-compliance with laws and regulations, the auditor shall determine whether the auditor has a responsibility to report the identified or suspected non-compliance to parties outside the entity.

6.5 Communication/Reporting of Non-compliance

6.5.1 To Management

The auditor should, as soon as possible, either communicate with the audit committee, the board of directors and senior management, or obtain evidence that they are appropriately informed, regarding non-compliance that comes to the auditors' attention. However, the auditor need not do so for matters that are clearly inconsequential or trivial and may reach agreement in advance on the nature of such matters to be communicated.

1. If in the auditor's judgment the non-compliance is believed to be intentional and/or material, the auditor should communicate the finding without delay.
2. If the auditor suspects that members of senior management, including members of the Board of Directors, are involved in non-compliance, the auditor should communicate the matter to the next higher level of authority at the entity, such as an audit committee or Board of Directors.
3. Where no higher authority exists, or if the auditor believes that the communication may not be acted upon or is unsure as to the person to whom to report, the auditor may consider seeking legal advice.

Notes

6.5.2 To the Users of the Auditor's Report on the Financial Statements

1. If the auditor concludes that the non-compliance has a material effect on the financial statements, the auditor should express a qualified or an adverse opinion.
2. If the auditor is precluded by the entity from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements, has, or is likely to have, occurred, the auditor should express a qualified opinion or a disclaimer of opinion on the financial statements on the basis of a limitation on the scope of the audit.
3. If the auditor is unable to determine whether non-compliance has occurred because of limitations imposed by the circumstances rather than by the entity, the auditor should consider the effect on the auditor's report.

6.5.3 To Regulatory and Enforcement Authorities

The auditor's duty of confidentiality would ordinarily preclude reporting non-compliance to a third party. However, in certain circumstances, that duty of confidentiality is overridden by statute, law or by courts of law.

Notes The auditor is required to report certain matters of non-compliance to the Reserve Bank of India as per the requirements of Non-banking Financial companies Auditor's Report (Reserve Bank) Directions, 1988, issued by the Reserve Bank of India.

6.6 Withdrawal from the Engagement

The auditor may conclude that withdrawal from the engagement is necessary when the entity does not take the remedial action that the auditor considers necessary in the circumstances, even when the non-compliance is not material to the financial statements. Factors that would affect the auditor's conclusion include within the implications of the involvement of the highest authority within the entity which may affect the reliability of management representations, and the effects on the auditor of continuing association with the entity. In appropriate circumstances, the auditor may consider seeking legal advice.

An outgoing auditor, on receiving communication from the incoming auditor, should send a reply to him as soon as possible, setting out in detail the reasons, which according to him had given rise to the attendant circumstances but without disclosing any information as regards the affairs of the client which he is not competent to do. However, with the permission of the client he may disclose information regarding affairs of the client to the incoming auditor.

Did u know? ***Effective Date:*** This Statement on Standard Auditing Practices becomes operative for all audits commencing on or after 1st July, 2001.

6.7 Indications that Non-compliance may have occurred

Examples of the type of information that may come to the auditor's attention that may indicate that non-compliance with laws and regulations has occurred are listed below:

1. Investigation by government departments or payment of fines, additional taxes or penalties.

Notes

2. Payment for unspecified services or loans to consultants, related parties, employees or government employees.
3. Sales commission or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to those ordinarily paid by the entity or in its industry or to the services actually received.
4. Purchases at prices significantly above or below market price.
5. Unusual payments in cash and other unusual transactions.
6. Unusual transactions with companies registered in tax havens.
7. Payments for goods or services made other than to the country from which the goods or services originated.
8. Payments without proper exchange control documentation.
9. Existence of an accounting system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.
10. Unauthorized transactions or improperly recorded transactions.
11. Media comment.

6.8 Audit and Accounting Standards

Accounting Standards are the statements of code of practice of the regulatory accounting bodies that are to be observed in the preparation and presentation of financial statements. In layman terms, accounting standards are the written documents issued by the expert institutes or other regulatory bodies covering various aspects of measurement, treatment, presentation and disclosure of accounting transactions.

Notes The Institute of Chartered Accountants of India (ICAI) recognizing the need to harmonize the diverse accounting policies and practices at present in use in India constituted Accounting Standards Board (ASB) on April 21, 1977. The main role of ASB is to formulate Accounting Standards from time-to-time.

When an auditor conducts the audit of accounts of a business entity such as a company there are three fundamental accounting assumptions that he must keep in mind. These are laid down by the Accounting Standard (AS-I) prescribed by the Institute of Chartered Accountants of India. These fundamental accounting assumptions are as follows: (1) Going Concern, (2) Consistency, and (3) Accrual. The above mentioned accounting assumptions underlie the preparation and presentation of financial statements. Each one of these accounting assumptions has been dealt with in detail in this research paper.

6.8.1 Going concern as per AS-I

The definition of a going concern as given in AS-I states that "*the continuance of an entity is assumed for a foreseeable future and that there is neither an intention nor necessity of liquidation or of curtailing materially the scale of operations*". Thus, if an entity is in a position to normally produce and sell its goods and perform its obligations towards various bodies, whether governmental or otherwise, then it could be called a 'going concern'. SAP 16 has now specified that the "foreseeable period" should be a period not exceeding one year after the balance sheet date. There may be situations within the fundamental accounting assumptions of going concern, consistency and accrual,

Notes

when an entity may not satisfy any one of them and as a consequence shows results which may not affect its liquidity, though theoretically there may be a possibility of technical insolvency. The standard is not clear as to the manner of consideration of the same. For example, if a company with a small capital base has been showing marginal profits after depreciation but without accounting for gratuity. Gratuity is paid as and when liability arises on cash basis. If the gratuity is provided, the company will come under the purview of potential sickness under SICA. Such a policy is violative of the accrual concept. The company's activities may not be affected because gratuity is only a contingent liability and the liability to pay arises only when all workers decide to retire on the same day. Hence, the auditor need not doubt the condition of the company, as days to day activities are not affected.

6.8.2 Financial Indicators

There are a number of indicators which can help the Auditor in determining whether the status of a company as a going concern is affected. These indicators can be categorized into three sets. These are:

1. ***The financial indicators*** that indicate whether the company is a 'going concern' is as follows:
   - Negative net worth or negative working capital;
   - fixed term borrowings approaching maturity without realistic prospects of renewal or repayment or excessive reliance on short term borrowings to finance long term assets;
   - Adverse key financial ratios; Substantial operating losses; Substantial negative cash flows from operations;
   - Arrears or discontinuance of dividends;
   - Inability to pay creditors on due dates;
   - Difficulty in complying with terms of loan agreements;
   - Change from credit to cash on delivery transactions with suppliers;
   - Inability to obtain finance for essential new product development or other essential investments;
   - Entering into a scheme of arrangement with creditors for reduction of liability.
2. ***Operating indicators:*** The operating indicators showing that the company is a 'going concern' is as follows:
   - Loss of key management without replacement;
   - Loss of major market, franchise, license or principal supplier;
   - Labour difficulties or shortage of important supplies.
3. ***Other Indicator:*** The other indicators of the same are: Non-compliance with capital or other statutory requirements; Pending legal proceedings against the entity that may, if successful result in judgments that could not be met; Changes in Legislation or Governmental policy Sickness of the company under any statutory definition. Thus, it can be stated that the role of the Auditor has been made more proactive than ever before as far as the 'going concern' is concerned. Any of the above factors if present or apprehended will entail detailed enquiry by the Auditors. While looking at the above mentioned criteria the AS-3 which is regarding cash flow has to be kept in mind. The moment a cash flow statement is prepared, normally it would show the true colors of the company.

Notes

However, a fund flow statement would also be of great value as then the various sources of funds would also have been revealed and also indicate how the same have been utilized. If short-term funds have been used for long-term purposes, then that would amount to diversion of funds. The impact of such diversion would then have to be studied in terms of SAP-16 to ascertain whether such diversion would affect the liquidity of the company on a long-term basis. As far as negative working capital is concerned, there are a few issues which are rather complicated. The fact that there is negative working capital may not always be an indication of sickness. Many businesses today work on trust. There are units which have been technically sick nut have the backing and confidence of creditors, workers, bankers, etc. They continue to get credit and bankers have reposed their faith on the units due to either the ingenuity of the promoters, honesty, work ethics, etc. Any adverse report by the Auditor under SAP-16 would have a negative impact on the units such as these. The role of the Auditor in such a situation becomes very tricky as the aim is not to threaten the very existence of the company. As far as non-financial indicators are concerned, they are to be looked into with great care as any mistaken reading of the same may result in the devastation of the business of the company. It is thus, critical that the Auditor after having applied his mind to the indicators has a discussion with the management and seeks explanations from them and to see what measures are being taken to reverse any adverse situation which may have arisen.

6.9 Four Stages on Scale of Assessment

The validity of the going concern status may be judged on the following scale:

- Going concern status being appropriate;
- Going concern status being questionable and resolved by management explanations;
- Going concern status being questionable and managements explanations being inadequate;
- Going concern status being inappropriate.

6.9.1 Going concern Status being Appropriate

This being a basic accounting assumption, if in the opinion of the Auditor, an entity is found to being a 'going concern' then the Auditor need not qualify so in the Report.

6.9.2 Going concern Status being Questionable and Resolved by Management Explanations

The Auditor has to exercise his judgment as to the factors, which point to the entity's stature as a non-going concern. If he thinks that the company may have a chance to recover and will not become insolvent then he may not have it in the report

6.9.3 Going concern Status being Questionable and Managements Explanations being Inadequate

In case the explanations given by the management are not found to be adequate by the Auditor, he should consider whether the financial statements: Adequately describe the principal condition that raises substantial doubt about the company's ability to continue in operation for the foreseeable future; State that there is significant uncertainty that the entity will be able to continue as a going concern and therefore, may be unable to realize its assets and discharge its liabilities in the normal course of its business. State that the financial statements do not include any adjustments relating to recoverability and classification of recorded assets and classification of liabilities that may be

Notes

necessary if the entity is unable to continue as a 'going concern'. SAP 16 states that if adequate disclosure of the above facts is made in the financial statements, the auditor need not qualify his report. However, he is required to highlight the problem by drawing attention to the note in the financial statement which discloses the matter as set out above. The Auditor can also issue a disclaimer of opinion for going concern uncertainty. Adverse opinion or qualified opinion should be expressed where the Auditor feels that the disclosure is not adequate.

6.9.4 Going concern Status being Inappropriate

If the Auditor feels that the company will not be able to maintain its status as a going concern he should state that the assumption of the company being a going concern is not applicable in the particular case. SAP 16 has become operational for all Audits relating to accounting periods beginning April 1999. There may be a few problems in the areas where the judgment of auditor is sought regarding non-financial matters. The high responsibility given to the auditor has also meant that the liabilities for failure to deliver are also enhanced. There are doubts as to whether the profession is ready to deliver such high levels of expectations.

6.10 Duty of Statutory Auditor for Compliance with Accounting Standards

Section 211(3A) of Companies Act, 1956 provides that every profit and loss account and balance sheet of the company shall comply with the accounting standards.

The statutory auditors are required to make qualification in their report in case any item is treated differently from the prescribed Accounting Standard. However, while qualifying, they should consider the materiality of the relevant item. In addition to this Section 227(3)(d) of Companies Act, 1956 requires an auditor to report whether, in his opinion, the profit and loss account and balance sheet are complied with the accounting standards referred to in Section 211(3C) of Companies Act, 1956.

How many Accounting Standards have been prescribed? Are these applicable to all companies irrespective of its size?

In all 29 Accounting Standards have been prescribed. However their applicability is dependent on its size – Level I/II/III Company. The following table lists out the Accounting Standards and its applicability.

Level I Company: Enterprises, which fall in any one or more of the following categories, at any time during the accounting period, are classified as Level I enterprises:

1. Enterprises whose equity or debt securities are listed whether in India or outside India.
2. Enterprises, which are in the process of listing their equity or debt securities as evidenced by the board of directors' resolution in this regard.
3. Banks including co-operative banks.
4. Financial Institutions
5. Enterprises carrying on insurance business.
6. All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds ₹ 500 million. Turnover does not include 'other income'.

Notes

7. All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of ₹ 100 million at any time during the accounting period.

8. Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

Level II Company: Enterprises, which are, not Level I enterprises but fall in any one or more of the following categories are classified as Level II enterprises;

1. All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds ₹ 4 million, but does not exceed ₹ 500 million. Turnover does not include 'other income'.

2. All commercial, industrial and business reporting enterprises having borrowing, including public deposits, in excess of ₹ 10 million but not in excess of ₹ 100 million at any time during the accounting period.

3. Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

Level III Company: Enterprises, which are not covered under Level I and Level II are considered as Level III enterprises.

6.11 Applicability

Level II and Level III enterprises are considered as SMEs.

Level I enterprises are required to comply fully with all the accounting standards.

No relaxation is given to Level II and Level III enterprises in respect of recognition and measurement principles. Relaxations are provided with regard to disclosure requirements. Accordingly, Level II and Level III enterprises are fully exempted from certain accounting standards, which mainly lay down disclosure requirements. In respect of certain other accounting standards, which lay down recognition, measurement and disclosure requirements, relaxations from certain disclosure requirements are given.

Table 6.1: Levels of Applicability

Sr. No.	Particulars	Applicability
1.	Disclosure of Accounting Policies	I, II, III
2.	Valuation of Inventories	I, II, III
3.	Cash Flow Statements	I
4.	Contingencies and Events Occurring After the Balance Sheet Date	I, II, III
5.	Net Profit or Loss for the period, Prior period Items and Changes in Accounting Policies.	I, II, III
6.	Depreciation Accounting	I, II, III
7.	Construction Contracts	I, II, III
8.	Accounting for Research and Development (This standard has been withdrawn w.e.f. 01.04.2004 for all levels of enterprises and AS 26 is applicable)	As withdrawn

Contd...

Notes

9.	Revenue recognition	I, II, III
10.	Accounting for Fixed Assets	I, II, III
11.	The Effect of Changes in Foreign Exchange Rates	I, II, III
12.	Accounting for Government Grants	I, II, III
13.	Accounting for Investments	I, II, III
14.	Accounting for Amalgamations	I, II, III
15.	Accounting for Retirement Benefits in the Financial Statements of Employers	I, II, III
16.	Borrowing Costs	I, II, III
17.	Segment Reporting	I II. with modification III. with modification
18.	Related Party Disclosures	I II. with modification III. with modification
19.	Leases	I II. with modification III. with modification
20.	Earning Per Share	I II. with modification III. with modification
21.	Consolidated Financial Statements	I
22.	Accounting for Taxes on Income	I,II,III
23.	Accounting for Investments in Associates in Consolidated Financial Statements	I
24.	Discontinuing Operations	I
25.	Interim Financial Reporting	I
26.	Intangible Assets	I,II,III
27.	Financial Reporting of Interests in Joint Ventures	I. with clarification II. with clarification III. with clarification
28.	Impairment of Assets	I II. with modification III. with modification
29.	Provisions, Contingent Liabilities and Contingent Asset	

Self Assessment

Fill in the blanks:

7. Auditor's Duty against non compliance .....; .....; ..... and .....
8. Documentation of findings by auditor include copies of ..... and .....
9. The auditor's duty of confidentiality would ordinarily preclude reporting non-compliance to a .....
10. When an auditor conducts the audit of accounts of a business entity three fundamental accounting assumptions that he must keep in mind are.....;..... and .....

Notes

6.12 Summary

- When planning and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognize that non-compliance by the entity with the laws and regulations may materially affect the financial statements.
- The term "non-compliance" as used in the SAP refers to acts of omission or commission by the entity being audited, either intentional or unintentional, which are contrary to the prevailing laws or regulations.
- Laws and regulations vary considerably in their relation to the financial statements. Some laws or regulations determine the form or content of an entity's financial statements or the amounts to be recorded or disclosures to be made in financial statements. Other laws or regulations are to be complied with by management or prescribe the provisions under which entity is allowed to conduct its business.
- It is management's responsibility to ensure that the entity's operations are conducted in accordance with laws and regulations. The responsibility for the prevention and detection of non-compliance rests with management.
- If the auditor becomes aware of information concerning an instance of non-compliance or suspected non-compliance with laws and regulations, the auditor shall obtain: (a) An understanding of the nature of the act and the circumstances in which it has occurred; and (b) Further information to evaluate the possible effect on the financial statements.
- The auditor should, as soon as possible, either communicate with the audit committee, the board of directors and senior management, or obtain evidence that they are appropriately informed, regarding non-compliance that comes to the auditors' attention.
- Accounting assumptions underlie the preparation and presentation of financial statements fundamental accounting assumptions are as follows: (1) Going Concern, (2) Consistency and (3) Accrual.

6.13 Keywords

Accounting Standards are the statements of code of practice of the regulatory accounting bodies that are to be observed in the preparation and presentation of financial statements.

Going concern as given in AS-I states that "the continuance of an entity is assumed for a foreseeable future and that there is neither an intention nor necessity of liquidation or of curtailing materially the scale of operations."

The term **"non-compliance**" as used refers to acts of omission or commission by the entity being audited, either intentional or unintentional, which are contrary to the prevailing laws or regulations.

6.14 Review Questions

1. What is the term non-compliance with laws and regulation means?
2. What are Auditor's Duty while considering laws and regulation in an audit of financial statements?
3. What audit procedures are necessary to be applied by the auditor when non-compliance is identified or suspected?
4. What are reporting responsibility of the auditor for non compliance with the laws and regulations by the entity under audit?
5. What shall be effect of non-compliance on auditor's report?

Notes

6. What audit procedures necessary to applied by the auditor when non-compliance is identified or suspected?
7. When evaluating the possible effect on the financial statements, what factors an auditor must consider?
8. What are the indications that non-compliance may have occurred?
9. What is the duty of statutory auditor for compliance with accounting standards?

Answers: Self Assessment

1. False
2. True
3. True
4. Entity's operations
5. Material misstatement
6. Collusion; forgery; deliberate failure to record transactions; management override of controls; or intentional misrepresentations made to the auditor
7. Duty to understand the entities Environment and to obtain general understanding; Duty to obtain sufficient appropriate audit evidence; Duty to execute procedures; Duty to get Representations by Management
8. Records and documents; making minutes of conversations
9. Third party
10. Going Concern; Consistency; Accrual

6.15 Further Readings

Books

David Coderre, *Internal Audit: Efficiency through Automation*, John Wiley & Sons, 2009.

Emile Woolf, Moira Hindson, *Audit and Accountancy Pitfalls: A Casebook for Practising Accountants, Lawyers and Insurers*, John Wiley & Sons, 2011.

Iain Gray, Stuart Manson, *The Audit Process: Principles, Practice and Cases*, Cengage Learning EMEA, 2007.

Jeanette Franzel, *Single Audit: Opportunities exist to improve the Single Audit Process and Oversight*, DIANE Publishing, 2009.

Susan Switzer, *Internal Audit Reports Post Sarbanes-Oxley: A Guide to Process-Driven Reporting*, John Wiley & Sons, 2007.

Online links

www.asiatradehub.com/india/tr9.asp

www.auditservices.com/aevidence.html

www.investopedia.com/terms/a/auditing-evidence.asp#ixzz1x6PIvbTg

www.informationbible.com/article-auditing-in-depth-111904.html

Notes

Unit 7: Internal Control

CONTENTS

Objectives

After studying this unit, you will be able to:

- Define and discuss meaning of internal control;
- State the importance of internal control;

Notes

- Describe internal checking;
- Discuss procedure of internal audit;
- Evaluate internal control.

Introduction

The management style and the expectations of upper-level managers, particularly their control policies, determine the control environment. An effective control environment helps ensure that established policies and procedures are followed. The control environment includes independent oversight provided by a board of directors and, in publicly held companies, by an audit committee; management's integrity, ethical values, and philosophy; a defined organizational structure with competent and trustworthy employees; and the assignment of authority and responsibility.

Control activities are the specific policies and procedures management uses to achieve its objectives. The most important control activities involve segregation of duties, proper authorization of transactions and activities, adequate documents and records, physical control over assets and records, and independent checks on performance. A short description of each of these control activities appears below.

1. ***Segregation of duties*** requires that different individuals be assigned responsibility for different elements of related activities, particularly those involving authorization, custody, or record keeping. For example, the same person who is responsible for an asset's record keeping should not be responsible for physical control of that asset having different individuals perform these functions creates a system of checks and balances.
2. ***Proper authorization*** of transactions and activities helps ensure that all company activities adhere to established guide lines unless responsible managers authorize another course of action. For example, a fixed price list may serve as an official authorization of price for a large sales staff. In addition, there may be a control to allow a sales manager to authorize reason able deviations from the price list.
3. ***Adequate documents and records*** provide evidence that financial statements are accurate. Controls designed to ensure adequate record keeping include the creation of invoices and other documents that are easy to use and sufficiently informative; the use of pre-numbered, consecutive documents; and the timely preparation of documents.
4. ***Physical control*** over assets and records helps protect the company's assets. These control activities may include electronic or mechanical controls (such as a safe, employee ID cards, fences, cash registers, fireproof files, and locks) or computer-related controls dealing with access privileges or established backup and recovery procedures.
5. ***Independent checks*** on performance, which is carried out by employees who did not do the work being checked, help ensure the reliability of accounting information and the efficiency of operations. For example, a supervisor verifies the accuracy of a retail clerk's cash drawer at the end of the day. Internal auditors may also verity that the supervisor performed the check of the cash drawer.

In order to identify and establish effective controls, management must continually assess the risk, monitor control implementation, and modify controls as needed. Top managers of publicly held companies must sign a statement of responsibility for internal controls and include this statement in their annual report to stockholders.

Notes

7.1 Internal Control

Internal control is the process designed to ensure reliable financial reporting, effective and efficient operations, and compliance with applicable laws and regulations. Safeguarding assets against theft and unauthorized use, acquisition, or disposal is also part of internal control.

Internal Control defined as a process designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

1. Effectiveness and efficiency of operations
2. Reliability of financial reporting
3. Compliance with applicable laws and regulations

Several key points should be made about this definition:

Internal control is, to some degree, everyone's responsibility. For example Within the University, administrative employees at the department-level are primarily responsible for internal control in their departments.

Notes People at every level of an organization affect internal control.

Effective internal control is a built-in part of the management process (i.e., plan, organize, direct, and control). Internal control keeps an organization on course toward its objectives and the achievement of its mission, and minimizes surprises along the way. Internal control promotes effectiveness and efficiency of operations, reduces the risk of asset loss, and helps to ensure compliance with laws and regulations. Internal control also ensures the reliability of financial reporting (i.e., all transactions are recorded and that all recorded transactions are real, properly valued, recorded on a timely basis, properly classified, and correctly summarized and posted).

Notes Effective internal control helps an organization achieve its operations, financial reporting, and compliance objectives.

Effective internal control helps an organization achieve its objectives; it does not ensure success. There are several reasons why internal control cannot provide absolute assurance that objectives will be achieved: cost/benefit realities, collusion among employees, and external events beyond an organization's control.

Caution Internal control can provide only reasonable assurance – not absolute assurance – regarding the achievement of an organization's objectives.

7.2 Internal Control Process

Internal control consists of five inter-related components as follows:

1. Control (or Operating) environment
2. Risk assessment
3. Control activities

Notes

4. Information and communication
5. Monitoring

All five internal control components must be present to conclude that internal control is effective.

7.2.1 Control Environment

The control environment is the control consciousness of an organization; it is the atmosphere in which people conduct their activities and carry out their control responsibilities. An effective control environment is an environment where competent people understand their responsibilities, the limits to their authority, and are knowledgeable, mindful, and committed to doing what is right and doing it the right way. They are committed to following an organization's policies and procedures and its ethical and behavioral standards. The control environment encompasses technical competence and ethical commitment; it is an intangible factor that is essential to effective internal control. A governing board and management enhance an organization's control environment when they establish and effectively communicate written policies and procedures, a code of ethics, and standards of conduct. Moreover, a governing board and management enhance the control environment when they behave in an ethical manner-creating a positive "tone at the top"—and when they require that same standard of conduct from everyone in the organization.

Task Identify various factors contribute to internal control for a manufacturing company.

Who is Responsible?

Management is responsible for "setting the tone" for their organization. Management should foster a control environment that encourages:

1. the highest levels of integrity and personal and professional standards.
2. a leadership philosophy and operating style which promote internal control throughout the organization assignment of authority and responsibility.

7.2.2 Importance of Internal Control

Internal controls help safeguard funds, provide efficient and effective management of assets, and permit accurate financial accounting. Internal controls cannot eliminate all errors and irregularities, but they can alert management to potential problems.

Effective controls reduce the risk of asset loss and help ensure that plan information is complete and accurate, financial statements are reliable, and laws and regulations are complied with.

Internal auditors play an important role in their organization's corporate governance, internal control structure, risk management analysis, and financial reporting process. In the past decade, auditors actively have provided management with consulting and assurance services to assist in compliance with regulations such as the U.S. Sarbanes-Oxley Act of 2002. Internal audit resources also have been expanded to satisfy the high demand for services to assist in executive certifications of internal controls and financial reports.

Example: U.S. Securities and Exchange Commission's (SEC's) Proxy Disclosure Enhancements rules released in December require companies listed on U.S. exchanges to disclose their governance measures, including their board structure, the board's oversight of risk management, and its relationship with executive compensation policies and practices.

Notes

In the coming years, internal auditors may be expected to expand their role to assume more responsibilities in improving risk management, reducing organizational complexity and costs, and participating in developing strategic and governance processes.

Example: U.S. Securities and Exchange Commission's (SEC's) Proxy Disclosure Enhancements rules released in December require companies listed on U.S. exchanges to disclose their governance measures, including their board structure, the board's oversight of risk management, and its relationship with executive compensation policies and practices.

The proxy disclosure rules create opportunities for internal auditors to report on and provide their opinions about their organization's compliance with its own governance and risk assessment requirements. In particular, auditors may need to express opinions in the areas of corporate governance, risk management, and internal controls.

Fraud Detection

Small businesses lose millions of money every year to employee theft. Types of fraud committed by employees include skimming payments from customers; check tampering, cash theft and misuse of company credit cards, and improper payroll transactions. Many small-business owners may believe they lack the staff to create an internal audit policy or carry out audits to combat these problems. However, even with a small staff, a small business may create an effective internal control system for monitoring employees and their behavior. A formal internal audit policy, even if conducted part time by individuals normally assigned other duties, performs other tasks besides detecting fraud. Examining policies and procedures on a regular basis ensures that the company minimizes its exposure to fraud and other losses. Extension of credit to customers provides one such area of loss prevention.

Internal Controls in a Computerised Environment

It includes:

- General control and application controls in a computerised environment. The purpose of application controls is to establish specific control procedures over the accounting applications in order to provide reasonable assurance that all transactions are authorised and recorded and are processed completely, accurately and on a timely basis.
- Development of computer application, for example, standards over systems design, programming and documentation; testing procedures using test data; approval by computer users and management; segregation of duties from those who design and those who test; installation procedures and training of staff, etc.
- Prevention or detection of unauthorised changes to program, which include full records of program changes, password protection, restricted access to central computer, virus checks, backup copies of program or control copies.
- Testing and documentation of program changes
- Controls to prevent wrong programs or files being used
- Controls to prevent unauthorised amendments to data files
- Controls to ensure continuity of operation, for example, storing extra copies of programs and data files off-site, protection of equipment against fire and other hazards, backup power sources, disaster recover procedures or maintenance agreements and insurance.

Notes

Use of Internal Control Systems by Auditors

An internal control can only provide, at best, a reasonable assurance that objectives are being reached because of inherent limitations, such as, human error and potential for fraud. These inherent limitations demonstrate why auditors cannot obtain all their evidence from tests of the systems of internal control.

7.3 Internal Auditing

Performed by professionals with an in-depth understanding of the business culture, systems, and processes, the internal audit activity provides assurance that internal controls in place are adequate to mitigate the risks, governance processes are effective and efficient, and organizational goals and objectives are met.

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

Independence is established by the organizational and reporting structure. Objectivity is achieved by an appropriate mind-set. The internal audit activity evaluates risk exposures relating to the organization's governance, operations and information systems, in relation to:

1. Effectiveness and efficiency of operations.
2. Reliability and integrity of financial and operational information.
3. Safeguarding of assets.
4. Compliance with laws, regulations, and contracts.

Based on the results of the risk assessment, the internal auditors evaluate the adequacy and effectiveness of how risks are identified and managed in the above areas. They also assess other aspects such as ethics and values within the organization, performance management, communication of risk and control information within the organization in order to facilitate a good governance process.

The internal auditors are expected to provide recommendations for improvement in those areas where opportunities or deficiencies are identified. While management is responsible for internal controls, the internal audit activity provides assurance to management and the audit committee that internal controls are effective and working as intended.

The internal audit activity is led by the Chief Audit Executive (CAE). The CAE delineates the scope of activities, authority, and independence for internal auditing in a written charter that is approved by the audit committee.

An effective internal audit activity is a valuable resource for management and the board or its equivalent, and the audit committee due to its understanding of the organization and its culture, operations, and risk profile. The objectivity, skills, and knowledge of competent internal auditors can significantly add value to an organization's internal control, risk management, and governance processes. Similarly an effective internal audit activity can provide assurance to other stakeholders such as regulators, employees, providers of finance, and shareholders.

Did u know? As the primary body for the internal audit profession, The IIA maintains the International Standards for the Professional Practice of Internal Auditing and the professions Code of Ethics. IIA members are required to adhere to the Standards and Code of Ethics.

Notes

7.4 Internal Check

The purpose of internal audit is to evaluate the internal check system. There is division of duties among the employees. When all staff member are working properly it means there is effective internal check system. The work of an auditor is reduced. He can apply test checks to complete audit duty?

Internal checking is an accounting procedure or physical control to safeguard assets against loss due to fraud or other irregularities. Internal check is an element of internal control. Weak internal check mechanisms mandate a greater degree of auditing procedures. An example of internal control is segregating the record keeping for an asset and its physical custody, such as in the case with inventory and cash. No one individual should have complete control over a transaction from beginning to end. Internal checks make it difficult for an employee to steal cash or other assets and concurrently cover up by entering corresponding amounts in the accounts.

Example: An example of internal check is the establishment of input and output controls within a data processing department. A group or person has the responsibility of checking control totals provided by the user department with those generated during the processing of the data. Examples of physical controls are guards and gates to restrict access.

Self Assessment

Fill in the blanks:

1. The internal audit activity is led by the .....
2. The purpose of internal audit is to evaluate the .....
3. Internal checking is an accounting procedure or physical control to safeguard ..... due to fraud or other irregularities.

7.5 Evaluation of Internal Controls with Special Reference to the Audit of Public Sector Enterprises in India

Internal Control comprises the plan and all the co-ordinate methods and measures adopted within an organization with the express objectives of:

1. Safeguarding the assets of the organization,
2. Verifying the accuracy and reliability of its accounting data,
3. Promoting operational efficiency, and
4. Fostering and encouraging adherence to the prescribed managerial policies.

7.5.1 Objectives and Relevance

In recent years, the relevance and objectives of Internal Accounting Controls have expanded far beyond the traditional ambit of protection against theft and fraud, well into the areas of effectiveness, accountability and operational efficiency of the organization. Hence the need for evaluation of the system of internal control, while conducting the audit of the accounts of Government organizations, whether the nature of their operations be commercial or civil.

Notes

7.5.2 Increasing Awareness in the International Context

Viewed in the Indian context, the Government in consultation with the Institute of Chartered Accountants of India, issued the Manufacturing and other Companies (Auditors' Report) Order, 1975, (Order) for rationalization of the requirements for such evaluation. The revised Order considerably enhances the reporting responsibilities of the Auditor while reporting upon the adequacy and reasonableness of the procedures as also the financial health of the company. It is significant to state in this context that the Order is supplemental to the directions given by the Comptroller and Auditor-General of India (CAG) under the Companies Act, in respect of Government Companies with regard to which matters specified in the Order would constitute an integral part of the Auditor's Report submitted, and reply to the questionnaire issued by the CAG would continue to be submitted as hitherto. The Order applies to every company engaged or proposed to engage in one or more of the following activities:-

1. Manufacturing, mining or processing,
2. Supplying or rendering services,
3. Trading, and
4. The business of financing investments.

Caselet

USA, System Based Audit

The National Audit Office of the United Kingdom, in collaboration with the Overseas Development Administration, in its Manual entitled "A Guide to Certification Audit" emphasizes the evaluation of internal control procedures during Systems Based Audit (SBA). In the United States of America, the introduction of the Foreign Corrupt Practices Act of 1977 (FCPA) requires the corporate management to maintain a system of internal accounting controls, sufficient to provide reasonable assurances for the proper execution of transactions and effecting accountability. Thus, the world over, the need for internal controls has received considerable impetus and there has admittedly been a conscious and significant increase in the necessity for ensuring the existence of effective internal controls.

A system of internal control recognizes the basic principle that it should be as difficult as is practical and feasible, for individuals to be dishonest or careless. Such a premise is indeed not based on a cynical view of human nature in general, but rather on the realistic assumption that there could be a few persons who would be dishonest or careless if it is easy for them to be so. Further, apart from the prevention and detection of fraud, internal controls should reflect the strength of the overall accounting environment in an organization as also the accuracy of its financial and operational records.

7.5.3 Two Dimensions of Internal Control

The two dimensions of internal controls are

1. ***Administrative Controls***, which include but are not limited to the plan of organization and records that are concerned with the decision processes leading to the management's authorization of transactions.
2. ***Accounting Controls*** comprise the plan of organization, procedures and records that are concerned with safeguarding of assets and the reliability of financial records designed to

Notes

provide reasonable assurance that the transactions are recorded and executed in accordance with the general and /or specific authorization of the Management, recording of transactions to ensure the preparation of financial statements in conformity with the generally accepted accounting principles and any other criteria applicable to such statements, proper maintenance of accountable of assets, Management's authorization of access to assets and accountability for the physical verification of assets.

From the above it is clear that in an audit engagement the distinction between the two types of controls requires considerable dexterity as the two are very often inter-related. Needless to say that the distinction should not be artificially made and administrative controls generally have a nexus with the accounting controls even if the linkage is indirect.

7.5.4 Scope of Review

Naturally therefore, the scope and objectives of the Statutory Auditor would vary and depend upon both the size and structure of the entity as also the requirements of the Management. Normally, however, the Statutory Auditor operates in one or more of the following areas.

1. Review of the Accounting Systems and the related internal controls. Thus while the adequacy of the accounting systems is the responsibility of the Management, the Statutory Auditor is usually assigned the specific responsibility for reviewing the accounting systems and the related internal controls, as also monitoring their operations.
2. Review of financial and operating information including identification, measurement, and classification and reporting such information specifically enquiring into individual items including detailed testing of transactions, procedures and balances.
3. Examination of the economy, efficiency and effectiveness of operations including non-financial controls.

Thus, before an evaluation is undertaken the auditor should determine:-

1. The degree of reliance that can be placed on the various systems and procedures in existence.
2. The nature, extent and timing of substantive audit tests to be applied. In this process due to factors including the limitations of time, the volume of transactions and magnitude of operations the Auditor can conduct:-
3. Selective Verification in areas where he finds that internal control is effective.
4. Detailed or comprehensive verification of transactions in areas where the internal control is weak.
5. Internal control investigation and evaluation is most relevant in the context of
   (a) Independent financial audits,
   (b) Special systems study engagements.

7.5.5 Advantages of Internal Control Evaluation

1. Enables an Auditor to restrict his detailed examination in areas where internal controls is satisfactory, and intensifying the scrutiny in areas where the controls are weak.
2. Resultantly, the time available to the auditor is more gainfully employed.
3. Highlights areas of weakness in the operating systems, for suitable remedial action to be taken by the Management.

Notes

4. Facilitates acquisition of an in-depth knowledge and understanding of the systems and procedures, actually in operation.
5. Enables the Statutory Auditor in the determination of the degree of effectiveness of Internal Audit in the auditee organization.
6. Enables Government Audit to review the comprehensiveness in specific terms, of the evaluation conducted, both by the Internal Audit Wing as also by the Statutory Auditor of the organization.

7.5.6 Inter-relationship between Audit and Internal Controls

The Statement on Standard Auditing Practices (SAP) pertaining to the "Study and Evaluation of the Accounting System and Related Internal Controls in connection with an Audit", defines the inter-relationship between the Statutory Auditor and internal control.

The System of Internal Control is the plan of organization and all the methods and procedures adopted by the Management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of business, including adherence to Management policies, the safeguarding of assets, 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 functions of the accounting system. The internal audit functions constitute a separate component of internal control established with the objective of determining whether other internal controls are well designed and properly operated.

7.5.7 Distinction between Control Environment and Control Procedures

It would be necessary at this stage, to make a distinction between the concepts of 'control environment' and 'control procedures'. The control environment refers to the overall attitude, awareness and actions of the Management regarding control and its role and importance in the entity.

Factors reflected in the control environment include:

1. Management's philosophy and operating style.
2. The organizational structure and methods of assigning authority and responsibility.
3. Management's control system (including internal audit functions).
4. The functions of the Board of Directors, personnel policies, procedures and external influences.

A strong control environment (e.g. one with tight budgetary controls and an effective audit function) can significantly complement specific controls. However, this by itself does not ensure the overall effectiveness of the system of internal control. Hence arises the necessity for 'control procedures'.

7.5.8 Control Procedures

Control procedures encompass policies and procedures established by the Management, in order to provide for the attainment of certain objectives. These could include the existence of systems for:

1. An effective system of reconciliation of Books of Accounts.
2. Check of the arithmetical accuracy of the records.

Notes

3. Controls over computer applications and environment.
4. Maintenance of control accounts and Trial Balances.
5. Approval and control of balances.
6. Comparison of results of cash, security and inventory checks with accounting records.
7. Limiting direct physical access to assets and records.
8. Comparison of budgetary estimates with actual estimates
9. Physical verification of assets and a system of safeguarding the assets.
10. Appropriate action taken with regard to any differences and discrepancies.
11. Distribution and proper allocation of functional responsibilities.
12. System of operation of accounting procedures for ascertainment of accurate of accurate and reliable accounting data.
13. Existence of an effective system for the efficient operation of the asset and a well regulated system for safeguarding of assets.
14. System of managerial review of the work allocated to various individuals in the organization.

Self Assessment

4. Assume a hypothetical IT audit specialist, who works for the accounting firm of Townsend and Townsend, LLP. One of the accounting firm's partners, Harold Mobley, requested that the IT audit specialist review the systems development process at a potential new audit client, Collins Harp Enterprises. Collins Harp Enterprises develops most of its computer application software internally. The IT function, which is managed by Linda Seth the IT vice president, consists of five in-house programmers. The programmers develop and modify both applications and systems software. Linda provides relatively free latitude to programmers because she believes that allowing that type of creativity increases the quality of the software developed. Most of the ideas for software developments come from Linda Seth based upon her interactions with IT personnel at other companies. Relatively few requests for software changes come from non-IT personnel at Collins Harp. Minimal documentation is generated during the software development process. Programmers have access to live copies of program tapes and disks stored in secondary storage. And, those programmers have the ability to compile source code programs into object code, and they regularly forward object code versions of those programs to the Librarian in charge of secondary storage. While new programs and changes to existing programs are tested, only the programming staff assists in the testing process. An executive at Collins Harp asked the audit partner to have someone with good IT training review the systems development process to identify weaknesses and recommendations for improvements.

   Question: Analyses the case and draw your inference. What useful information is provided by the given case?

7.6 EDP Environment –The New Dimension

The challenges faced by the Auditor are considerable in an environment where the use of the computer in data processing operations is on the increase. Thus it is possible that while in a manual system, incompatible functions such as the authority to initiate and execute a transaction

Notes

and the recording of the transaction , are assigned to different departments or to different individuals within the accounting department, in a computerized environment, these incompatible functions may be consolidated within the EDP department. Therefore the need arises for alternative controls including:-

1. Organization controls with appropriate segregation of duties within the EDP Department.
2. Sound personnel practices with effective control over the quality of work.
3. Standard operating procedures for ensuring high quality processing and limiting the possibility of errors as also the unauthorized use of files, programs and reports.
4. Systems development and documentation controls.

7.6.1 Methodology for Evaluation

Evaluation of internal control systems can be done in a variety of ways. It would be reasonable to expect that the desired degree of documentation would be in proportion with the size and activities of the organization. The following are the general methods adopted:-

1. Appraisal by workflow
2. Appraisal by duties
3. Appraisal by questionnaire

The adoption of any of the above methods does not preclude the use of one or more methods in connection.

7.6.2 Internal Control Questionnaire

Evaluation of Internal Controls by the questionnaire methods (used in conjunction with other methods.) is a convenient and efficient medium for documented evidence of such review having actually taken place.

A standard Internal Control Questionnaire has therefore, been presented by the Research Committee of Chartered Accountants of India. The questions are so framed that most of the answers can be given by "Yes" or "No" or "Not applicable". Affirmative answers generally indicate good internal controls while negative answers indicate weaknesses. In such cases, it would be advisable to add explanatory note. The arrears of coverage by the questionnaire relate to:

1. Cash and Bank Receipts
2. System of Accounts in Branches and Factories
3. Cash and Bank Payments
4. Salaries and Wages
5. Purchases and Creditors
6. Sales and Debtors
7. Investments
8. Stocks
9. Fixed Assets
10. Borrowings
11. Share Capital
12. Loans and Advances.

Notes

Sample questions on some of the above mentioned areas could include:-

1. Is an organization chart readily available?
2. Does the organization chart show a clear definition and allocation of duties and responsibilities of officials and employees?
3. Is a chart of Accounts in use?
4. Is the accounting records kept up-to-date?
5. Are they balanced monthly?
6. Are control accounts kept in the general ledger in respect of all transactions where the volume justifies it?
7. Are subsidiary records reconciled with the respective control accounts periodically?
8. Are daily returns and reports received from branches/factories for collections, sales and dispatches, production and receipt of goods?
9. Is an Internal Audit Manual in use?
10. Is there reconciliation of proofs of collection with amounts banked?
11. Is purchasing centralized in the purchase department?
12. Are purchases made only from approved suppliers?

7.6.3 Methodology for Adoption while using the Questionnaire

The Auditors may obtain answers on separate sheets, duly indexed against the questions to which they relate. Inevitably a standard format for a questionnaire may not be feasible for universal applicability as individual variations may be required. The following methods could be adopted:

1. Answers could be compiled by the auditor on the basis of his observations and personal interaction with the auditee.
2. Alternatively, the questionnaire may be given to auditee who could furnish answers on separate sheets. The advantage of this method is that the auditee would have an opportunity to review his own systems of internal control through the mere process of answering the questionnaire.
3. The auditor should then conduct a test check in order to ascertain the accuracy of the replies and the actual operation of the system.
4. All negative answers are to be reviewed by the auditor with the auditee. The auditor may also decide whether any qualification would be necessary in his report.
5. In the light of the questionnaire, the auditor should formulate his Audit Plan and Programme.
6. A review of the questionnaire, in the event of any major changes that may have taken place in the auditee organisation, should be conducted by the auditor.

7.6.4 Systems Based Audit (SBA)

As can be seen from the nature of the above sample questions, the objective of the auditor is to formulate an opinion on the existence, effectiveness and adequacy of internal controls and whether these are designed as far as possible, to ensure the completeness and accuracy of records

Notes

as also to safeguard the assets. The auditor cannot rely on the controls of the auditee , for the prevention and detection of fraud and errors. Therefore he is bound to obtain some degree of assurance through his own substantive testing. The quantum would depend on the effectiveness of the internal controls for preventing and detecting material errors.

7.6.5 Systems Control Evaluation

The Systems Control Evaluation (SCE) based on the questions and answers exercise illustrated above, is thus designed to identify the controls in the system which would satisfy the general audit objectives (prevent or detect the various types of material errors). Having identified the controls, the auditor assesses the adequacy of the process. He would necessarily be required to adopt a critical approach attempting to envisage situations in which they might fail to operate and consequently result in the occurrence of an error or fraud. Further, the auditor should also consider how promptly errors could be identified and the impact on the financial statements; in the event of their remaining undetected. Such evaluation should necessarily cover the entire operation of controls for the entire accounting period. This should be borne in mind while conducting Compliance Testing. Having completed this evaluation, the auditor should then formulate his assessment based upon the suggested guidelines and categorize the assessment of internal controls.

7.6.6 Inherent Limitations of Internal Control

It is generally accepted that internal control procedures can provide reasonable and in no case, absolute assurance, that the objectives of such controls relating to accounting systems are achieved. This could be due to the possible existence of certain inherent limitations including:-

1. Management's consideration that a control be cost effective
2. The fact that most controls tend to be directed at anticipated types of transactions and not at unusual and unforeseeable transactions.
3. The potential for human error due to carelessness, distractions, errors of judgment and misinterpretation of instruction.
4. The possibility of circumvention of controls through collusion with parties outside the entity or with employees of the entity, (e.g. a lack of segregation of duties between computer programmers and computer operations).
5. The possibility that a person responsible for exercising control could abuse that responsibility.
6. The possibility that the procedures may become inadequate due to changes in conditions and compliance with procedures may deteriorate.
7. Manipulation of transactions or estimates or judgments, required in the preparation of financial statements.

However, despite the existence of certain possible inherent weaknesses that would exist in almost every system, howsoever perfect in design, the corrective action taken for rectification by the Management and its periodic assessment through the Systems Control Evaluation method adopted in Systems Based Audit enables the fulfillment of the principal objectives of establishing and effectively operating Internal Control Procedures.

Self Assessment

Notes

Fill in the blanks:

5. Methodology for internal evaluation include:..... ; ..... and .....
6. Answers of internal control questionnaire are compiled by the auditor on the basis of his ..... with the auditee.
7. The corrective action taken for rectification by the management and its periodic assessment through ..... method enables the fulfillment of the principal objectives of internal control procedures.

7.7 Summary

- The internal audit activity evaluates risk exposures relating to the organization's governance, operations and information systems, in relation to: Effectiveness and efficiency of operations; Reliability and integrity of financial and operational information; Safeguarding of assets; Compliance with laws, regulations, and contracts.
- Internal check is an element of internal control. Weak internal check mechanisms mandate a greater degree of auditing procedures.
- Control procedures encompass policies and procedures established by the Management, in order to provide for the attainment of certain objectives. These could include the existence of systems for: An effective system of reconciliation of Books of Accounts; Check of the arithmetical accuracy of the records; Controls over computer applications and environment; Maintenance of control accounts and Trial Balances; Approval and control of balances; Comparison of results of cash, security and inventory checks with accounting records; Limiting direct physical access to assets and records, etc.
- A strong control environment (e.g. one with tight budgetary controls and an effective audit function) can significantly complement specific controls.
- Control procedures encompass policies and procedures established by the Management, in order to provide for the attainment of certain objectives.
- Evaluation of Internal Controls by the questionnaire methods (used in conjunction with other methods.) is a convenient and efficient medium for documented evidence of such review having actually taken place.

7.8 Keywords

Internal Auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations.

Statement on Standard Auditing Practices (SAP): The Statement on Standard Auditing Practices (SAP) pertaining to the "Study and Evaluation of the Accounting System and Related Internal Controls in connection with an Audit", defines the inter-relationship between the Statutory Auditor and internal control.

Systems Control Evaluation (SCE): It is based on the questions and answers exercise illustrated above, is thus designed to identify the controls in the system which would satisfy the general audit objectives (prevent or detect the various types of material errors).

Notes

7.9 Review Questions

1. Define internal control and internal check. Explain the internal control process with respect to audit.
2. What are the factors reflected in the control environment?
3. Distinguish between control environment and control procedures.
4. Establish inter-relationship between audit and internal controls.
5. What are the advantages of internal control evaluation?
6. Identify the scope and objectives of the Statutory Auditor and its role in internal control.
7. What are the two dimensions of internal control?
8. Write short notes on:
   (a) Internal Control Questionnaire
   (b) EDP Environment the New Dimension
   (c) Systems Based Audit (SBA)
   (d) Systems Control Evaluation

Answers: Self Assessment

1. Chief Audit Executive (CAE)
2. Internal check system
3. Assets against loss
4. This case is appropriate when covering the importance of considering risks associated with the reliance on information technologies to produce financial statement information. Generally, this case is best used when the impact of information technology on internal controls is discussed. This case is most appropriate when discussing IT general controls, given that IT systems development processes are largely affected by IT general controls. This case provides an excellent vehicle for highlighting obvious concerns related to IT. This case is also useful for emphasizing public company auditor considerations of IT general controls as part of their audits of internal control over financial reporting required by Section 404 of the Sarbanes-Oxley Act. This case provides an illustration of IT general control issues that public company auditors may need to consider.
5. Appraisal by workflow; appraisal by duties; appraisal by questionnaire
6. Observations and personal interaction
7. the Systems Control Evaluation

7.10 Further Readings

Books

David Coderre, *Internal Audit: Efficiency through Automation*, John Wiley & Sons, 2009.

Emile Woolf, Moira Hindson, *Audit and Accountancy Pitfalls: A Casebook for Practising Accountants, Lawyers and Insurers*, John Wiley & Sons, 2011.

Notes

Iain Gray, Stuart Manson, *The Audit Process: Principles, Practice and Cases*, Cengage Learning EMEA, 2007.

Jeanette Franzel, *Single Audit: Opportunities exist to improve the Single Audit Process and Oversight*, DIANE Publishing, 2009.

Susan Switzer, *Internal Audit Reports Post Sarbanes-Oxley: A Guide to Process-Driven Reporting*, John Wiley & Sons, 2007.

Online links

www.asiatradehub.com/india/tr9.asp

www.auditservices.com/aevidence.html

www.investopedia.com/terms/a/auditing-evidence.asp#ixzz1x6PIvbTg

www.informationbible.com/article-auditing-in-depth-111904.html

http://www.asosai.org/asosai_old/journal1999/evaluation_of_internal_controls.htm

Notes

Unit 8: Auditing in an EDP Environment

CONTENTS

Notes

Objectives

After studying this unit, you will be able to:

- State audit process in an EDP environment;
- Evaluate problems in an EDP environment;
- Know about control in an EDP environment;
- Discuss planning an Internal Audit in an Electronic Data Processing Environment;
- Know about problems encountered in an Electronic Data Processing Environment;
- Discuss about internal audit practices in relation to computerized system;
- Know about different Computer Assisted Audit Techniques (CAATs).

Introduction

Now-a-days, the corporate world is getting more and more inclined towards the use of Information Technology (IT) and Computer Information System (CIS) in their daily operations. This has changed the manner in which the organizations' carry out their operations and various business processes. This has further led to change in the nature of audit evidences generated by each financial transaction. The method of collection and evaluation of audit evidences has also changed. This requires auditors to possess reasonable knowledge about EDI, SDLC, CASE tools and various hardware & software used in the organization.

8.1 Scope of Audit in CIS Environment/Impact of CIS on Auditing

The use of CIS in various organizations has caused drastic impact on audit approaches, techniques, risk involved and internal control methods. Following factors (risks) must be given due consideration while framing an audit plan for an organization:

1. ***High speed and automatic initiation/execution of transactions:*** In CIS environment, transactions are processed instantly. Once the transaction is fed into the system, it might get executed automatically without requiring for authorization of the same. Similarly, reports (even complex one's also) can be generated at a very high speed and can be viewed by multiple users at a time. Thus giving rise to many security issues.

2. ***Uniform processing of transaction, hence low clerical error:*** While feeding input, processing transactions and generating outputs, computer system performs multiple checks on data at each at each point of time. Moreover, the processing of transaction is in a uniform manner. Hence the clerical errors generated are minimized. However, there is a shift of errors from human generated errors towards system generated errors.

3. ***Unintentional or system generated errors:*** As discussed earlier, there is a shift in nature of errors from human generated to system generated. Errors occur due to lack of experienced personnel. And errors are mainly related to development, maintenance and execution of CIS.

4. ***Inexperienced personnel:*** Now-a-days, the technological advancement is occurring at a very fast pace. It has created a deficit of expertise staff to understand the current technology, both at client end as well as auditor end.

5. ***Concentration of duties:*** Under CIS environment, more than one kind of task/function can be performed by an individual. This leads to difficulty in segregation of duties among individual. Consequently, it gives rise to a number of security issues also.

Notes

6. ***Lack of audit trail:*** In computerized system, the processing of a transaction takes place instantly. This leads to loss of audit trail. Thus, auditor needs to apply some alternate procedure to compensate the loss of audit trial.

Did u know? ***Audit Trail:*** It can be defined as a step-by-step record by which a transaction can be traced. The auditor may apply one of the following methods to compensate the loss of audit trail:

1. ***Special/Exceptional Reports:*** The auditor may ask the client to arrange special reports and printouts.

Example: Sales orders for the month of December & March; purchase orders that have been short-closed by the purchase department.

2. ***Tagging and Tracing:***

   (a) It is a method of compensating the audit trail.

   (b) It involves tagging the clients input data such that only relevant data is highlighted on the screen, which needs to be verified by the auditor.

Example: Cash payments of more than ₹ 20,000/-; debtors outstanding for more than 3 months; purchase order pending for more than 30 days from expected delivery date; etc.

3. ***Alternative Review Procedures (ARP):*** It means to include a number of methods to compensate audit trial, such as:

   (a) *Auditors' judgement:* budgeting the figures and comparing them with actual figures.

   (b) *Ratio analysis/checking critical ratios:* This implies calculating certain ratios on the basis of budgeted data or previous period's data or data from similar industries and comparing them with the actual data of the client organization.

   (c) *Testing on total basis:* if individual items can't be checked in detail then auditor may take totals of reasonable chunks of data and check accordingly.

   (d) *Clerical recreation:* Auditor may manually generate certain figures that have been generated by the system (automatically).

4. ***Use of CAAT:*** The auditor may take the help of white-box audit approach or CAATs.

7. ***Auditor's participation in SDLC and dependence on other (manual) controls:*** We know that there is a constraint of audit trail in CIS environment. Thus, a computerized information system lacks manual reasonableness. An information system of an organization can only be effective if it has reasonable level of audit facilities integrated into it. Hence participation of auditor is highly important in SDLC. Moreover, auditor may use certain manual methods also while performing the audit.

8. ***Internal Control Environment & management supervision:*** The success of CIS highly depends upon the involvement of management in development and maintenance of CIS. Under CIS environment, the risk of fraud & error is relatively high. Thus higher management supervision and better internal control environment is required.

Notes

9. ***Use of CAAT:*** The audit under CIS environment cannot be carried by traditional (manual) approaches, effectively. Since the processing of transaction in CIS environment is fast and complicated, the audit must be carried out using Computer Assisted Audit Techniques (CAAT). This requires a reasonably good amount of IT skills on part of the auditors.

Impact of Changes on Business Process

EDI: Electronic Data Interchange, as the name suggests means exchange of data/information/ documents from one user to another, electronically (with the help of computers). In other words, EDI is the computer-to-computer exchange of documents/information in public standard format. Under EDI framework, once transaction (data) is fed into a computer many records are automatically updated. There is no need to reenter the data into accounting system. This saves a lot of time & effort and enables an error free Transaction Processing System (TPS).

Process of recording transactions: Unlike, manual system where a transaction goes through a sequence of steps in order to get recorded in the principal books [Entry Ledger Final Accounts (Balance Sheet and Profit & Loss Account)]. Under CIS environment, the above mentioned three processes are carried out simultaneously.

Accounting/Transaction Processing System: As mentioned above the CIS mechanism leads to abandonment of maintenance primary records.

Table 8.1 : Business Process

Batch Processing (Old Concept)	OLRT / RTOL System (New Concept)	Time Sharing & Service Bureau (Distinct & New Concept)
1. It is a simple system and somewhat like traditional manual system. 2. In this process transactions are accumulated and processed in groups. 3. In this files are not updated quickly. E.g.: Accountant accumulates all the cash receipts vouchers for the day and updates his accounting record by the end of a working day	1. OLRT – On-Line / Real-Time. 2. Under this system transaction are processed as soon as they occur. 3. All the records are updated simultaneously on occurrence of a transaction. E.g.: On issue of a Sales invoice, Sales ledger and debtor's ledger are updated, automatically. 4. Software packages like Tally, SAP, etc. works like this	1. Time sharing is a situation where a single computer serves more than one user. 2. A service bureau is an organization which processes transaction on behalf of its client organization. E.g.: a service bureau handling payroll (including ESI/PF) for a small company. 3. If an organization uses services of a service bureau then the auditor must obtain reasonable evidences in support of the controls exercised by the client organization over the activities performed by service bureau. 4. Nowadays, many of accounting firms are doing this kind of activities

Data Storage/file system: The data storage facilities and filing system of the organisation has gone through drastic changes as result of changes in the style of carrying out business processes.

Notes

Table 8.2: Data Storage System

Flat File System (Old Concept)	Integrated Database System (New Concept)
1. In few words, in a flat file system, users own their own data and they are responsible of their respective data files. 2. It leads to data redundancy and repetition of tasks. E.g.: Try and visualize admission system of a government college, where you are asked to fill-up a hand-written form. a. On the basis of this form, the Admission Officer makes entry in his register (Book-1) and asks you to deposit the fees with the Cashier. b. Now Cashier takes the fees and passes receipt entry in his cash register (Book-2) and issues a Cash Receipt. c. Finally, you present the Cash Receipt to the Admission Officer and he issues you the Admit Card and registers your name in Student's Register (Book-3). d. Later on the Accounts Officer will update his own accounting records (Book-4) on the basis Cash Book & Students Register maintained by above mentioned two officers. 3. It is evident from above example that how one simple transaction need to be recorded in 4 separate set of books kept with separate users.	1. In this the transaction is entered only once and the data corresponding to such transaction is shared by multiple users. 2. It works on client-server technology / topology. 3. It contains a set of interrelated files. When input is fed from one end, the master file (server) itself gets updated. This master file can be retrieved by more than one user (clients). Hence reduces data redundancy. E.g.: A person sitting at sales office issue Sales Invoice to its customer. Under this system master files related to Sales and Debtors are automatically updated. The person sitting in back-office can anytime check the Sales data or outstanding debtors. 4. This kind of system is mainly used with On-Line / Real-Time Systems.

Organizational structure: Since there is very high dependence of the organization of CIS, now-a-days. Thus, there is a need for separate department (group of people) to take care of IT needs of the organization. Some of the personnel are listed below:

1. ***EDP Manager:*** is responsible for overall management and administration of the IT department.
2. ***Data Administrator:*** ascertains the data requirements of various users of information system in the organization.
3. ***Database Administrator:*** is responsible for operational efficiency and security of the organizational database.
4. ***System Analyst:*** takes care of the information requirement of the users for new as well as existing applications; designs information system architecture to meet these requirements; facilitates implementation of information systems and maintains documentation.
5. ***System Programmers:*** is responsible for the maintenance of operating system (OS) software, network and hardware requirements.
6. ***Application Programmer:*** designs new programs and modifies existing to meet the data processing needs; remove errors and improves efficiency of the existing application software.
7. ***Operation Specialist:*** plans and controls the day-to-day issues, which emerge during normal course of work, of the users of information.
8. ***Librarian:*** maintains library of magnetic media and documentation.

Notes

Modified internal control base: In CIS environment since most of the processes are automated, the probability of occurrence of error substantially increases. Moreover, the risk of fraud is higher in CIS environment, as it is less-easily identifiable. Thus, there is a shift in internal control base in CIS environment as compared to traditional manual system. Following are two main categories of internal control required in CIS environment:

Table 8.3 : EDP Structure

A. General EDP Controls: Overall controls over EDP environment.	B. EDP Application Controls: Specific controls over specific applications
1. ***Organizational & Management Controls:*** These controls are designed to establish an organization wide frame-work for CIS activities. It includes: a. Designing appropriate control policies & procedure; b. Properly segregating duties among various individuals. 2. ***System Software Controls:*** These controls are meant to provide assurance that system software is acquired or developed in an authorized manner. It includes: a. Authorization, approval, testing, implementation and documentation of new system software and system software modification; b. Restriction of access to system software and documentation to authorized personnel. 3. ***Application System Development & Maintenance Controls:*** These control are designed to provide assurance that systems are developed and maintained in an authorized and efficient manner and also to establish control over: a. testing, conversion, implementation and documentation of new revised system; b. changes made to application system; c. access to system documentation; d. Acquisition of application system from third parties. 4. ***Computer Operation Controls:*** These help in controlling the operations of the computer system. They assure that: a. The systems are used for authorized purposes only. b. Access to computer operation is restricted to authorized personnel. c. Only authorized programs are to be used. d. Processing errors are detected and corrected on timely basis. 5. ***Data Entry & Program Controls:*** These assures that: a. Access to data and program is restricted to authorized personnel. b. An authorization structure is established over transaction being entered into the system	1. ***Control Over Inputs:*** These controls are drawn to assure that: a. Transactions are properly authorized before being processed by the computer. b. There are adequate checks installed in the input form to assure the correctness of data entered by the users. c. Incorrect transactions are rejected, corrected and if necessary, resubmitted on a timely basis. 2. ***Control Over Processing & data files:*** These controls ensure that: a. Transactions are properly processed by the computer. b. Transactions are not lost, added duplicated or improperly changed. c. Processing errors are identified and corrected on a timely basis. 3. ***Control Over Output:*** They assure that: a. Results of processing are complete, accurate and through ride media. b. Outputs so generated, satisfy the requirement of the user. c. Access to output is restricted to authorized personnel

Notes

8.2 Prerequisites while Auditing in CIS Environment

Audit Approach in CIS Environment

There have been drastic changes in audit approaches and methodologies as a result of emergence of CIS environment. The selection of one of the approaches depends upon the knowledge base expertise of Auditors. There are mainly two approaches for auditing in CIS environment that are explained as follows:

Black-box Approach (Auditing around the computer): In this approach, the auditor is mainly concerned about the Inputs fed-in by the client and the output generated by the system. The auditor completely ignores the internal processing of the Information System.

For example, while testing payroll of a company, under black-box approach, the auditor may first find out the total monthly hours worked by selected employees from their respective time cards and then he may check the salary/wage rate from the rate card to find out the salary/wage payable to each employee. On the basis of above, the auditor ascertains his own output by comparing hours, rates, extensions, overtime & leaves. Finally, the auditor compares his own results with the system generated results.

This approach may be enumerated with the help of the following flowchart:

CIS → Client's Output → Compare with Client's output → Client's Input

→ Auditor's predetermined output → Compare with Client's output → Auditor's Input

→ Client's CIS & use of CAAT

Notes The biggest advantage of auditing around the computer is the ease and simplicity, since the auditor does not require in-depth knowledge of system application program in order to perform his duties. On the contrary, a major disadvantage is that, under this approach, the auditor is completely ignorant about the internal processes of the system. Moreover, in order to generate certain complex reports, printouts cannot be arranged to apply the audit procedures.

White-box Approach (Auditing through the computer): Under this approach, the auditor is not only concerned with the subject matter of the audit (i.e. inputs and outputs), but also with the internal processing of the computer system. This means to include various auditing with the help of Audit software and Computer-aided Audit Techniques (CAAT).

8.3 Audit Process in an EDP Environment

In an EDP (Electronic Data Processing) audit the auditor may not vouch each and every transaction but he must perform overall analytical checking to ensure that the financial records show true and fair view of the business entity.

Audit process in such a system may involve following steps:

1. ***Evaluation of the internal control system:*** Auditor should carefully evaluate the internal control system. He should check the system existing in the entity, as well its actual use by the business. It is possible that whereas a well designed system is present but it is not put to use by the management. Based upon the evaluation of such a system, the auditor should decide the degree of reliance that can be placed on it.

Notes

2. ***Checking the records:*** After checking the reliability of the internal control system auditor should proceed to checking the record produced by the system. He should check the basic records available in the entity. As far as possible auditor should insist on maintaining the supporting vouchers which can be checked with the books of accounts.
3. ***Explanation and information:*** Auditor should make inquiries from the management and staff regarding the work. Basing on such inquiries he can decide upon the truthfulness of the financial records.
4. ***Analysis of the financial statements:*** Auditor should then check the financial statement prepared form the books of account. All the other checking methods should be applied as are used in the manual auditing.

EDP Audit

1. ***Current IT Trends:***
   (a) End user computing
   (b) Declining Hardware prices, increase in micro user
   (c) RDBM extensive use
   (d) System development and CASE tools adopted by many users..
   (e) Shift from DOS to UNIX & C language.
   (f) Knowledge based and decision support systems.
   (g) Increased data communication and networking
   (h) Use of EDI (Electronic data interchange)
   (i) Scanners and voice recognition system for input.
2. ***Impact on Auditing:***
   (a) Unintentional Errors (inexperienced persons)
   (b) Program modification can take place with a view to fraud.
   (c) Improper use of DSS.
   (d) Auditors participation in SDLC is necessary.
   (e) Use of sophisticated audit software.
   (f) Data communication and networking – new risk.
   (g) Data security problems.
   (h) Move towards EDI (Elimination of much of traditional audit trail).
   (i) Change in nature of audit evidence.

Self Assessment

Fill in the blanks:

1. The auditor should obtain an understanding of the significance and ..... of the EDP activities.
2. Transaction is exchanged electronically with other ..... in Electronic Data Interchange (EDI) systems.

Notes

8.4 Auditing and EDP Environment—Meaning of Electronic Data Processing (EDP)

Auditing in computer information system Environment CIS Environment or electronic data processing exists when an organization uses one or more computer (s) of any type or size for preparation of financial statements. While there is change in overall objective and scope of audit under CIS or EDP, the auditor will need to assess the effect of computers on (a) processing, (b) storage (c) retrieval, and (d) communication of financial information.

Caution Under electronic data processing system, there is virtual elimination of errors such as calculation mistakes, posting errors, totaling, etc. However, any error in programming may result in serious errors and produce incorrect result.

8.4.1 Basic Features of EDP Environment

The following are the basic features of CIS or EDP environment:

1. ***EDP infrastructure:*** This includes hardware, operating systems and application software.
   (a) *Hardware:* Hardware consists of CPU (central processing unit), Monitor, Printer, Mouse and Keyboard. One may put it to use differently, such as
      (i) Personal computer (PC) used by individual who feeds and processes data on a single machine.
      (ii) Local area network (LAN), where there is connection between two or more computers located at a given small place, (say, office) to store and program any data files centrally.
      (iii) Remote linked PCs, where location of PCs is at different places or cities, but interconnected with one another.
      (iv) Distributed data processing, where a mainframe computer handles main processing, and subsidiary processing takes place at decentralized processors.
      (v) Electronic data interchange (EDI), under which there is transfer of structured data without manual review to individual computers, sparing them the need to process the data themselves.
   (b) *Operating systems:* These may be window, Microsoft (MS) Office, Disc Operating system (DOS), LINUX, etc. They oversee the communication of data between the computer processor and its magnetic discs, as well as the management of files and programs on the discs.
   (c) *Application software:* This is a set of computer programs, such as TALLY, MYOB, Simply accounting, Quicken etc. that is a specially development accounting Software, including operating system, compilers, packages and user programs, which enable a particular computer centre to operate.
2. ***Lack of documents and transactions trail:*** In manual accounting, there is a transactions trail. Firstly, a document (voucher, invoice, receipt, etc.) originates transaction. Then, there is entry of the transaction in the original books of account (daybooks, journal, etc) Thereafter, there is posting of the transaction in the principal books (ledger, etc). Lastly, the net effect of transaction reflected in financial statements.

Notes

In electronic data processing, on the other hand, there are often no transaction – creating documents and no visible transaction trail. For example, if there is direct feeding of data into computer, there may not be any physical input documents, e.g. voucher, invoice, receipt, etc. and no transaction trail.

Example: In an online, system, salespersons may directly feed sale transactions in the computer without any supporting documents, or there may be certain transactions generated by the system based on program instructions such as sending reminders to customers who have defaulted in payment.

Therefore, to assess how electronic data processing may influence the audit examination process, he should consider the availability of data

(a) Entered in computer,

(b) Retained in data files, and

(c) Generated for outputs.

The data may be available only in machine – readable form and accessible only for a brief period. In certain cases, the auditor may have to request the client to retain any particular data for examination. Lack of visible inputs increases the risk of errors remaining hidden, which is in direct contrast to manual accounting system where such errors are visible due to presence of physical input documents.

3. ***Concentration of processing of information in few hands:*** In EDP environment, only a small number of persons process the entire information. As against this, in the manual system, there is division of the same work among several persons. As a result, customary controls based on segregation of diverse functions may be absent or ineffective. Further persons operating the electronic data processing system achieve expertise as regards the sources of data, manner of processing, and generation and distribution of output. Some times they may use their exclusive control over electronic data processing systems to change the data or the program itself, to commit fraud. Probability of such fraud is greater in organizations having systems like "Electronic Data Interchange" where almost entire data and programs are only available at the central office or few locations.

4. ***Possibility of errors:*** While electronic data processing reduces the risk of human errors like calculation mistakes, any error in programming may result in incorrect processing of all transactions. Moreover, in the absence of continuous check by observation of errors as in manual system, errors in electronic data processing may remain hidden for long. Further, there is also likelihood of errors if persons, without authority to access data, make changes in the stored data.

5. ***Increased management supervision and effective auditing:*** Electronic data processing systems makes it possible for management to review and supervise the operations of the business. This is because it will have a more effective internal control system through several analytical tools generated by electronic data processing.

The auditor can also use computerized auditing tools to make the audit examination more effective. In fact, the electronic data processing systems have in-built software and hardware controls, a feature not present in the manual system.

8.4.2 Advantages of EDP Systems in Auditing

1. ***EDP systems are more reliable:*** A computers works as programmed. If the programming has taken into account all possible circumstances, the computer will work more reliably

Notes

and consistently than the manual system. In the manual system, the auditor may undertake detailed checking of a number of transactions, yet certain errors and fraud may remain undiscovered. Not so in the case of electronic data processing systems. He has only to see whether there is effective internal control on programs and, if so, checking of certain significant or unusual transactions will assure accuracy in accounting.

2. ***EDP system may have in-built control procedures:*** With built-in automatic control procedures, the electronic data processing systems will themselves indicate certain unusual or significant transactions such as, overdue payments, falling of inventory levels below the prescribed levels, etc. In manual system, the auditor will have to make extra efforts for the purpose. Prescription of "password" control in electronic data processing systems will secure the data against access by unauthorized persons. In manual system, there is always possibility of unauthorized access to accounts.

3. ***Automatic updating of all relevant computer files by a single transaction:*** Feeding of a single transaction in the computer will update the relevant records in all files. For example, purchase of raw materials from a single supplier will update the accounts of the supplier, purchases, and inventory. In manual system, different individuals will need to update the relevant files under their charge. Likewise, with proper programming, electronic data processing systems can perform certain tasks without human intervention.

Example: Generation of monthly accounts in case of credit customers will remove the need for manual preparation of accounts in individual cases.

8.4.3 Audit Procedures in EDP/CIS Environment

1. ***Traditional approach to audit of computer-processed information:*** While processing the information processed on computers, The auditor may adopt a traditional approach, assuming that the processing of information has been under the manual system, and not through computers. The only difference he notices is that the object of his audit examination is computer printouts; and not the handwritten books of account. The result is that he does not suitably modify his audit program, and carries on work as before. However this approach has certain inherent flaws. Firstly, it does not involve evaluation of internal control system relating to computers, which may result in more errors and fraud than under the manual system. Secondly, the auditor may devote unduly long time on certain audit procedures, such as checking and posting of transaction which he can avoid if an effective internal control is in place. Thirdly, it ignores the benefits of costs and risks that would be available to the auditor if he adopts techniques suitable to auditing through computers.

2. ***Auditing in EDP environment:*** In this case the auditor should evaluate the internal control relating to electronic data processing and other controls, and accordingly make extensive use of computer(s) to determine the nature, timing and extent of compliance or substantive audit procedures. However, this requires him to have adequate knowledge of computer systems to plan, direct, supervise and review the work performed by others. For this, he may himself acquire the necessary specialized skills, or hire persons suited for the job.

8.4.4 How Auditors should Approach Auditing in EDP Environment?

Electronic data processing environment is an area that requires special techniques in approaching, as it is apparently risky and more technological skills is needed to the Auditor before real audit is performed. However the professional guides issued by the International Auditing Standards have disclosed several methods that have to be followed by Auditors when doing audit in

Notes

specialized areas this does not exclude auditing in an electronic data processing environment. In actual fact the auditor should approach auditing in electronic data processing environment as follows:

1. ***Evaluate reliability of accounting and internal control system:*** The auditor should ascertain how far the accounting and internal control system of the business is reliable. To this end, he should check the following:

   (a) *Are there restrictions on access to electronic data processing?*

   The restriction should be in respect of access to hardware, program and data files. Computer room should be under the custody of a responsible official. He alone should handle program and data files. Further, he should make these available only to the persons authorized for the purpose, and keep a record of issue of program and data files. Other restriction can be by way giving password (a secret code) to authorized computers users. Yet another restriction can be through giving different rights different users, for example, some can only read data files, others may both read and alter data files, yet others may even alter program files.

   The auditor should also see whether there are adequate methods of hardware control. For example, almost every computer once started itself checks the proper functioning of its various components and devices. If not it shows a message on the computer screen. If the computer system has parity check; it will show whether, due to cause such as dirty or humidity level, there is improper functioning in the transfer of data between the input-output devices. Such a flaw may cause loss or corruption of data, which the computer system itself will rectify by retrying the transfer. Computer system having a check by way of double reading of data, i.e. on a hard disc and that written to strong media, will show errors in the process.

   (b) *Is there provision for timely detection and correction of errors?*

   Errors may arise during the feeding of data, processing, or due to any fault in the computer system. Here, the auditor should ensure that transactions processed by the computer have due authority, their recording in the computer data files is accurate, there is no loss, addition, duplication or improper change in them, and there is correction and resubmission of incorrect transactions. He should also see that there is correct use of master files, transaction files and program files.

Caution The Auditor should review the error – correction procedure, as it will show proper functioning of the internal control system.

   (c) *Is there arrangement for resumption of system, if interrupted?*

   In case of electronic data processing systems due to power failure or any mechanical fault, there should be proper arrangement for resuming the system without loosing the entries or records.

   (d) *Is electronic data processing – generated output accurate and complete?*

   Accuracy and completeness of output will depend on the accuracy and completeness of the data fed into the computer and its processing. This calls for proper input and controls. Recalculation of figures and comparing the output with manual records are other methods for the purpose. The auditor should see that there is restriction on access to processing of data such that accurate and complete output is produced, and that only authorized persons get it on time.

Notes

(e) *Is there adequate security provision for the stored data?*

Because of wrong processing or due to natural or man-made reasons, there may be loss or destruction of stored data. The auditor should see that there are proper safety arrangements to secure the stored data in any such eventuality. While doing so, the auditor should also see whether there are proper backup and recovery procedures. These procedures involve keeping copies of programs and data at a place other than the place of location of the computer. Most application programs have an in-built system of maintaining two versions of computer file, the current one and the preceding one. The current version will contain alterations made during the latest processing, and the preceding one the pre-alteration version. Some computer systems even have three files, the current one, preceding the preceding version, and the version preceding the preceding version.

(f) *Is the source code of application software in safe custody?.*

The auditor should ensure that the source code of application software is in safe custody of a responsible official. He should only allow access to it by a duly authorized person (s), and keep a record of the persons gaining access to it.

2. ***Assess "inherent and control" risks:*** The auditor should assess inherent and control risk for material financial misstatement.

Risk Assessment and internal Control

Risk in an electronic data processing environment may arise from the following;

(a) There may not be adequate procedures to control program or system change.

(b) Hardware or software malfunctioning may remain undetected.

(c) During transmission, there may be loss or corruption of data.

(d) Computer facilitates, files and program may be available to unauthorized access.

(e) Users may not participate fully in review-output, to ensure its reasonableness and maintaining responsibility for authorization.

3. ***Effect of inherent and control risk:*** Inherent and control risk in electronic data processing environment may have either all round effect on all accounts, or account specific effect.

(a) *Risk having all round-effect on all accounts:* It may arise from deficiencies in program development, system soft ware support, physical electronic data processing security, and control over access to special privilege utility programs. These deficiencies will affect all application systems processed in computer and result in material misstatement in financial statements.

(b) *Account specific risk:* Account specific risks may result in fraud and errors such as the summarized real cases resulted from inherent and control risks:

(i) The Trolley Dodgers case – Control deficiencies in payroll transaction cycle allowed an accounting manager to embezzle several hundred thousand dollars.

(ii) Goodner Brothers, Inc – An employee of this tire wholesaler found himself in serious financial trouble. To remedy this problem, the employee took advantage of his employer's weak internal controls by stealing a large amount of inventory which he then sold to other parties.

(iii) Troberg stores – An important but commonly overlooked internal control objective is ensuring 'compliance with applicable laws and regulations' The management of this company violated the provisions of a national statute, imposing a heavy monetary cost on the company in the process.

Notes

8.4.5 Audit Techniques

1. Audit objectives remain the same whether processing of data is manual or computerized.

   While designing audit procedures in electronic data processing environment, the auditor should keep in mind two things:

   (a) Ensure that there is adequate compliance and substantive procedures and transmitted data are correct and complete

   (b) Apply professional skepticism by cross verification of records, reconciliation between primary and subsidiary ledgers, questioning and critical assessment of audit evidence. The procedures adopted for the purpose may be manual, by way of computer-assisted audit techniques, or on combination of both.

   Auditing "around" or "through" computers

   In an electronic data processing environment, an auditor may carry out compliance procedures and substantive tests of transactions with the help of computers, or without it. If he conducts the audit in a traditional manner by examining the data and information generated by computer system of the client it will be auditing around the computer. In this case, the auditor only relies on the data and information printouts given to him by the client.

   On the other hand, if the auditor himself uses computer system to carry out compliance and substantive test procedures, it will be auditing through the computer. However, this will require the auditor and/or his staff to possess adequate knowledge of electronic data processing.

2. ***Computer-assisted audit techniques:*** These may be as follows:

   (a) *Test data:* They represented a set of test data prepared by the auditor himself, or by using any such data prepared by the internal auditor of the client. Test data comprise transactions of all kinds prepared specifically to test a program or a set of programs of the client. To evaluate the effectiveness of the client's program (s), the auditor may run his test data on the client's computer using the programs of the client himself.

   Use of test data serves as an assurance about the correct functioning of tested programs. However, its limitation is that preparation of the test data requires care and expertise on the part of auditor. For example, it will involve selection of the type of master files or records (ledger like records where there is continuous updating through transaction records), e.g. processing of a test transaction showing receipt of payment from a debtor will reflect in the file that contains records of sundry debtors. Moreover, the test data should cover all types and variations, whether they are actual data used by the client, or certain modifications, to ascertain that the client's program includes necessary controls.

   For control purposes, the auditor should maintain proper working papers regarding the use of test data. Working papers should show the programs put to test, and the results-both expected and actual. He should also ensure that the programs tested are those actually used by the client, and that actual records remain unaffected by the tests used by him.

   (b) *Modified test data facility:* It is a simulated form of a test data technique. Under it, the auditor creates artificial transactions, processes them along with normal processing of actual transactions of the enterprise, and compares the results of the two. This will

Notes

expose whether the processing done by the enterprise is correct. However, employees operating the electronic data processing system in the enterprise should know nothing about this exercise.

(c) *Audit software:* The auditor may use audit software specially developed for a particular audit or, more often, Generalized Audit Software (GAS) Design of audit program created for a particular audit will serve the needs of testing the audit programs of the client. On the other hand, generalized audit software will perform certain common data processing functions, like checking calculations, examining the correctness of records, comparing client records with the data obtained through other procedures, summarize or rearrange data, selecting samples, etc.

Documentation

As evidence of proper planning and organization of his examination, the auditor should document the following:

1. His audit plan;
2. Nature, timing and extent of audit procedures performed by him;
3. Conclusion drawn from the evidence obtained; and
4. Safe storage of the evidence in electronic form.

8.4.6 Audit Planning

Planning the audit for an electronic data processing environment client is not expected to be the same as planning the audit for the manual data processing client. The auditor is required to measure the usefulness and existence of reliable controls in the system before he or she start auditing. In electronic data processing environment an IT environment check list will have to be used together with interrogating the client main IT executives.

Important issues to be assessed regarding the whole of information technology field which comprises data processing systems are listed and elaborated in the schedule below:

1. ***Procedure:*** Find out the process to register new users to the system.

   Inherent risk: Illegal access to components.

2 ***Procedure:*** Examine the reliability of the procedures taken when a previous user is required to leave or stop using the machine.

   Inherent risk: Previous user still has access to the system.

3. ***Procedure:*** Find out whether access to the computer room is free to any person.

   Inherent risk: Unauthorized personnel and visitors may enter the computer room for malicious motives.

4. ***Procedure:*** Investigate whether there is any rotation of staff (segregation of duties) in system operations.

   Inherent risk: There may be fraud attempts by non changed staff.

5. ***Procedure:*** Using the organizational chart verify the existence of job description in IT positions in the entity.

   Inherent risk: Staff may be performing other people's duties involuntarily.

Notes

6. ***Procedure:*** Find out whether internet downloading and other uses of the internet is restricted to safeguard entity's information.

   Inherent risk: Virus penetration into the system is simple due to uncontrolled internet activities

7. ***Procedure:*** Investigate to be sure that, the use of antivirus programs is present, there is safe storage of backups which are frequently tested to identify irrelevant backups

   Inherent risk: Restoration of data is not possible when misfortunes occur.

Nature, Timing and Extent of Audit Procedures

It is customary for Auditors to perform timing and design of audit procedures that are supposed to suit the audit they need to execute. This is important because the audit evidence obtained after audit need to have relevance to the audit report issued. The relevance so mentioned is verified by reviewing the documentation of nature, timing and extent of procedures employed in the audit; this is done in a process called quality review.

Conclusions drawn from the evidence obtained

Conclusions drawn by the Auditor are the final output of the audit which when presented in a formal and standardized manner is called an audit report. Conclusions such as these need to be documented systematically and in a way that another auditor who have not participated in the audit should be able to use them in reporting without the need of more elaboration from the auditor involved in the audit.

Safe Storage of the Evidence in Electronic Form

After completion of the audit and collection of relevant and sufficient audit evidence it is advised that the Auditor should store the evidence so obtained in a safe storage and which is expected to be in electronic form. This may be put in disc storage devices which are not easily affected by viruses and not easily altered.

8.5 Auditor's Challenges and Modern Ways for Auditing Electronic Data Processing (EDP) Accounts or Financial Statements

Electronic data processing is the function of planning, recording, managing and reporting business transactions by the use of computers and related peripherals. In EDP data is first taken from source documents such as invoices, revenue receipts, payment vouchers, written checks etc. There after data inputs to the computer where it is entered via the keyboard or other data entry peripherals. The entered data is then processed according to the accounting package in use; since there are different structures of modules used in sundry accounting application software, processing of the same data may differ from one package to another. It is said earlier that reporting is one of processing features, then it is apparent or undoubted that types of reports produced by different packages may vary from one system or package to another.

Example: Some system may provide almost all basic financial reports such as

1. The trial balance,
2. The statement of financial position commonly known as the balance sheet ,

Notes

3. The statement of financial performance which is commonly known as the statement of income and expenditure or the profit and loss account,
4. The statement of cash flows,
5. The statement of changes in equity.

These types of packages offering almost all financial reports may be said to be compatible to all types of financial processing needs and are really expensive and used in many business and non business entities.

Turning to other packages that don't offer all statements we can see that they have specific and limited applications that range from business to non business, some give only the trial balance leaving the rest of the report to be prepared by the accountant. Others give all other statement except the cash flows statement. These problem calls for the need to have the so called system analyst in organizations. These professionals have the responsibility of studying the need of the organization as refers to electronic processing data issues. They do this by doing a so called feasibility study which will be facilitated by communication with top financial executives of the organization.

Electronic data processing has merits and demerits to the society and the professionals. The following are some of the advantages and disadvantages that may be observed in every day life of our businesses.

8.5.1 Advantages

1. Fast and instant services in financial institution or banks as compared to manual data processing, as formally it used to be harder to get even your saving or current statement from the bank.
2. Records of Retired civil servants were not easily and readily available in the past and caused much disturbances to old people who had served in the government for many years; where as in modern electronic data processing such services are performed very fast and the retiree are free from the former troubles.
3. Performance in manufacturing industries and related works have improved due to inventory automated systems which controls purchases and stocks so that there is no idle cash tied into unnecessary stock pile ups.

8.5.2 Disadvantages

The electronic data processing systems have decreased vacancies for accountants as one person can perform the tasks that could have been done by five people. For example by entering a transaction where purchases have been bought by cash or on credit, stock will automatically be adjusted, total purchases also will be adjusted bank account if it is by cash also will be adjusted, Creditors total amount will be adjusted if the purchase was on credit and finally the financial statements i.e. financial position statement and financial performance statement and cash flows if purchase was by cash will automatically be adjusted. These are just few of activities that will be done after a simple entry of the transaction in the system by one accountant.

Electronic data processing requires more expertise and therefore a lot of money is required to be invested in IT so that the organization can run smoothly.

It is not possible to use electronic data processing without computers and where there is no steady supply of power.

After discussing the merits and demerits of electronic data processing in the modern business arena lets talk a bit about some challenges facing organizations and these systems today. It is a

Notes

non disputed fact that electronic data processing has today gained popularity among the majority of business organizations. However, some challenges need to be addressed before and after the organization have decided to turn from manual to electronic data processing. The first thing to be done by the organization is to ensure that it has its own Information technology policy which caters for Administration, replacement and maintenance of computers and peripherals and lastly but more significant Facilities and Access policy which will deal with Access codes and passwords. This is the remedy or answer to the challenge of security risks that I wanted to talk about. Yes, Security is a great or giant enemy of the electronic data processing systems. As some people may enter harmful programs known as viruses into the electronic data processing system and destroy important files or even running programs; likewise other unfaithful employee may access records and delete or change records to suit their interest and henceforth cause loss to the company. There are many risks but let me stop here.

For many years auditing have been performed in computer free environments, and as a result auditing have been done in manual accounting tools such as working sheets that the auditor uses to record his or her work. Control risk in manual processing and electronic processing are not the same this have necessitated the use of modern risk assessment techniques and audit. Also the use of computer assisted techniques has been brought into use as a result of the introduction of the electronic data processing in many organizations.

Task Visit a company of your choice which maintains its accounts on computers. Discuss with system manager and prepare a note on controls instituted by the management for carrying out auditing process.

8.6 Problems Encountered in an Electronic Data Processing Environment

Among the problems encountered in an EDP environment, the following are important:

1. The usual controls based on proper segregation of incompatible functions may be absent or may be less effective in an EDP environment. This is because the number of persons involved in the processing of financial information in an EDP environment is comparatively small. Moreover, the need for a centralized data processing function means that certain data processing personnel may be the only ones with a detailed knowledge of the source of the data, how it is used and the distribution and the use of output. This may also mean that they are familiar with the internal controls operating and hence may be in a position to alter the programs or data during processing or while stored. These factors increase the possibilities for manipulation.
2. Poor security for master files – they may be tempered with or lost.
3. Transactions and master file data are often concentrated either in one computer installation located centrally or in a number of installations distributed throughout the enterprise. Computer programs which provide the ability to obtain access to and alter such data are likely to be stored at the same location as the data. This increases the possibilities for unauthorized access to, and alteration of, programs and data.
4. Vulnerability of data and program storage media – magnetic discs or tapes on which large volume of data are stored while using EDP methods are vulnerable to theft, loss or intentional or accidental destruction.
5. Poor facilities in case of misfortunes e.g. fire, breakdowns etc.
6. Lack of control over computer service personnel.

Notes

The common weaknesses mentioned above related to the organizational structure of an EDP environment. In addition, system characteristics which result from the nature of EDP processing include the following:

1. There is every possibility for the audit trail to get obscured by the loss of visibility of the accounting records, and the increased amalgamation and summarization of data by computer programs. On the other hand, in a manual system it is possible to follow a transaction through the system by examining source documents, records, files and reports.
2. Data may be entered directly into the computer system without supporting documents.
3. Computerized data may not be retained for as long as manually prepared accounting data.
4. Through the use of remote terminals, it may be possible for unauthorized access to, and alteration of, program and data by persons inside or outside the enterprise.

8.7 Internal Controls in an EDP Environment

It is highly desirable that the auditor obtains a sufficient understanding of the client's internal controls (I/C) to plan the audit and assess control risk. If on assessment the control risk is showed to be low, the auditor can reduce substantive testing. When EDP is used in significant accounting applications, then the auditor must consider the effects the computer has when evaluating the internal controls. The auditor's approach to considering IC is the same in a computerized environment as in a manual environment:

Obtain and document understanding of the internal controls

1. Assess control risk
2. Perform tests of controls
3. Reassess control risk
4. Obtain and document understanding of the I/C

The extent to which the auditor needs to understand the computer system is dependent upon the preliminary audit strategy selected:

1. Primarily substantive approach—treat computer as a black number crunching box and just audit the inputs and outputs (auditing around the computer)
2. Lower assessment of control risk—you rely on the computer's controls (audit through the computer)

Assess Control Risk

The auditor needs to assess the risk that the internal controls (including EDP controls) will not prevent or detect material errors or irregularities that will affect the financial statements. The Auditor considers the strengths and weaknesses of the general controls first. Example of this in the Advances Module One of the application (programmed) controls requires authorization from a officer before an Cash credit account can overdraw above the drawing limit fixed. However, if the general controls over changes to programs cannot be relied on, then the advances module could be modified to allow an unauthorized clearing. Thus, the application control could not be relied on either.

Notes

Caselet

Long Distance Discount Services, Mississippi

Long Distance Discount Services, Inc. (LDDS) began in Hattiesburg, Mississippi. in 1983. In 1985 LDDS selected Bernard Ebbers to be its CEO. The company went public in 1989 through a merger with Advantage Companies Inc. The company name was changed to LDDS WorldCom in 1995, and later just WorldCom. The company's growth under WorldCom was fueled primarily through acquisitions during the 1990s and reached its apex with the acquisition of MCI in 1998. Among the companies that were bought or merged with WorldCom were Advanced Communications Corp. (1992), Metromedia Communication Corp.(1993), Resurgens Communications Group(1993), IDB Communications Group, Inc (1994), Williams Technology Group, Inc. (1995), and MFS Communications Company (1996). The acquisition of MFS included UUNet Technologies, Inc., which had been acquired by MFS shortly before the merger with WorldCom.

In February 1998, a complex transaction saw WorldCom purchase online pioneer CompuServe from its parent company H&R Block. WorldCom then retained the CompuServe Network Services Division, sold its online service to America Online, and received AOL's network division, ANS. The acquisition of Digex (DIGX) in June 2001 was also complex; WorldCom acquired Digex's corporate parent, Intermedia Communications, and then sold all of Intermedia's non-Digex assets to Allegiance Telecom.

MCI Acquisition

On November 10, 1997, WorldCom and MCI Communications announced their US$37 billion merger to form MCI WorldCom, making it the largest merger in US history. On September 15, 1998 the new company, MCI WorldCom, opened for business.

Sprint Merger

On October 5, 1999 Sprint Corporation and MCI WorldCom announced a $129 billion merger agreement between the two companies. Had the deal been completed, it would have been the largest corporate merger in history, ultimately putting MCI WorldCom ahead of AT&T as the largest communications company in the United States. However, the deal did not go through because of pressure from the US Department of Justice and the European Union on concerns of it creating a monopoly. On July 13, 2000, the boards of directors of both companies acted to terminate the merger. Later that year, MCI WorldCom renamed itself to simply "WorldCom" without Sprint being part of the company.

Accounting Scandals

CEO Bernard Ebbers became very wealthy from the rising price of his holdings in WorldCom common stock. However, in the year 2000, the telecommunications industry entered a downturn and WorldCom's aggressive growth strategy suffered a serious setback when it was forced by the US Justice Department to abandon its proposed merger with Sprint in mid 2000. By that time, WorldCom's stock was declining and Ebbers came under increasing pressure from banks to cover margin calls on his WorldCom stock that was used to finance his other businesses (timber and yachting, among others). During 2001, Ebbers persuaded WorldCom's board of directors to provide him corporate loans and guarantees in excess of $400 million to cover his margin calls. The board hoped that the loans would avert the need for Ebbers to sell substantial amounts of his WorldCom stock, as his doing so would put further downward pressure in the stock's price. However, this strategy ultimately failed and Ebbers was ousted as CEO in April 2002 and replaced by John Sidgmore, former CEO of UUNet Technologies, Inc.

Contd...

Notes

Beginning modestly in mid-year 1999 and continuing at an accelerated pace through May 2002, the company (under the direction of Ebbers, Scott Sullivan (CFO), David Myers (Controller) and Buford "Buddy" Yates (Director of General Accounting)) used fraudulent accounting methods to mask its declining earnings by painting a false picture of financial growth and profitability to prop up the price of WorldCom's stock.

The fraud was accomplished primarily in two ways:

1. Underreporting 'line costs' (interconnection expenses with other telecommunication companies) by capitalizing these costs on the balance sheet rather than properly expensing them.
2. Inflating revenues with bogus accounting entries from "corporate unallocated revenue accounts".

In 2002, a small team of internal auditors at WorldCom worked together, often at night and in secret, to investigate and unearth $3.8 billion in fraud. Shortly thereafter, the company's audit committee and board of directors were notified of the fraud and acted swiftly: Sullivan was fired, Myers resigned, Arthur Andersen withdrew its audit opinion for 2001, and the U.S. Securities and Exchange Commission (SEC) launched an investigation into these matters on June 26, 2002 (see accounting scandals). By the end of 2003, it was estimated that the company's total assets had been inflated by around $11 billion.

Bankruptcy

On July 21, 2002, WorldCom filed for Chapter 11 bankruptcy protection in the largest such filing in United States history at the time (since overtaken by the collapse of Lehman Brothers and Washington Mutual in September 2008). The WorldCom bankruptcy proceedings were held before U.S. Federal Bankruptcy Judge Arthur J. Gonzalez who simultaneously heard the Enron bankruptcy proceedings which were the second largest bankruptcy case resulting from one of the largest corporate fraud scandals. None of the criminal proceedings against WorldCom and its officers and agents was originated by referral from Gonzalez or the Department of Justice lawyers. WorldCom changed its name to MCI, and moved its corporate headquarters from Clinton, Mississippi, to Dulles, Virginia, on April 14, 2003.

Under the bankruptcy reorganization agreement, the company paid $750 million to the SEC in cash and stock in the new MCI, which was intended to be paid to wronged investors.

In the previous units, we have discussed in detail about the concept of internal audit in general. Obviously, a question may come to your mind that whether it makes any difference to internal audit in an Electronic Data Processing (EDP) environment. The answer is both Yes and No. While the objectives of internal audit do not change in an EDP environment, the audit techniques, procedures used will often differ from those used in manual or mechanical data processing environment.

8.8 Planning an Internal Audit in an Electronic Data Processing Environment

In planning the portions of the internal audit which may be affected by the entity's EDP Environment, the auditor should obtain an understanding of the significance and complexity of the EDP activities and the availability of data for use in the audit. This understanding would include such matters as:

1. The organizational structure of the entity's EDP activities and the extent of concentration or distribution of computer processing and development throughout the entity, particularly as they may affect segregation of duties at both the user and EDP personnel levels.

Notes

2. The significance of computer processing in each significant accounting application. For this purpose significance relates to materiality of the financial report assertions affected by the computer processing.

3. The complexity of computer processing in each significant accounting application. Applications may be considered complex when, for example:

   (a) The volume of transactions is such that users would find it difficult to identify and correct errors in processing;

   (b) The computer automatically generates material transaction or entries directly to another application (integrated systems);

   (c) The computer performs complicated computations of financial information and/or automatically generates material transactions or entries that may not be (or are not) validated independently; and

   (d) Transaction are exchanged electronically with other organizations as in Electronic Data Interchange (EDI) systems;

4. Plans by the entity to replace or significantly change the EDP Environment, where these changes will affect the internal control structure.

5. The availability of data, source documents, certain computer files, and other evidential matter that may be required by the auditor may exist for only a short period or only in machine readable form. An entity's system may generate internal reports that may be useful in performing substantive tests (particularly analytical procedures). The potential for use of computer assisted audit techniques may permit increased efficiency in the performance of audit procedures, or may enable the auditor to economically apply certain procedures to an entire population of accounts or transactions.

In planning the internal audit, the auditor designs audit procedures that will provide sufficient appropriate audit evidence. During the initial planning, phase of the audit, the auditor needs to assess whether to use computer assisted audit techniques. The need to process and analyze large quantities of data using computers may provide the auditor with opportunities to apply general or specialized computer assisted audit techniques may be used as tests of control or substantive procedures to obtain sufficient appropriate audit evidence.

Assessment of Risk: The internal auditor should make an assessment of inherent and control risks for material financial report assertions. The inherent and control risks in an EDP environment may have both a pervasive and an account specific effect on the likelihood of material misstatement. The risks may result from deficiencies in persuasive EDP activities such as program development and maintenance, systems software support, operations etc. Once proper plans are laid out, the issues of concern during the execution stage are as follows:

1. The user requirements must be clearly understood and as far as possible, the specifications must be signed off formally prior to starting the system design.

2. If standard packages are to be used, their limitations and the scope of customization must be clearly understood.

3. Staff at all levels must be appropriately trained and the entire organization slowly molded into the computer culture. Properly designed training programs for top management and users are every essential.

4. Reliability of hardware and software is of utmost importance, since users would lose confidence otherwise.

5. The organization must be service oriented and not view itself as being in an ivory tower, which tends to happen at times.

Notes

6. User requirements are bound to change over a period of time, primarily due to the experience gained. The systems must be flexible enough to accommodate such changes.

Task Visit a company of your choice which maintains its accounts on computers. Discuss with system manager and prepare a note on problems encountered by them in processing accounting data.

Self Assessment

Fill in the blanks:

3. The usual controls based on proper segregation of incompatible functions may be absent or may be less ..... in an EDP environment.
4. Transactions and master file data are often concentrated either in one computer installation located centrally or in a number of ..... distributed throughout the enterprise.

8.8.1 Internal Audit Practices in Relation to Computerized System

The continuous expansion of the range of internal auditing services, together with the limited resources available, have created increased interest in finding new ways which the internal auditor can achieve his audit objectives more efficiently. At the same time the major developments in electronic data processing have provided new capabilities. All of these factors have led internal auditors to make greater use for computers in their audit work. That use of especially advantageous when there are voluminous data and processing involved. Computers also make possible to a greater extent the use of the many types of statistical sampling. It is appropriate, therefore, that we examine in more depth how internal auditors can utilize computers in achieving their audit objectives in all operational areas.

The extended use of computers by companies of all size has stimulated changes in the auditor's approach. The auditor can no longer be satisfied with only manual audit procedures to fulfill audit objectives. The whole internal control environment may change from those in a manual setting. The nature of the audit evidence changes when information is a manual setting. The nature of the audit evidence changes when information is readable only by electronic means. The use of computer assisted audit techniques may result in the performance of audit tests by the computer which were previously done manually. In addition, these techniques may enable the auditor to carry out audit procedures that were hitherto impracticable. As new systems are acquired or developed he can determine whether data can be accumulated and stored in a manner that will facilitate later audit. Through maximum utilization of computer assisted audit techniques, the internal auditor may not only improve the quality of audits, but also sharpen his capabilities to perform special reviews for management thus provide better service.

8.8.2 Requirements for a Computer Audit Program System

Prior to selecting a computer audit package, a review should be made of the generalized computer audit program systems that have been developed by other organizations. No single software package may satisfy all the requirements of every audit group or assignment. The following are some characteristics of an effective system.

1. Simplicity
2. Understandability

Notes

3. Adaptability
4. Vendor technical support
5. Statistical sampling capability
6. Acceptability
7. Processing capabilities
8. Report writing.

Mechanics of Use: If data of audit interest are processed on a computer, the auditor should be on the lookout for methods of using the computer to audit such data. The capabilities of most computer audit packages open up new opportunities to use the computer to fulfill audit responsibilities. The use of the computer is especially desirable when there is a large volume of data and the data are readily available from the computer files. The auditor determines the identity and content of all potentially useful files early to his audit, and obtains a copy of the data layout for each record written on those files.

Once the auditor has recognized the availability of computer file of interest in the audit, he considers methods for using a computer audit package, it is important to understand how the computers audit package work. Basically, the package has the capability of listing those records which match other records in the same file or in different files. One or more data fields designated by the auditor are compared. Record layouts of the two files can be different, except for the fields to be matched. The computer audit package can also print account details and totals for records defined by the auditor.

In addition, the audit package is capable of performing various calculations and solution of formulae. Special programs can be used for any computational task required. Sampling plans can be developed and the results of sampling tests evaluated and projected. In addition, the computer using its comparison capability, can select all or a sample of records having the characteristics stated by the auditor. Multiple sets of characteristics can be designated for a single application. For each stratum, statistics are provided on the number of records on the input file, the number of records selected, and the sum of designated fields. Each stratum may be sampled or printed in its entirety.

Applications: There are various areas in internal auditing for use of audit software packages. Once the techniques are mastered, the applications to computer files are performed manually and determine the feasibility of applying computer techniques. Another approach is to include special computer routines in the normal, everyday processing. An example is in the review of cheques disbursements. As transactions are processed, the computer can automatically select a sample, or print out expenditures in excess of a specified amount by classification. The following are some application for potential use by internal auditors.

1. ***Inventories:*** The use of computer software packages in reviews of inventories results in significant savings of audit staff time and elimination of detailed checking of voluminous data manually. In testing a perpetual inventory, a statistical sample can be taken by the computer of inventory parts, stratified as to high and low values. Counts summarized and tabulated by quantity, rupees and percentages. In addition, tests of pricing can be made by comparison of perpetual inventory records with a master cost tape showing the costs of all parts. Other application include tests for meeting standards for filling requisitions, printouts of stocks with recurring shortages or averages, and summaries of trends in losses through pilferage.
2. ***Payrolls:*** There are operational as well as financial areas relating to payrolls that lend themselves to the use of audit software packages. Printouts can be made to review labour

Notes

utilization – amount of overtime, labour charged to jobs in excess of standards, and downtime. Comparisons can be made with prior performance as well as with standards to indicate performance needing improvement. In addition, the programs can identify new and terminated employees, as well as changes, for checking against payroll authorization file in the personnel department.

3. ***Maintenance:*** Overruns in excess of specified percentage can be pin pointed for analysis of causes. Backlogs of maintenance request can be aged and printed out for review.

4. ***Energy:*** Plants or departments with excessive use of gas and electricity are identified for monitoring under the energy program.

5. ***Travel and Telephone:*** Excessive chores by employee or departments can be identified for follow up and possible reductions.

6. ***Sales:*** Data can be accumulated as to sales by salesperson, territory, or product in relation to quotas and performance by others.

Self Assessment

Fill in the blanks:

5. The extended use of computers by companies of all size has stimulated changes in the ..... approach.

6. Prior to selecting a computer audit package, a review should be made of the generalized computer audit program systems that have been ..... by other organizations.

8.9 Computer assisted Audit Techniques (CAATs)

An auditor uses various Computer assisted Audit Techniques to carry out audit procedures while auditing through the computer. Under CIS environment, the auditing cannot be carried effectively using traditional/conventional and manual techniques of auditing. The auditing through the computer requires the use of various audit software packages and some computer-assisted audit techniques.

8.9.1 Audit Software

The use of CAAT allows the auditor to test the reliability and credibility of the clients' information system, without being much dependent upon the clients' software. Now-a-days, there are a plenty of audit software options available with the auditor, with the help of which he can perform his audit independently and effectively. This audit software may include package programs, purpose-written programs, utility programs or system management program. These programs are explained as follows:

1. ***Package Programs:***

   (a) These are generalized computer software packages.

   (b) These packages come with a lot of generalized features and utilities, which can be used at many clients' site.

   (c) Since these software packages are highly generalized and are available across the globe, so one does not face any compatibility issues. Almost all the organization maintains certain level of compatibility with these programs.

Notes

Example: MS-Excel can be the most common example for such programs.

2. ***Purpose-written Programs:***
   (a) These programs are created to perform specific natured audit task.
   (b) These packages are not available for sale in the open market. The auditor is required to get these programs developed.
   (c) The auditor may appoint some outside agency to develop the program on his behalf (outsourcing) or he may himself hire the programmers and get it built in-house.
   (d) While choosing the purpose-written program option, the auditor must take into consideration, the cost related issues.
3. ***Utility Programs:***
   (a) These programs are used to perform common data processing functions such as sorting; sampling; documenting; creating, emailing & printing files/reports, etc.
   (b) Although, these are not specifically designed for the audit purposes but can be extremely useful while performing the audit.

Example: Acrobat's Adobe Reader; Microsoft's Office also consist of certain utility programs such as MS-Access, MS-Word, MS-PowerPoint, etc.

4. ***System Management Software:***
   (a) These software/programs are also not specifically meant for audit purpose.
   (b) These are productive tools, meant to enhance the performance of the Operating System.

Example: Disk Defragment, Task Manager, Task Scheduler, Disk Cleanup, etc. are some of the examples of system management software.

8.9.2 Steps involved in Application of CAAT

Following steps are required to be undertaken by the auditor in effective application of CAAT:

1. Set the objective of CAAT application;
2. Determine the content and accessibility of the entity's files;
3. Determine the scope: identify the specific files or databases to be examined;
4. Understand the relationship between the data tables where a database is to be examined;
5. Define the specific tests or procedures and related transactions and balances affected;
6. Define the output requirements;
7. Arrange files & databases: arrange with the user and IT departments, if appropriate, for copies of the relevant files or database tables to be made at the appropriate cutoff date and time;
8. Audit team: identify the personnel who may participate in the design and application of CAAT;
9. Cost effectiveness: refine the estimates of costs and benefits;

Notes

10. Follow-up: ensure that the use of CAAT is properly controlled;
11. Arrange the administrative activities, including the necessary skills and computer facilities;
12. Reconcile data to be used for CAAT with the accounting and other records;
13. Execute CAAT application;
14 Evaluate the results;
15. Document CAATs to be used including objectives, high level flowcharts and run instructions; and
16. Assess the effect of changes to the programs/system on the use of CAAT.

8.9.3 Techniques

Some of such techniques are mentioned below:

1. ***Test Data Approach:***
   (a) Under this approach auditor prepared transaction data (test data) is processed by the client's processing system under the control of auditor.
   (b) The auditor plants certain errors in data along with correct transactions.
   (c) The results of the processing are compared with the predetermined output by him.
   (d) If errors are detected by the computer for follow up and corrections, this indicates that all the application and general controls are functioning properly. Ideally, test data should test each control on which auditor wishes to rely on.
   (e) The major disadvantage of this approach relates to the difficulty in designing test data. To prepare it, an auditor must be technical proficient in designing erroneous data as well as data which can test each control. He should assure himself that the programmes being tested are actually the same as used by the client.
2. ***Integrated Test Data Approach:***
   (a) Under integrated test data approach, the auditor creates a fictitious entity (e.g. fictitious customer accounts, fictitious vendor accounts) within the client's actual data.
   (b) Hypothetical data for fictitious transactions are, thus, integrated with actual client data and processed. Subsequently, it is removed from records of the client by either manually reversing journal entries or through programme commands and then financial reports are complied.
   (c) Advantages: provides assurance that the programmes being tested by the auditor, have actually been used by the client, long term economies and can be precisely targeted for specific procedures within the programmes.
   (d) Disadvantages: difficult to ensure that fictitious transactions does not impact actual results, errors, may be detected but well laid frauds difficult to detect and high initial cost.
3. ***Generalized Audit Software (GAS):*** Under all the above approaches test data and integrated test data an auditor is required to prepare input data or create programmes. In case of generalized audit software, audit programmes are designed by computer manufacturers,

Notes

software professionals and large firms of auditors. The functions which can be performed through GAS are as follows:

(a) ***Examination and review of records based on auditor's criteria:*** The computer can scan the records and point out the exceptions to the criteria established by auditor. For example, software can be designed to scan accounts receivable balances for amounts exceeding the credit limit.

(b) ***Selecting and printing audit samples:*** The computer can be used to select and print audit samples using statistical or judgmental sampling techniques.

Example: Receivable accounts may be selected for confirmation using random sampling tables and the computer might be used to print the confirmation letter and address on the employees.

(c) ***Testing calculations and making computations:*** GAS helps the auditor to test the accuracy of computations in client's data files with greater speed as compared to a manual system.

Example: The auditor can calculate the bad debts to sales ratio for the present year and compare it with the past years to ensure reasonableness of bad debts written off during the year under audit.

(d) ***Comparing data on separate files:*** An auditor can compare data on separate files to determine whether compatible information is in agreement. Differences, if any, should be reconciled and investigated. Examples include comparing, paid vouchers to cash disbursement through cheques and purchases of inventory as per stock records to creditors file.

(e) ***Summarizing data and performing analysis:*** The auditor summarizes and reorganizes client data for his purposes. This can be done earlier with the help of GAS.

Example: He may want to determine the chances of recovery of debtors by looking at the ageing schedule or summarize inventory turnover statistics to determine slow moving inventory items.

(f) ***Comparing audit data with client's records:*** Audited data, must be converted to machine readable form and may be, then, compared with the information in records of the client.

Example: Comments made by the auditor of inventory quantities on hand may be compared with the quantity shown in the perpetual inventory records or stock verification sheets of the client.

From the above discussion, it is apparent that the use of generalized audit software can greatly assist the auditor in performing compliance substantive tests. However, this use is limited by the availability of client's data, auditor's ingenuity and the strength of client's internal control system.

8.9.4 Uses of CAAT

CAAT may be used to perform following audit procedures:

1. ***Detailed and in-depth test of transactions and balances:*** The auditor can check the transaction in-depth and in detail, since he can select a larger sample size. There is a lot of time saving, while applying CAAT, thus he may apply more time to analyse a transaction.

Notes

2. ***Application of complex analytical review procedures:*** The can perform complex procedure and calculations with the help of CIS. He may extract detailed and complex reports also to support his procedure.

3. ***Application of statistical sampling techniques to extract the relevant data:*** While extract data from the client's information system, the auditor can take help of complex statistical and scientific techniques in order to improve the quality and prudence of sample selected. Application of statistical and scientific methods is almost impossible, without the help of computer systems.

Example: MS Excel is an application program that contains a number of statistical and mathematical formulae and techniques.

4. ***Test of general EDP controls:*** The auditor may check various input controls; processing controls; output controls; data storage, transmission and security controls. The auditor can check the access rules and procedure.

5. ***Test of Application controls:*** The auditor can check the functioning of various applications installed and running in the system. The auditor may check the authenticity of various application programs.

6. ***Re-performing calculations and processing:*** The auditor can also re-perform calculations performed by the client's accounting system.

7. ***Better reporting Methods:*** Under CIS environment there are a number of reporting techniques are available with the auditor. The auditor can use of various graphical designs and multimedia techniques in order to make his report effective, concrete and more catchy.

Example: MS PowerPoint is one of the software used to prepare presentations.

8.9.5 Considerations in Use of CAAT

While planning an audit with the help of CAAT, the auditor must take care of the following factors:

1. ***IT knowledge and experience of the Audit Team:*** Both the auditor and the audit team should have sufficient skills and experience to handle the audit under CAAT.

2. ***Availability of relevant Audit Software and suitable computer facilities:*** The auditor can use the CAAT and maintain the independence only if he has sufficient infrastructure, in the form of computer hardware and audit software, available with him. Otherwise the cooperation and assistance of the client entity's personnel will be required.

3. ***Impracticability of manual test:*** Now-a-days, many organisations are adopting eco-friendly approaches while performing the business operations. Moreover, many computer information system perform tasks where there is no hard copy evidence is generated. Hence making it impractical for the auditor to perform the tests manually.

4. ***Effective and Efficiency:*** With the help of CAAT, it is possible to test large number of transactions together with a better level of precision. This brings efficiency and effectiveness in performing the audit assignment.

5. ***Time Constraint:*** The auditor is required to perform the assignment in the limited time span. Whereas, a large amount of data is required to be stored (such as transaction details

and reports) for such short audit period. Thus the auditor is required to make arrangement for retention and retrieval of data.

6. ***Detection of fraud and error:*** The CAAT allows the auditor to plan and execute the audit work more effectively with the help of sophisticated audit software. But, under CIS environment, frauds are intentional and generally deep-laid. Moreover, there are chances that some frauds are highlighted, but there is no concrete evidence to prove the same. Thus it cannot be said that the auditing through the computer will increase the probability of detection of fraud.

7. ***Use of CAAT in small organisations:*** In small business organisation, use of CAAT might not be a cost-effective and viable alternative. This is because of two reasons, first the revenue per assignment is not very huge, and second the client entity might not have the appropriate technical infrastructure to run CAAT.

8.9.6 Testing CAAT

Before applying or completely relying CAAT, the auditor must first obtain reasonable assurance of the integrity, reliability, usefulness, and security of CAAT through appropriate planning, design, testing, processing and review of documentation. There are many testing methods; some of them are listed below:

1. ***Test Data:*** The auditor enters the test data into the entity's computer system and compares the result with predetermined results.

2. ***Test Packs:*** It involves testing a set of data, chosen by the auditor from the entity's system and testing it separately from the normal processing procedure.

3. ***Integrated Test Facility:*** In this approach, auditor establishes a dummy unit, into which test transactions are posted during the normal processing cycle of the entity. However, these dummy entries are eliminated later on.

8.9.7 Measures to Exercise Control over CAAT Applications

Since, most of the audit procedures performed using CAAT are highly automated and machine driven. Moreover, many-a-times, a situation may occur, where the auditor also requires the cooperation of client entity's IT staff for extensive knowledge of computer installation. In such circumstances, the chances of inappropriately influencing the CAAT results by the client's staff. Thus, while applying CAAT in audit procedure, due care and control must be exercised. Following points are important to consider:

1. The kind of audit procedure that needs to be performed by CAAT;

2. Review the entity's general controls that may affect the integrity of CAAT, for example, controls over program changes and access to computer files. When such controls cannot be relied on to ensure the integrity of CAAT, the auditor may consider processing CAAT application at another suitable computer facility; and

3. Ensure appropriate integration of the output by the auditor into the audit process, and later on in drawing audit conclusions and reporting.

The success or failure of auditing with CAAT highly depends upon the degree of control exercised on the overall application of CAAT. The control over the CAAT applications can be:

1. ***Control over Software Application:***

   (a) *Participation in design and testing of CAAT:* The success of CAAT significantly depends upon the participation of the principal auditor in the designing and testing of CAAT.

Notes

(b) *Checking the coding:* Wherever applicable, detailed checking the coding of the program to ensure that it is in-line with the program specification.

(c) *Compatibility with client's system:* Asking the client entity's IT staff to check the compatibility of the audit software with the operating system used in the client's information system.

(d) *Testing the software:* Before running the audit software on the main system's data files, the software must be run on small test files in a different system.

(e) *Testing the test results:* The results of the above test.

(f) *Addressing the security issues:* The must establish appropriate security measures to safeguard the integrity and confidentiality of client's data.

(g) *Regular follow-up:* Sufficient evidence must be obtained so as to ensure that the audit software is functioning, as planned. And also ensure that there is proper vendor support.

2. ***Control over Test Data:***

(a) Controlling the sequence in which the test data needs to be sent.

(b) Initially, performing the test runs with small chunks of test data, before submitting the main audit test data.

(c) Predicting the results of the test data and comparing it with the actual test data output.

(d) Confirming that the current version of the programs was used to process the test data.

(e) Ensure that the client entity used the same version of software throughout the audit period, on which the audit is being conducted.

(f) Make sure that dummy entries are deleted, which were fed in the system, while performing the audit.

(g) The auditor should one thing in mind while performing the audit that, "CAAT is one of the 'solutions' for Audit and no the 'substitute' to Audit."

Self Assessment

Fill in the blanks:

7. An auditor uses various Computer assisted Audit ..... to carry out audit procedures while auditing through the computer.

8. Under integrated test data approach, the auditor creates a ..... entity within the client's actual data.

8.10 Summary

- In planning the portions of the internal audit which may be affected by the entity's EDP Environment, the auditor should obtain an understanding of the significance and complexity of the EDP activities and the availability of data for use in the audit.
- In planning the internal audit, the auditor designs audit procedures that will provide sufficient appropriate audit evidence. During the initial planning, phase of the audit, the auditor needs to assess whether to use computer assisted audit techniques.

Notes

- The internal auditor should make an assessment of inherent and control risks for material financial report assertions. The inherent and control risks in an EDP environment may have both a pervasive and an account specific effect on the likelihood of material misstatement.
- The usual controls based on proper segregation of incompatible functions may be absent or may be less effective in an EDP environment. This is because the number of persons involved in the processing of financial information in an EDP environment is comparatively small.
- The continuous expansion of the range of internal auditing services, together with the limited resources available, have created increased interest in finding new ways which the internal auditor can achieve his audit objectives more efficiently.
- Once the auditor has recognized the availability of computer file of interest in the audit, he considers methods for using a computer audit package, it is important to understand how the computers audit package work.
- There are various areas in internal auditing for use of audit software packages.
- An auditor uses various Computer assisted Audit Techniques (CAATs) to carry out audit procedures while auditing through the computer viz. Test Data Approach, Integrated Test Data Approach and Generalized Audit Software.

8.11 Keywords

CAATs: Computer assisted Audit Techniques

Data File Interrogation: Data File Interrogation is a method which is used to interrogate financial data files. It is a form of substantive testing, as it involves the direct examination of transactions and balances.

EDP Audit: A process of auditing in a computerized environment.

EDP Environment: Exits when a computer of any type or size is involved in the processing by an entity of financial information of significance to the audit.

GAS: Generalized Audit Software

Generalized Audit Package: GAPs are standard packages developed by software companies specifically for the purpose of auditors for auditing data stored on computer.

Substantive Tests: Tests designed to obtain evidence to verify balance of an account or a specific financial statement assertion.

Test data techniques are used to conduct audit by way of entering sample of transactions into client's computer system and comparing the output with predetermined output to make sure that the output being generated by client's computer system is correct.

8.12 Review Questions

1. Describe the planning process of an internal audit in an EDP environment.
2. Explain the problems encountered in an EDP environment.
3. Describe the internal audit practices in relation to computerized system.
4. Discuss the Computer assisted Audit Techniques (CAATs).
5. Distinguish between the Audit around the computer and audit through the computer.

Notes

6. Describe the procedure to perform Computer assisted Auditing using generalized audit package.
7. What do you mean by Generalized Audit Packages (GAPs)? Write down the typical steps in using audit package.
8. Describe the various factors which determine the use of Computer assisted Audit Techniques (CAAT).
9. What is Generalized Audit Package (GAP)? Describe the various facilities to be provided by the GAP.
10. What major steps are required to be undertaken by the auditor prior to implementation of a CAAT? Explain.
11. Write a short note on the White box Approach for Audit.
12. Describe the Integrated Test Facility (ITF) method used in conducting audit through computer.
13. Write short note on Integrated Test Facility.
14. Write short note on the Program (Parallel) Simulation.
15. Explain the following techniques of audit used by internal auditors:
    (a) System activity files interrogation.
    (b) Program comparison
16. Explain "test data technique" of audit in a computerized environment with the help of test pack approach.
17. Mention uses of CAATs. What factors should be considered in determining whether to use CAATs?
18. Write short note on Data File Interrogation.
19. What considerations should be given while using CAATs in Small Business Computer Environment? Discuss in brief.

Answers: Self Assessment

1.	Complexity	2.	Organizations
3.	Effective	4.	Installation
5.	Auditor's	6.	Developed
7.	Techniques	8.	Fictitious

8.13 Further Readings

Books

Contemporary Auditing – Real issues & Cases.

David Coderre, *Internal Audit: Efficiency through Automation*, John Wiley & Sons, 2009.

Dinkar Pagare, *Principles and Practice of Auditing*, Sultan Chand & Sons, Eleventh edition, 2007.

Notes

Emile Woolf, Moira Hindson, *Audit and Accountancy Pitfalls: A Casebook for Practising Accountants, Lawyers and Insurers*, John Wiley & Sons, 2011.

Handbook of International Auditing Standards by IFAC

Iain Gray, Stuart Manson, *The Audit Process: Principles, Practice and Cases*, Cengage Learning EMEA, 2007.

Jeanette Franzel, *Single Audit: Opportunities exist to improve the Single Audit Process and Oversight*, DIANE Publishing, 2009.

Susan Switzer, *Internal Audit Reports Post Sarbanes-Oxley: A Guide to Process-Driven Reporting*, John Wiley & Sons, 2007.

Online links

www.auditservices.com/aevidence.html

www.investopedia.com/terms/a/auditing-evidence.asp#ixzz1x6PIvbTg

www.informationbible.com/article-auditing-in-depth-111904.html

www.asiatradehub.com/india/tr9.asp

Notes

Unit 9: Vouching

CONTENTS

Objectives

After studying this unit, you will be able to:

- Discuss meaning of vouching;
- Describe objectives of vouching;
- Analyse the principles of vouching;

Notes

- Discuss substantial procedures involved in vouching;
- State procedure for vouching of cash transactions;
- Discuss procedure for vouching of trading transactions.

Introduction

Vouching means to test the truth of items appearing in the books of original entry. It is an important part of an auditor's duty to certify as correct the transactions recorded in the looks of accounts. The Accountant of a business is responsible for passing entries in the books of prime entry. The question arises how and on what basis such entries have been passed. The auditor's primary duty is to check these entries and only then certify the accounts as correct and free from any error or fraud.

9.1 Vouching

Some of the important definitions by well known authors are giving below:

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

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

According to F R M De Paula, "*Vouching does not mean merely the inspection of receipts with the cash book, but includes the examination of the transactions of a business together with documentary and other evidence of sufficient validity to satisfy an auditor that such transactions are in order, have been properly authorized and are correctly recorded in the books*".

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

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

Notes Vouching is a method of examination to not only substantiates an entry in the books of account with documentary evidences, but also to see that these evidences are adequate, reliable and really connected with the business.

9.1.1 Objectives of Vouching

The main objectives of vouching are:

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

Notes

4. A careful examination of all original evidence such as invoice receipt of correspondence minutes, contracts etc.

5. Vouching is very useful in proving the accuracy of the entries in the books of accounts. It also indicates about that transaction, which is omitted from the books of account.

Did u know? Vouching is called the essence of auditing. So audit is not possible without vouching. The object of vouching is to find out the accuracy of the entries appearing in the books of accounts and detect that no entry has been omitted from the books of account.

9.1.2 Procedures of Vouching

The following are the procedures to vouching:

1. ***Reading out:*** The vouching is a task of the auditor. The junior audit can read out the contents of the vouchers. He can inform the senior auditor about the data name of organization, number of voucher and amount of vouchers.

2. ***Comparison:*** The senior can head the contents called out by junior auditor. He tally each and every item stated in the voucher with entries in the books of accounts. Thus comparison is a part of vouching procedure.

3. ***Ticking:*** The senior auditor can use various ticks or symbols to clear the items checked. The ticks may be an abbreviation of words. Such ticks or symbols may differ from auditor to auditor because these are code words.

4. ***Stamping:*** The senior auditor instead of signature or initials he can use stamps for checking the vouchers can use the rubber stamps. The rubber stamp may have the wording checking and cancelled on it.

5. ***Signatures:*** The senior auditor can vouch the entries with the help of vouchers. He can put his signature or initials on every voucher for safety measures. The signed vouchers cannot be presented again for another entry.

6. ***Query:*** The voucher may be missing. The entries may be doubtful due to over writing and erasing. The audit staff can make the word "Q" against such entry. This entry is recorded in working papers.

7. ***Management:*** The audit staff can be giving sometime to the management for clearing the objections. The doubtful entries are handed over in written form. The management can examine the record in detail.

8. ***Reply:*** The management may reply after one or two days about the doubtful entries. The auditor can examine the reply of the managers. The auditor can judge whether the reply is right or wrong.

9. ***Clearance:*** The audit staff can clear the query for which proper answer is made available. The auditor may not be satisfied with the answer of objections. He can inform the management about this query.

10. ***No Satisfactory:*** The auditor may reject the unsatisfactory reply. He has skill, training and experience. He can use all available means to test the truth. He can note down poor clarification in working papers.

Notes

11. ***Objections:*** The objection stated in the working papers can be discussed with the management at the end of audit. He can form an opinion on the basis of such objections. He can submit his report either clear or qualified.

9.1.3 Precautions

The following are the precautions of vouching:

1. A vouching is documentary evidence in support of a transaction in the books of account.
2. The act of establishing the accuracy and authenticity of entries in the account books is called vouching. Vouching is a technical term which refers to the inspection by auditor of documentary evidence supporting and substantiating transactions.
3. Vouching is considered to be the essence of auditing and therefore the auditor should be very careful while vouching.
4. Vouching means to substantiate an entity in the books of account not only with any documentary evidence such as agreement, receipts, counterfoils of a receipts, but also to see that the transactions has been properly authorized, recorded and entered in the books of account.
5. Vouching also means checking of additions, ledger posting, extracting of balances in the ledger, etc.
6. The extent to which the auditor should check will depend upon the size of the business, the accounts of which he is auditing.
7. A voucher is documentary evidence is support of a transaction in the books of account. It may be a receipt, counterfoil of a receipt book, an agreement, resolution passed by Board of Directors or Shareholders and as recorded in the minutes books, and invoice, bank pay-in-slip, Bought note, Sold note, correspondence, gatekeeper's books, wages book, order book and so on.

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

1. All the vouchers are consecutively numbered and filed in order of the entries in the accounts.
2. He should pay attention to the dates, name of party to whom the voucher is issued and amount.
3. The voucher inspected should be cancelled by a stamp.
4. Special attention should be paid to those vouchers which are in the personal name of one of the patterns, directors, manager or secretary.
5. He should see that every voucher is passed as in order by a responsible officer.
6. He should also note, whether the vouchers is stamped.
7. He should also find out the nature of payment as to whether it relates to the business.
8. He should see as to which account the payment is posted- revenue or capital.
9. Attention should be paid to the amount both in words and figures.
10. Note should be made of any item which further elucidation or information or evidence which is available from various deeds.
11. If duplicate voucher for missing one is produced, it should be properly securitized to avoid any fraud. List of missing voucher should be prepared and reasons and

Notes

explanation for their loss should be obtained from the client and it the auditor is not satisfied with the explanations, he should mention this fact in his report.

12. The audit clerk should not take the help of any members of the staff of the client for an explanation, while vouching receipts.

Self Assessment

State whether the following statements are true or false:

1. Vouching is an act of comparing entries in the books of accounts with documentary evidence in support.
2. Vouching does not indicate about that transaction, which is omitted from the books of account.
3. The vouchers are considers correct only when the proper authority signs on them.
4. The stamps are required according to the valuation of the amount or cash memo.
5. The senior auditor instead of signature or initials he can use stamps for checking the vouchers can use the rubber stamps.

9.2 Vouching of Cash Transactions

After preparing Audit note book, audit planning, auditing working papers, audit preparations etc., the next step is to proceed with the examination of accounting entries passed in the books of account during the period under review. In this step the auditor has to check the entries with its supporting documents to determine the accuracy and authenticity of the entries passed by verifying the vouchers, bills and other supporting documents. This process of checking the evidence of the entries called vouching. It may relate to cash as well as trading transactions.

Auditor is required to certify the financial statements prepared by the accountant as the statement shows the true and fair view of the results of operations and the state of affairs of the business. Unless he tries to establish the accuracy and authenticity of all the transactions recorded in the books of account, auditor will be falling from discharging his duty.

Voucher is a piece of paper or a document that confirms the truth of a happening in the field of accountancy; it confirms either the payment or receipt of money. The voucher is an evidence of occurrence of a transaction that is entered in the books of accounts. It is the authority on the basis of which entries made. Vouching clearly shows the nature of the transaction.

Vouching is extensive examination of documents carried out for the purpose of established the authenticity of the transactions recorded in the books of accounts. Vouching also involves evaluation of internal checks and examination of internal controls relating to recording of transactions. Only on the basis of the conclusions drawn while vouching, auditors determine the nature and extent of their work subsequent to vouching. Therefore, extreme care should be taken while vouching. Important facts obtained from vouchers are date of transaction, name of the party, adherence, nature of the transactions, the amount mentioned in the voucher, and authority.

The main objectives of the audit of cash book:

1. To ensure that all receipts are accounted for
2. To ensure that no fraudulent payments have been made;
3. To know that all receipts and payments have been properly recorded; and
4. To verify the cash in hand and at bank.

Notes

While examining the vouchers the audit clerk should note the period for which the payment has been made.

9.2.1 Internal Check as regards Cash Book

Before the auditor starts the vouching of the cash book, he should enquire about the system of internal check in operation. There are lot chances of misappropriation of cash if there is no well-organized system of internal check. He should enquire as to the duties of the cashier, and whether he has access to the ledger and other books of original entry. The following system of internal check as regard receipt and payment of cash is suggested:

1. When cash is received, it should be acknowledged by means of a printed receipt which should have a counterfoil or by a carbon receipt.
2. As soon as cash is received, it should be entered in a rough cash book or diary.
3. Remittance should be opened by the cashier in the presence of a responsible officer who should not be connected with the cashier's office.
4. All the receipts of the day should be deposited in the bank at the end of the day or the next morning.
5. Bank reconciliation statement should be prepared frequently by the cashier and also by someone else.
6. The cashier should not have any control over the ledgers.
7. Petty cash should be organized under the Imprest system.
8. Casting of cash book should be independently checked.
9. All payments as far as possible, except for petty cash, should be made by cheques.
10. Cashier should not sanction the payments of special nature. Directors should do so.

Caution There are lot chances of misappropriation of cash if there is no well-organized system of internal check.

9.2.2 Procedure in regard to Vouching the Debit Side of the Cash Book

After satisfying himself that there is a good internal check system regarding the receipts and payments of cash, the audit clerk should now proceed to vouch the debit side of the cashbook. Some of the important items which usually appear on the debit side of the cash book and the duty of an auditor in that connection are given below:

Opening Balance: This should be compared with the balance shown in the duly audited balance sheet of the previous year.

Cash Sales: There are grater chances of fraud under this head. The salesman may sell goods and may not an entry in the cash book and thus misappropriate the money. The auditors should compare the dates on the cash memos and the cash book. If discount has been allowed on sales, he should see that a uniform policy and rate of discount has been followed. He may also compare a few items of sale with the stock.

Receipts from Debtors: The auditor should vouch cash received form debtors to whom goods have been sold on credit in the past. The only evidence available on account of this item is the

Notes

counterfoils of the receipts issued to the debtors. Whenever possible, after taking permission form his clients, a statement of accounts should be sent to the debtors to confirm the balances show in the statement so sent.

Income from Interest, Dividends, etc.: Interest received on account of fixed deposits in the bank account should be vouched with the bank pass book; Dividend received can be vouched with the counterfoil of "tops" of the dividend warrants or the letterers covering the cheque. Interest received on securities can be vouched form the securities themselves or from the tax deduction certificate issued by the Reserve Bank.

Loans: The receipt of loan should be vouched with the agreement with the lender. He should see whether his client is entitled to raise loan. He should examine the rate of interest payable, the terms of repayment and the security offered which should be examined.

Rents Received: The auditors should examine the Lease Deed and agreements to ascertain the amount of rent payable, the due date, and provision regarding the repairs, etc. Particular attention should be paid towards rent-outstanding. It is possible that rent might have been received but misappropriated while it may be shown as 'outstanding'.

Rent received: Bill receivable Book should be compared with Cash book and the Pass book to see that the amount has been received on the due date. Inquires should be made regarding the bills when have matured but the amount has not been received for them. Such bills might have been dishonored or retired.

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

Sale of Investment: The amount received on account of the sale of investment should be vouched with the Broker's sold note. If they have been sold through the bank, examine the bank advice. 'Ex-dividend' and 'Cum-dividend' must be inquired.

Insurance Claim Money: Insurance money received against a claim from and insurance company should be checked with correspondence passing between the client and insurance company, the account rendered by the insurance broker or company.

Share Capital: In the case of firms, the partnership Deed should be examined. In case of company the Memorandum of Association should be examined.

Sale of Fixed Assets: This item may be vouched with correspondence, auctioneer's account, sale contract minute book of the Board of Directors or any other evidence available. He should see that the proper asset account has been credited with the amount. If there is any profit, that should be credited to the Capital Reserve Account which is not available for distribution to the shareholders.

Miscellaneous Receipts: Correspondence, contracts or any other document will help auditor to vouch such transactions.

9.2.3 Credit Side or the Payment Side of the Cash Book

When the auditor has finished the vouching of the debit side of the cash book and having satisfied himself that there is a good internal check system, he should now proceed to vouch the cash payments which mean that he should satisfy himself that the payments have been actually made:

1. to the right persons or parties;
2. for the business itself;

Notes

3. have been sanctioned by a person holding some authority; and
4. have been properly recorded in the books of account.

The detection of misappropriation of money depends largely upon an intelligent and careful vouching of this side of the cash book. Some of the important items which usually appear on the credit side of the cash book and the duties of an auditor thereto are given below:

Payments to Creditors: Money paid to creditors on open accounts can be vouched with the receipts issued by the creditors acknowledging the receipt of money. Money due to them can be compared with the accounts of the creditors and the actual invoices received form the suppliers of the goods. The auditor should examine whether periodical statements are submitted by the creditors and are compared with the creditor's accounts. He may have to refer to minutes, contracts, and other evidences before he passes an entry. If any voucher is missing, he should insist upon getting a duplicate copy of it. He should vouch such an item with any other possible documentary evidence.

Wages: Another important entry, which is usually a big one, is that of wages. There are many chances of misappropriation of cash under this head. Before the auditor proceeds with his work, he should make a through investigation regarding the internal check system which is in operation. The chances of fraud or errors are:

1. The inclusion of fictitious names of dummy workers in the wages book;
2. Errors or fraud at time and piece-work records;
3. Possibility of clerical errors;
4. Overstating of rates of wages;
5. Overstating the hours of work or days of work put in by the workers;
6. Conversion of unpaid wages.

9.2.4 Understatement of deductions

The following internal check for the payment of wages is, however, suggested to avoid fraud. The system will be of great help to the auditor.

1. ***Time records:*** If the wages are to be paid according to the time spent by the workers, correct record of the time spent by them in the factory should be recorded.
2. ***Piecework Records:*** Where the wages are to be paid according to piece-wage system, each worker should be given a card which should record the amount of work done by the worker.
3. ***Preparation of Wages sheets:*** Worker's number. Name, occupation and rate of wages per day or month, time – ordinary and overtime, Gross amount payable, any deduction, any advance payment of wages, Net wages payable, and signature of the workers must be mentioned in the Wages sheet.
4. ***Payment of Wages:*** Wages may be paid by cash or Bank cheque. Related cash book and Bank book must be examined by the auditor.

Task Make list of items to be included under internal test checks for vouching cash transactions.

Notes

9.2.5 Auditor Duty as regards Wages

1. He should see whether the internal check system as detailed above is satisfactory and there is no loophole for any fraud.
2. He should check the casts of the wages sheets or wages book.
3. He should check the total of wages payable with the amount of cash or cheque.
4. He should check the name of some of the workers as mentioned the wages sheets with the job cards.
5. He should also see that the wages sheets are properly initialed or signed by all the persons responsible for the preparation of the wages sheet.
6. He should pay a surprise visit on the day of payment of wages.
7. He should compare the sanctioned strength of the workers with the wages sheet.
8. Wages sheets of the previous months should be compared with the current month.
9. Leave register should be examined.

9.2.6 Examine the System of Employment of Casual Labour

1. ***Capital Expenditure:*** The duty of an auditor in this connection is to see that the payment is in order, that it is dully authorized and that the money spent has been properly capitalized. Such expenditure requires special attention. The agreement for the purchase of property or the lease deed should be examined. Invoice of the supplier should be examined.
2. ***Loans:*** He should examine the receipt given by the borrower and the loan agreement, Pro-Note or bill of exchange. He should read carefully terms of loan regarding the rate of interest, the dates on which interest has to pay and the date of repayment of the loan. He should make inquiry whether his client is authorized to advance loans.
3. ***Salaries:*** Salaries book should be examined. He should see that the total for the salaries book for a particular month agrees with the cheque drawn for salaries or the item in the cash book under the cash column.
4. ***Travelling Allowance:*** He should the rules and regulations regarding the payment of travelling allowance. Calculation should be made. If there are so such rules, he should recommend to the management to frame rules. He should examine the vouchers which should be counteragent by a responsible official.
5. ***Insurance of Premiums:*** In case of new policy, the cover note or the receipt from the insurance company and the policy itself should be examined. In case of renewal, the renewal receipt for the premium should be examined.
6. ***Bill Payable:*** Returned bills duly cancelled should be examined. It would be a sufficient evidence of the amount having been paid. Reference may be made to the Bank pass and Bills payable Books.
7. ***Freight, Carriage and Custom Duties:*** The statements of account regarding the payment of freight and carriage, submitted by the shippers, clearing or forwarding agents, together with the receipts issued by them, should be examined to see that the payments has been duly made and accounted for.

Notes

8. ***Bank Charges:*** Bank charges such as commissions, interest on overdraft and loan, etc, should be examined with the pass book of Bank. He should check the calculation of interest.

9. ***Partner's Drawings:*** Partnership Deed should be examined as to what is the maximum amount and the time for which a partner can draw money and whether he is to be charged any interest on drawings. He should vouch this entry with the Partner's Drawing Book or account and see that he signature of the partner is there against such entry.

10. ***Postage:*** The Postage book should be compared with the Cash book or the Petty cash book and the balance of stamps in hand should be counted.

11. ***Petty Cash:*** There are greater chances of misappropriation of cash as thee are no voucher for a number of petty payments. He should, therefore make an enquiry into the internal check system of petty system of petty cash payments. The petty cash book should be maintained on the imprest system. The auditor should count the petty cash balance on the balance sheet date.

12. ***Directors' Fee:*** As a general rule the directors of a company cannot claim any remuneration unless the articles expressly provide for it. In any case they are not entitled to get any monthly salary. He should examine the Articles of association to find out the fee payable to the directors. He should also examine the minute book or the attendance registrar of the Board of Directors or the resolution passed at a general meeting sanctioning such a payment to ascertain the number of meeting attended by them, and to calculate the fee payable to the directors.

13. ***Miscellaneous expenses, such as rent, rates, taxes, advertising, lighting, etc.:*** He should examine the vouchers as usual and see that the expenditure is properly appropriated between the periods where necessary.

14. ***Bank:*** During the course of the year, cash or cheques are sent to the bank for deposit or collection and money is withdrawn from it frequently. Therefore such receipts and payments are to be vouched. These transactions in the Cash Book should be compared with the pass Book. Payments into the bank should be vouched with counterfoils of the paying-in-book. With regard to the balance at the bank, reconciliation statement should be prepared by the client to verify the balance. A copy of such a Reconciliation statement should be retained by the auditor as his working paper for future reference.

Self Assessment

Fill in the blanks:

6. Voucher is a piece of paper or a document that confirms the truth of a happening and confirm either the .....
7. Vouching also involves ..... and ..... relating to recording of transactions.
8. The only evidence available on account of Receipts from Debtors is the .....
9. Interest received on account of fixed deposits in the bank account should be vouched with the .....

9.3 Vouching of Trading Transactions

Having examined the cash book, the auditor may now, proceed to check the trading transactions. One of the objects of auditing is to check and prevent misappropriation of goods. The auditor

Notes

should see that the client pays for only those goods which have actually been ordered and received. Before the auditor begins his work, he should examine the internal check system regarding the purchase on credit, returns outward, etc.

9.3.1 Internal Check as regards Purchases

The system of internal check will depend upon the size of the business and the staff available. If auditor finds a bad or inefficient system the auditor should exercise great care exhaustively the purchase book and the ledger. Whenever goods are required in a particular department, the head of such a department should send the 'Purchase Requisition' which should show the quantity, quality, if possible the price of the maximum price at which they may be purchased, the time by which the goods must be supplied, etc., to the Purchase department which should invite tenders or quotations from suppliers.

The auditor should inquire about the procedure for opening and acceptance of the tenders. A responsible officer in addition to the storekeeper should be present when the goods are received and unpacked to see the accuracy of the quality and quantity of the goods.

9.3.2 Procedure of Good Internal Check regarding Purchase

1. All the orders sent out should be recorded in the Purchase Order Book which should have two carbon copies. One to be sent to the supplier of the goods and the other to be retained for reference purpose.
2. When the goods, are received the gatekeeper or the storekeeper should make a record in the Goods Inward Book after having check the quantity, weight etc.
3. The invoice should then be checked with the Goods Inward Book maintained by the storekeeper and the delivery note, if any, to see that the goods received are correctly recorded in the Stock Register, according to the invoice.
4. Another clerk should check the invoice regarding calculation, etc.
5. After this, the invoice should be sent to the head of the department who placed the order for the goods to see that the prices and qualities etc., are correct.
6. The departmental head will then pass over the invoice to the clerk who will record the same in the Purchase Book.
7. Every Person who has to deal the invoice and the goods should initial the invoice.

Task Make list of items to be included under internal test checks for vouching trading transactions.

9.3.3 Duty of an Auditor in Connection with Credit Purchase

After having satisfied himself that there is a good internal check system regarding the purchase, the auditor should now proceed to vouch the Purchase Book. While examining the invoice, the auditor should pay attention to the following points:

1. Whether the invoice is in the name of his client.
2. Who is authorized to place orders for Goods?
3. The date of invoice should relate to the period under review.

Notes

4. He should also see that only those goods which are dealt with by client have been purchased.
5. The auditor also sees that the goods mentioned in the invoice are not capital goods.
6. He should, as a 'test check', compare some invoice with the Goods Inward Book or the Gatekeeper's Inward Book in order to see that the goods have been actually received.
7. The auditor should cast a cross casts of the Purchase book.
8. He should see whether trade discount has been deducted from the invoice before making the entry in the Purchase Book.
9. While examining the invoices, if the auditor comes across invoices marked 'copy' or 'duplicate', he should satisfy himself that they were obtained in respect on only those invoices which have been actually lost or missed and they have not already been entered anywhere else in the Purchase Book.
10. If an invoice runs into several pages, the auditor should see that the grand total is correct.

9.3.4 Purchase Return

When the goods are returned to the seller, being not according to the sample or of inferior quality, a credit note should be obtained if the price has already been paid. If the price has not been paid, a note should be sent to the cash department to send less amount to seller. The auditor should compare the credit note with the purchase Returns Journal or Return Outwards Book and Gate keeper's Outwork Book or the stores records. The auditor should pay particular attention to heavy returns at the beginning or the close of the year as such entries might have been passed to adjust a fictitious purchase in the past.

9.3.5 Credit Sales

The auditor should now proceed to vouch the Day Book or the Sales Book which records only credit sales. The auditor has to be more careful in the case of vouching sales, as documentary evidence is not as conclusive as in case of purchase. He should enquire into the internal check system regarding the sales may be outlined as below:

1. Whenever on order is received, it should be recorded in the Order Received Book, giving details regarding the date on which the order was received, the name of the customer, the particulars about the goods, date of delivery, made of transport, etc.
2. The order or a copy of it is sent to the Despatch Department.
3. When the Despatch Department has packed the goods, another clerk should compare the goods.
4. A responsible official will now mark the rate at which the goods are to be charged.
5. The invoice will then prepare in duplicate or triplicate by means of carbon papers.
6. One copy of the invoice will be sent to the invoice clerk who enters it in the Sales Book and later on this is sent to the customer, another copy will be sent to the gatekeeper who will record in the Goods Outward Book that such and such goods left the premises, the third copy will be retained for further reference.

Notes

Notes The auditor has to be more careful in the case of vouching sales, as documentary evidence is not as conclusive as in case of purchase.

9.3.6 The Duties of an Auditor in connection with Credit Sales

1. He should see that the internal check system is efficient.
2. He should compare the data of the copy of the invoice with the data in the Sales Book.
3. He should see that the sales are not omitted from being entered in the Sales Book.
4. He should further see that the sale of an asset is not treated as ordinary sale, otherwise profit will be inflated.
5. With the permission of the client, the auditor should send Statements of Account to the customers to confirm the accuracy of the balance.
6. He should check the Sales Book for the last days or weeks of the financial period and the Returns Inward Book for a few days or weeks after the close of the period in order to see whether fictitious sales or returns had been recorded to inflate profits.
7. He should check the casts and cross casts of the Sales Book.
8. The cancelled invoice should be checked with the duplicate copy of the invoice.
9. Sales tax, insurance charges, etc, which are recoverable from the customers should be debited to the customer's account and credited to the appropriate accounts.
10. If there is a significant difference of trade discount allowed to two different sales, he should inquire into the reason of such a distinction.

9.3.7 Sales Return

When the goods are returned from customers, being defective or on account of any other reason, they should be entered by the gatekeeper in the register known as Gatekeeper's Return Inward Book and the Stock Register and also recorded to the Sales return book and credit note should be issued and signed by the responsible official.

9.3.8 Goods sold on Sale or Return System

Until the customer approves of the goods they cannot be treated as sales. It may so happen that on the date of the balance sheet, some of the goods might be with the customers who might not have sent their approval. In such case, these goods cannot be treated as sales. The auditor should, therefore, see that until the approval, such goods must be shown as 'goods with customers' and deducted from sales of the current period and from the list of the debtors.

9.3.9 Goods sent on Consignment

When the goods are sent out to agents to be sold at the owner's risk a separate book called 'Consignments Outward Journal' should be maintained if the number of such transactions is large. This book should be vouched with the copies of the proforma invoice, correspondence, account sale, and contracts with the consignees.

Notes

Journal

All those entries which cannot be passed through any other book of prime entry are passed through the Journal. The following transactions are usually passed through the Journal:

1. Opening Entries.
2. The acquisition of different assets or liabilities taken over forms the vendors.
3. The issue and allotment of shares.
4. Forfeiture of shares.
5. Adjusting entries.
6. Closing entries.
7. Entries relating to consignments.
8. Entries relating to dishonor of bills, etc.

The auditor should pay attention to the transactions passed through the journal. While vouching the entries in the journal, the auditor should see that

1. the transaction has been properly authorized;
2. the transaction is within the power of the company; and
3. the transaction is supported by documentary evidences.

The auditor should not pass any entry in the journal until he is quite satisfied with regard to its validity and correctness.

Bought Ledger

The auditor should now proceed to check the bought ledger, i.e., the ledger which contains the creditor's accounts. The opening balance of different accounts in the bought ledger should be checked with the previous year's audited balance sheet or the schedule of creditors duly checked by the previous auditor. The ledger can be vouched with the help of the audited balance sheet of the previous year. Purchase Journal, Purchase Returns Book, cash Book, Journal, Allowance Book, Bills Payable Book etc. The casting of the accounts in the Bought ledger should now be checked with the balance as shown in the schedule of creditors which has been supplied to him by the client. If the books are maintained on 'Self-balancing system', the total of the balance shown in the 'creditors Ledger Adjustment Account' in the General Ledger should agree with the total of the schedule of creditors.

Sales Ledger

Having checked the bought ledger, the auditor should now proceed to check the sales ledger, i.e., the ledger which contains the accounts of the debtors. The opening debit balances will be checked from the previous audited balance sheet or the schedule of debtors duly checked by the previous auditor. The accounts in this ledger will be checked from the previous audited balance sheet and subsidiary books, such as Sales journal, Sales Return Book, Cash Book, Journal, Allowance Book, Bills Receivable Book, etc. For the Purpose of valuation of debts, he should ask

Notes

his client to supply him a list of good, doubtful and bad debts. He should scrutiny such a schedule. He can verify this list by applying the following tests to each account:

1. If the account is regularly settled and the advantages of cash discount taken by the debtor, the debt is good.
2. Whether the debt is outstanding beyond the period of credit allowed. If so, it may mean that the debt is doubtful.
3. Whether the payments are on account and the balance tends to increase. If it so it means the party is doubtful.
4. Whether an old balance is being carried forward and the new goods are supplied for cash. If so, it means, the debt is doubtful.
5. Whether a cheque or a bill received against a debt balance has ever been dishonored. If it has been the case, it shows the party is not financially sound, and that the debt may be doubtful or prove bad some day.
6. The law of limitation allows three years to recover a debt and if the debt is outstanding for a longer period, it means the debt is bad.
7. If the bills are constantly renewed, the party is financially weak and the debt may be treated as doubtful.
8. If payments are irregular, the debt may not be good, and may become bad some day.
9. Whether there is any unusual item of discount or allowance. If so, he should enquire the matter.

9.3.10 Total Accounts and Sectional Balancing

In big business house where there are large numbers of transactions, it will be difficult to prove the accuracy of the balances of the Bought and Sales Ledger. To do so the Total Debtors and Total Creditors Account with have to be prepared. The Total Debtors and Creditors accounts will contain all the items spearing on the debit side and the credit side of the accounts in the Sales and Purchase Ledgers. In case the client maintains the ledger on the self-balancing system, the chances of error will be minimized. The auditors should apply a few test checks and if he finds that there is no mistake, he may presume that everything is all right.

Self Assessment

Fill in the blanks:

10. After having satisfied himself that there is a good internal check system regarding the purchase, the auditor should now proceed to vouch the .....
11. The auditor should vouch the Day Book or the Sales Book which records only .....
12. .....is the ledger which contains the creditor's accounts.
13. .....can be vouched with the help of the audited balance sheet of the previous year
14. ..... is ledger which contains the accounts of the debtors.

9.4 Summary

- The main objectives of vouching are: to examine the accounting entries recorded in the books of accounts with reference to documentary evidence known as vouchers; to examine

the authenticity of the transactions recorded in the books of account; to examine the adequacy and reliability of documentary evidence.

- Principles of Vouching include: Arranged Voucher; Checking of Date; Checking of Authority; in case of cutting or change there should be no changes in the vouchers. So, these changes cannot be acceptable till the approval authority has made the signature; Compare the Words and Figures; Transaction Must Relate to Business; the auditor should not accept the voucher in personal name; Checking of Account; The stamps are required according to the valuation of the amount or cash memo. There is no need of vouchers if amount is less than twenty rupees; the auditor should not accept the cancelled vouchers; for finding the correct decision, the auditor can also take help from the working papers of the previous year; Minutes Book; By Laws; Agreements; Deed of Mortgage.
- Before the auditor starts the vouching of the cash book, he should enquire about the system of internal check in operation.
- After satisfying himself that there is a good internal check system regarding the receipts and payments of cash, the audit clerk should now proceed to vouch the debit side of the cashbook
- Under vouching for trading transaction one of the objects of auditing is to check and prevent misappropriation of goods. The auditor should see that the client pays for only those goods which have actually been ordered and received.
- Whenever goods are required in a particular department, the head of such a department should send the 'Purchase Requisition' which should show the quantity, quality, if possible the price of the maximum price at which they may be purchased, the time by which the goods must be supplied, etc., to the Purchase department which should invite tenders or quotations from suppliers.
- After having satisfied himself that there is a good internal check system regarding the purchase, the auditor should now proceed to vouch the Purchase Book.
- The auditor should not pass any entry in the journal until he is quite satisfied with regard to its validity and correctness.
- The auditors should apply a few test checks and if he finds that there is no mistake, he may presume that everything is all right.

9.5 Keywords

Bought Ledger: Ledger which contains the creditor's accounts.

Sales Ledger: the ledger which contains the accounts of the debtors.

Voucher is a piece of paper or a document that confirms the truth of a happening in the field of accountancy; it confirms either the payment or receipt of money.

Vouching: The exercise of establishing and verifying the accuracy and authenticity of the accounting entries passed in the book of account with reliable evidences are technically called 'vouching'. It means vouching is the testing the truth of all the entries made in the book of accounts.

9.6 Review Questions

1. Define vouching. Explain objectives and need of vouching in Audit.
2. What are the various principles of vouching?

Notes

3. Explain procedures involved in vouching.
4. How vouching of cash transactions is carried out? What is its relevance in auditing?
5. What do understand by trading transactions? How vouching of trading transactions is performed?
6. What is the importance of internal checks in carrying out vouching procedure?
7. Examine the system of employment of casual labour.
8. What are the Auditor's duty as regards Wages?
9. What are the duties of an auditor in connection with credit purchase?
10. What are the duties of an auditor in connection with credit sales?
11. What do you understand by total accounts and sectional balancing in vouching of big organization's account?

Answers: Self Assessment

1. True
2. False
3. True
4. True
5. True
6. Payment or receipt of money
7. evaluation of internal checks; examination of internal controls
8. counterfoils of the receipts issued to the debtors
9. bank pass book
10. Purchase Book
11. credit sales
12. bought ledger
13. The ledger
14. sales ledger

9.7 Further Readings

Books

David Coderre, *Internal Audit: Efficiency through Automation*, John Wiley & Sons, 2009.

Emile Woolf, Moira Hindson, *Audit and Accountancy Pitfalls: A Casebook for Practising Accountants*, Lawyers and Insurers, John Wiley & Sons, 2011.

Iain Gray, Stuart Manson, *The Audit Process: Principles, Practice and Cases*, Cengage Learning EMEA, 2007.

Jeanette Franzel, *Single Audit: Opportunities exist to improve the Single Audit Process and Oversight*, DIANE Publishing, 2009.

Susan Switzer, *Internal Audit Reports Post Sarbanes-Oxley: A Guide to Process-Driven Reporting*, John Wiley & Sons, 2007.

Notes

Online links

www.asiatradehub.com/india/tr9.asp

www.auditservices.com/aevidence.html

www.investopedia.com/terms/a/auditing-evidence.asp#ixzz1x6PIvbTg

www.informationbible.com/article-auditing-in-depth-111904.html

http://dc142.4shared.com/doc/9dO8voIJ/preview.htm

http://dc142.4shared.com/doc/0wRRk_9W/preview.html

Notes

Unit 10: Audit of Financial Statements

CONTENTS

Contd...

Notes

Objectives

After studying this unit, you will be able to:

- Evaluate and describe audit of income statement;
- Know audit of position statement in respect of the depreciation;
- Interpret auditing or valuation of inventory;
- Know audit of share capital, reserve and surplus, current assets and liabilities;
- Discuss audit procedure for investment, SPV's, fixed assets.

Introduction

A financial statement audit is the examination of an entity's financial statements and accompanying disclosures by an independent auditor, with the result being a report by the auditor, attesting to the fairness of presentation of the financial statements and related disclosures. The auditor's report must accompany the financial statements when they are issued to the intended recipients.

The purpose of a financial statement audit is to add credibility to the reported financial position and performance of a business. The Securities and Exchange Commission requires that all entities that are publicly held must file annual reports with it that are audited. Similarly, lenders typically require an audit of the financial statements of any entity to which they lend funds. Suppliers may also require audited financial statements before they will be willing to extend trade credit.

Audits have become increasing common as the complexity of the two primary accounting frameworks, Generally Accepted Accounting Principles and International Financial Reporting Standards, have increased, and because there have been an ongoing series of disclosures of fraudulent reporting by major companies.

Notes The Securities and Exchange Commission requires that all entities that are publicly held must file annual reports with it that are audited.

10.1 Stages of Financial Audit

The primary stages of an audit are:

1. ***Planning and risk assessment*** involves gaining an understanding of the business and the business environment in which it operates, and using this information to assess whether there may be risks that could impact the financial statements.

Notes

2. ***Internal controls testing*** involves the assessment of the effectiveness of an entity's suite of controls, concentrating on such areas as proper authorization, the safeguarding of assets, and the segregation of duties. This can involve an array of tests conducted on a sampling of transactions to determine the degree of control effectiveness. A high level of effectiveness allows the auditors to scale back some of their later audit procedures. If the controls are ineffective (i.e., there is a high risk of material misstatement), then the auditors must use other procedures to examine the financial statements. There are a variety of risk assessment questionnaires available that can assist with internal controls testing.

3. ***Substantive procedures*** involves a broad array of procedures, of which a small sampling is:

   (a) *Analysis:* Conduct a ratio comparison with historical, forecasted, and industry results to spot anomalies.

   (b) *Cash:* Review bank reconciliation, count on-hand cash, confirm restrictions on bank balances, issue bank confirmations.

   (c) *Marketable securities:* Confirm securities, review subsequent transactions, verify market value.

   (d) *Accounts receivable:* Confirm account balances, investigate subsequent collections, test year-end sales and cutoff procedures.

   (e) *Inventory:* Observe the physical inventory count, obtain confirmation of inventories held at other locations, test shipping and receiving cutoff procedures, examine paid supplier invoices, test the computation of allocated overhead, review current production costs, trace compiled inventory costs to the general ledger.

   (f) *Fixed assets:* Observe assets, review purchase and disposal authorizations, review lease documents, examine appraisal reports, recalculate depreciation and amortization.

   (g) *Accounts payable:* Confirm accounts, test year-end cutoff.

   (h) *Accrued expenses:* Examine subsequent payments; compare balances to prior years, recomputed accruals.

   (i) *Debt:* Confirm with lenders, review lease agreements, review references in board of directors minutes.

   (j) *Revenue:* Examine documents supporting a selection of sales, review subsequent transactions, recalculate percentage of completion computations, and review the history of sales returns and allowances.

   (k) *Expenses:* Examine documents supporting a selection of expenses, review subsequent transactions, and confirm unusual items with suppliers.

An audit is the most expense of all the types of examination of financial statements. The least expensive is a compilation, followed by a review. Due to its cost, many companies attempt to downgrade to a review or compilation, though this is only an option if it is acceptable to the report recipients.

10.2 Financial Statement Audit Procedures

Auditors verify financial statements for accuracy and completeness. Auditors who review firms' financial statements focus on internal controls and processes, operating guidelines, business risks and policies in financial reporting programs. They also may evaluate human resource

Notes

guidelines and accounting principles to verify that they adhere to regulatory procedures and standards generally accepted in firms' industries. These specialists may work in internal audit departments or at public accounting firms.

10.2.1 Risk Assessment

Auditors analyze entities' operations and transactions to appraise business risks, control weaknesses and segment profiles. They may focus on financial risks or operational exposures. Financial risks may be market and credit risks. Market risk originates from fluctuations in securities' prices; it is calculated by complex math tools such as VaR, which stands for value at risk, or Monte Carlo simulation methods that use various projections to arrive at a likely value. Credit risk is the risk of loss from business partner defaults; it is measured by internal rating models. Operational exposures—also called operating risks—originate from human actions or systems. They may relate to litigation, technology systems or regulatory actions. Auditors assign ratings—high, medium, low— to areas reviewed and allocate resources based on risk severity.

Example: An audit manager might assign more auditors to an area deemed "high-risk".

10.2.2 Internal Controls Testing

Auditors review and internal controls related to financial recording and reporting processes. They assess policies, procedures and guidelines existing in revenue-producing areas and verify that such procedures are operating correctly. Auditors tests two criteria: design and operating effectiveness. Controls are adequately designed if procedures are clearly stated, responsibilities are defined, and there are consequences for control breaches. Controls are operating effectively if they remedy deficiencies or internal weaknesses for which they are designed.

Example: An auditor might review the cash disbursement process to verify that duties are segregated between inventory receipt, warehouse management, vendor checks' scheduling, treasury activities and bank statements' reconciliation.

Notes Auditors who review firms' financial statements focus on internal controls and processes, operating guidelines, business risks and policies in financial reporting programs.

10.2.3 Analytical Procedures

Auditors apply analytical procedures in areas where adequate controls and processes are noted. Analytical procedures refer to comparisons between historical and current-year data, evaluations of key ratios and appraisals of financial trends. Audit specialists also verify that financial statements—balance sheet, income statement, owners' equity statement and statement of cash flows—are prepared and presented in accordance with accounting principles generally accepted in the industry.

Example: An auditor might review salespeople's commissions for five years and check whether increases in such figures are consistent with increases in revenues.

Notes

10.2.4 Tests of Details

Auditors check whether financial statements are accurate by conducting detailed tests on individual accounts, groups of accounts or financial statement sections. They focus on journal entries, financial records, operating agreements and business estimates to confirm amounts recorded in financial statements.

Example: An auditor reviews the firm's legal reserves at year-end and notes a balance of ₹ 1.5 million. The auditor could ask the legal department to confirm and explain such figures.

Self Assessment

Fill in the blanks:

1. Analytical procedures for financial audit refer to

   .....

   .....

2. ..... involves the assessment of the effectiveness of an entity's suite of controls, concentrating on such areas as proper authorization, the safeguarding of assets, and the segregation of duties.
3. .....is the risk of loss from business partner defaults and is measured by internal rating models.

10.3 Audit Procedures for Income Statements

Income statement audits are a routine part of closing financial books. Audits help to ensure the accuracy of the accounting data used to compile the statements as well as the overall calculations. An income statement audit can help isolate mathematical errors and ledger discrepancies or give peace of mind before filing the income statement during closing.

10.3.1 Statement Calculations

The first step in auditing income statements is to verify the summary calculations. Auditing starts with the income section, by confirming that the total revenue amount is equal to the sum of the income lines. By repeating this process for the expense category as well, manually calculate the difference between the revenue and expense numbers to verify the equity section, as owner's equity is simply the difference between the revenue and expenses.

10.3.2 Income Details

After determining that the calculations on the income statement itself are accurate, auditor needs to review the detail that contributes to the figures. Then pull summary transaction reports from the general ledger for each revenue account. Review the overall data on the summary reports for accuracy. Run transaction-level reports for the accounts so that one can view the details to confirm that the summary report figures are accurate. Each transaction-level report shows what has posted to the account. Then, comparison is made for the transactions in the ledger to the hard copy files, such as invoices or check stubs that support the journal entries, to confirm that they were posted correctly.

Notes

10.3.3 Expense Review

Pull ledger reports of the transactions in the expense accounts. Review the transaction detail reports for each expense account to confirm that the expense totals on the income statement report are accurate compared to the ledger activity. View the detail level in the ledger for the individual transactions posted in the period to confirm that they were recorded properly. Check the dates on the expenses to be sure that they apply to the period in question, and manually verify the calculations by adding them up you to ensure that the recorded totals are correct.

10.3.4 Paper Audit Sampling

After completing a full audit of the income statement, select a few transactions from each relevant account, such as a few credits posted to each revenue account and a few payments issued from each expense account. Request the documentation of the transactions selected to complete a sample audit of the account activity. The documentation in question would consist of check stubs and invoices or paperwork filed to support journal entries. Check the calculations of the invoices or the payment vouchers, and verify that the entries in the system match the documentation.

Task Make a checklist with the help of an anonymous income statement of various steps involved in performing income statement audit.

10.4 Valuation of Inventory

Stocks should be valued at lower of its cost or net realizable value. This has posted an imperative audit work step to ascertain that the respective items are value at cost or net realizable value:

How do we ensure that the stocks are valued properly?

1. Randomly selected a certain number from inventory listing.
2. To find out the most recent sales/subsequent sales after year end.
3. From the invoices, noted down selling price
4. Compare the selling price to the actual cost of the sample.
5. Cost > Selling Price, valued at selling price Selling Price > Cost, valued at cost.

Caution Each respective item has to be valued at cost or net realizable value.

Inventory Audit Procedures

If a company records its inventory as an asset, and it undergoes an annual audit, then the auditors will be conducting an audit of inventory. Given the massive size of some inventories, they may engage in quite a large number of inventory audit procedures before they are comfortable that the valuation stated for the inventory asset is reasonable. Here are some of the inventory audit procedures that auditors' may follow:

1. ***Cutoff analysis:*** The auditors will examine procedures for halting any further receiving into the warehouse or shipments from it at the time of the physical inventory count, so that extraneous inventory items are excluded. They typically test the last few receiving

Notes

and shipping transactions prior to the physical count, as well as transactions immediately following it, to see if properly accounting for them.

2. ***Observe the physical inventory count:*** The auditors want to be comfortable with the procedures company use to count the inventory. This means that they will discuss the counting procedure, observe counts as they are being done, test count some of the inventory themselves and trace their counts to the amounts recorded by the company's counters, and verify that all inventory count tags were accounted for. If company has multiple inventory storage locations, they may test the inventory in those locations where there are significant amounts of inventory. They may also ask for confirmations of inventory from the custodian of any public warehouse where the company is storing inventory.

3. ***Reconcile the inventory count to the general ledger:*** They will trace the valuation compiled from the physical inventory count to the company's general ledger, to verify that the counted balance was carried forward into the company's accounting records.

4. ***Test high-value items:*** If there are items in the inventory that are of unusually high value, the auditors will likely spend extra time counting them in inventory, ensuring that they are valued correctly, and tracing them into the valuation report that carries forward into the inventory balance in the general ledger.

5. ***Test error-prone items:*** If the auditors have noticed an error trend in prior years for specific inventory items, they will be more likely to test these items again.

6. ***Test inventory in transit:*** There is a risk that company has inventory in transit from one storage location to another at the time of the physical count. Auditors test for this by reviewing transfer documentation.

7. ***Test item costs:*** The auditors need to know where purchased costs in accounting records come from, so they will compare the amounts in recent supplier invoices to the costs listed in inventory valuation.

8. ***Review freight costs:*** Company can either include freight costs in inventory or charge it to expense in the period incurred, but it need to be consistent in its treatment - so the auditors will trace a selection of freight invoices through accounting system to see how they are handled.

9. ***Test for lower of cost or market:*** The auditors must follow the lower of cost or market rule, and will do so by comparing a selection of market prices to their recorded costs.

10. ***Finished goods cost analysis:*** If a significant proportion of the inventory valuation is comprised of finished goods, then the auditors will want to review the bill of materials for a selection of finished goods items, and test them to see if they show an accurate compilation of the components in the finished goods items, as well as correct costs.

11. ***Direct labor analysis:*** If direct labor is included in the cost of inventory, then the auditors will want to trace the labor charged during production on time cards or labor routings to the cost of the inventory. They will also investigate whether the labor costs listed in the valuation are supported by payroll records.

12. ***Overhead analysis:*** If company apply overhead costs to the inventory valuation, then the auditors will verify that it is consistently using the same general ledger accounts as the source for its overhead costs, whether overhead includes any abnormal costs (which should be charged to expense as incurred), and test the validity and consistency of the method use to apply overhead costs to inventory.

13. ***Work-in-process testing:*** If company has a significant amount of work-in-process (WIP) inventory, the auditors will test how it determines a percentage of completion for WIP items.

Notes

14. ***Inventory allowances:*** The auditors will determine whether the amounts have recorded as allowances for obsolete inventory or scrap are adequate, based on company's procedures for doing so, historical patterns, "where used" reports, and reports of inventory usage (as well as by physical observation during the physical count). If it does not have such allowances, they may require you to create them.
15. ***Inventory ownership:*** The auditors will review purchase records to ensure that the inventory in company's warehouse is actually owned by the company (as opposed to customer-owned inventory or inventory on consignment from suppliers).
16. ***Inventory layers:*** If you are using a FIFO or LIFO inventory valuation system, the auditors will test the inventory layers that company has recorded to verify that they are valid.

Did u know? If the company uses cycle counts instead of a physical count, the auditors can still use the procedures related to a physical count. They simply do so during one or more cycle counts, and can do so at any time; there is no need to only observe a cycle count that occurs at the end of the reporting period. Their tests may also evaluate the frequency of cycle counts, as well as the quality of the investigations conducted by counters into any variances found.

10.5 Audit Procedure for Share Capital

Points to be considered for audit of share capital. A private limited company has two types of share capital:

1. ***Equity Share Capital:*** This type of share capital is that part of capital that is not a preferential. In other words it is the basic kind of capital or an ordinary share capital.
2. ***Preferential Share Capital:*** This part of capital has the following characteristics:
   - It carries a preferential right as to the payment of dividend over other type of capital.
   - It carries the preferential right as to payment of capital in case of winding up or repayment of capital over the over the other type of capital.

Special Points in Audit of Share Capital

In case of share capital issued by the company following points merit consideration of the auditor:

1. ***Authorization of the issue:*** Auditor should check the minutes of the meeting of the board of directors to check the authorization of the terms of the terms of the issue of share capital.
2. ***Vouching share applications:*** Auditor should test check the share application forms and vouches their respective entries in the cash book.
3. ***Legal requirement:*** It should be checked that the legal requirements as laid down by the companies act, SEBI and other regulatory bodies are met.
4. ***Compilation requirements:*** Auditor should check that various compilation requirement of various statements with the registrar of companies are met with.

While doing the audit of share capital auditor should vouch the following carefully:

1. Memorandum of association
2. Articles of association

Notes

3. Minutes of the directors meetings
4. Prospectus
5. Share application form
6. Letters of allotment
7. Letters of refund
8. Share registers
9. Cash book
10. Ledger accounts.

10.6 Audit of Investments

The procedures that are adopted by the auditor for auditing investments include: evaluating features of investments which have an impact on the audit procedures and the important aspects of audit of investments:

1. ***Internal Control Evaluation:*** Control over acquisition, accretion and disposal of investments, safeguarding of investments, controls in respect of title of investments, information controls.
2. ***Verification of Transactions:*** Authority to invest, legal requirements, supporting documents, terms of sale or purchase (ex or cum dividend/interest), rights issues, bonus issues.
3. ***Physical Verification:*** Responsibility of auditor, use of depository/custodial services by the client, scripless trading, timing of physical examination, investments held by others, investments not held in the name of the client vis a vis legal requirements, procedure in finance/chit fund/nidhi companies etc., immovable properties held as investments.
4. ***Examination of Valuation or Disclosures:*** Valuation and disclosure of investments vis a vis, compliance with Accounting Standard (AS) 13 and statutory requirements, method of valuation.
5. ***Analytical Procedures:*** Comparison of various ratios.
6. Management Representations
7. Documentation by the auditor.

Notes The legal requirements, including disclosure norms, relating to investments under certain prominent statutes, illustrative letter of confirmation for investments held by banks, and management representation letter for investments.

10.7 Audit Procedures for Fixed Assets

Financial statement audits are performed to provide reasonable assurance that an entity's financial statements are fairly presented in accordance with generally accepted accounting principles. To obtain this assurance, auditors examine material account balances. The fixed asset balance, which deals with assets that can't easily be converted into cash, is a common material account balance on an entity's financial statements. It is audited through procedures that confirm the existence and valuation of the reported account balance.

Notes

10.7.1 Gather Evidence

The auditor's client, or the auditee, provides the auditor with a detailed listing of items included in fixed asset accounts. The detailed list, or a depreciation schedule, includes a description of the asset, the original cost, method of depreciation, depreciable life and prior and current years' depreciation expense. The auditor reviews the list for reasonableness and determines if the account balance on the financial statements matches the depreciation schedule.

10.7.2 Perform Analytics

Analytical procedures encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts. For instance, auditors compare the current year account balance to the prior year balance and determine if the difference is reasonable. A financial statement ratio, such as "depreciation expense as a percentage of fixed assets," is also considered an analytic. The auditor tracks ratios for a period of three to five years and evaluates ratios that produce unexpected variances.

10.7.3 Review Documentation

Review invoices to determine the client correctly recorded acquisition costs and dispositions of assets. To test existence of fixed assets, the auditor selects a sample of items and matches the detail on the invoice to the detail on the client's depreciation schedule. While reviewing invoices, or vouching, the auditor checks the date of purchase, the description of the asset and other costs incurred to place the asset in service. In addition, an auditor reviews gain and loss accounts to determine if dispositions are correctly recorded.

10.7.4 Inquiry and Observation

The auditor asks the client about the location of fixed assets and any changes in value of existing assets. The client's response helps the auditor determine which fixed assets he selects to physically observe. While observing an asset, the auditor determines that the asset exists and that the asset's condition is comparable to the remaining life listed on the depreciation schedule.

10.7.5 Recalculation

Recalculation consists of checking the mathematical accuracy of documents and records. The auditor selects a sample of items from the fixed asset listing and recalculates prior and current depreciation expense. The auditor determines if the amounts are accurate and records any necessary adjustments.

Self Assessment

Fill in the blanks:

4. Auditing starts with the income section by confirming that the total revenue amount is equal to the sum of the .....
5. Owner's equity is the difference between the .....
6. Stocks should be valued at.....
7. Auditor should test check the share application forms and vouches their respective entries in the .....
8. The fixed asset balance, which deals with assets that can't easily be converted into cash, is a common ..... on an entity's financial statements.

Notes

10.8 Audit of Investment and Securitization Transactions

Funds management department of the bank is one of the most sensitive and dynamic areas of a bank's operations. At any point of time it accounts for about 40% of the total financial resources and more than 55-60% of a bank's income. Rules and regulations are generally laid down governing the functioning of the activity by virtue of an investment policy document duly approved by the Board, which is required to be in conformity with regulatory guidelines issued by Reserve Bank of India from time to time. The investments are categorized into SLR and non- SLR exposures.

The SLR investments are required to be maintained on daily basis in Liquid assets and required to be reported to Reserve Bank of India on a fortnightly basis. Failure to maintain the required statutory minimum would not only entail in payment of penalty and interest for the shortfall but also the regulatory actions in the form of increased supervisory interventions and ultimate cancellation of banking licence. The investments that qualify for SLR are, Central Government and other approved Securities, Bonds Guaranteed by Central/State Governments, Excess CRR balances, Current balances with SBI and nationalized banks, Cash in hand. All other investments constitute non-SLR investments.

The Reserve Bank of India has issued detailed guidelines on classification, valuation and operations of investment portfolio by banks. Specific guidelines are given in regard to Ready Forward (buy back) deals, Transactions through Subsidiary General Ledger A/c, Use of Bank Receipts, and Retailing of Government securities, Internal Control System, Dealings through Brokers, Audit, Review and reporting. Detailed guidelines have also been issued by Reserve Bank of India in regard to exposure in non-SLR investments.

The investment portfolios of banks (both SLR & non-SLR) are closely monitored by the Reserve Bank through the Offsite Monitoring of Returns (OSMOS) submitted by banks. Banks are required to classify all their investment exposures into three categories viz. 'Held to Maturity', 'Available for Sale' and 'Held for Trading'.

Did u know? Securitization is a process by which the future cash inflows of an entity (originator) are converted and sold as debt instruments called pay through or pass through certificates with a fixed rate of return to the holders of the debt instrument in the form of beneficial interest. The originator of a typical securitization, transfers a portfolio of homogenous financial assets to a Special Purpose Vehicle (SPV), normally a trust. The SPV is basically funded by investors.

In return for the transfer, the originator gets cash up-front on the basis of a mutually agreed valuation of the receivables. The transfer value of the receivables is done in such a manner so as to give the lenders a reasonable rate of return. In 'pass-through' and 'pay-through' securitizations, receivables are transferred to the SPV at the inception of the securitization, and no further transfers are made. All cash collections are paid to the holders of beneficial interests in the SPV (basically the lenders).

Objective

The objective of investments are statutory requirements and to deploy surplus liquidity and floats for generating optimum returns. The objectives of securitization transactions are several, which inter alia include higher credit rating and cheaper borrowings. They can be done by conversion of existing or future cash in-flows of any entity i.e. loans, trade receivables, credit card receivables, rent etc. into tradable security. Securitization can, at times, be used for better

Notes

profitability. The importance of securitization lies in the fact that it helps to convert illiquid assets or future receivables into current cash inflows and that too at a low cost. The company may sell the receivables in the market and raise loans.

Caution The guidelines on Securitization of Standard assets (RBI guidelines) may be referred as and when required. It may be noted that these guidelines are applicable to bankers, financial institutions and non-banking financial companies.

10.9 Internal Control System

The auditors must ensure that the guidelines issued by the RBI in regard to the Internal Control System are strictly adhered to. There should be a clear functional separation of (i) trading, (ii) settlement, monitoring and control and (iii) accounting. Similarly, there should be a functional separation of trading and back office functions relating to bank's own Investment Accounts, Portfolio Management Scheme (PMS) Clients' Accounts and other Constituents (including brokers') accounts.

For every transaction entered into, the trading desk should prepare a deal slip which should contain data relating to nature of the deal, name of the counter-party, whether it is a direct deal or through a broker, and if through a broker, then name of the broker, details of security, amount, price, contract date and time. The deal slips should be serially numbered and controlled separately to ensure that each deal slip has been properly accounted for. For PMS transactions separate serial number should be maintained. Once the deal is concluded, the dealer should immediately pass on the deal slip to the back office for recording and processing. For each deal there must be a system of issue of confirmation to the counter-party. The timely receipt of requisite written confirmation from the counter-party, which must include all essential details of the contract, should be closely monitored by the back office.

Transactions put through the NDS-OM module do not warrant counter-party confirmation. All other government securities transactions/deals would require physical confirmations by the counter party. On the basis of vouchers passed by the back office (which should be done after verification of actual contract notes received from the broker/counter-party and confirmation of the deal by the counter-party), the Accounts Section should independently write the books of account. It must be ensured that the counterparty bank or the security purchased/sold should not be substituted. With regard to Subsidiary General Ledger (SGL) related transactions, the records of transfers must be maintained, the balances in bank's books must be matched with the statements received from the Public Debt Offices (PDOs) and reconciled on a quarterly basis. Before issue of SGL transfer forms covering their sale transactions, it should be ensured that sufficient balances are available in the respective.

No ready-forward and double ready-forward deals should be put through in any security including government securities on behalf of Portfolio Management Scheme (PMS) client's account or on behalf of other constituents including brokers.

A record of BRs issued/received, which are serially numbered, should be maintained and a system for verification of the authenticity of the BRs and SGL transfer forms received from the other banks and confirmation of authorized signatories should be put in place. It should be ensured that no bank receipts are issued under any circumstances in respect of transactions in government securities for which SGL facility is available. No BR should be issued on the basis of a BR (of another bank) held by the bank and no exchange should take place on the basis of exchange of BRs held by the bank. No BR should remain outstanding for more than 15 days.

Notes

Banks should put in place a reporting system to report to the top management, on a weekly basis, the details of transactions in securities, details of bouncing of SGL transfer forms issued by other banks, BRs outstanding for more than 15 days, capital market exposures, a review of investment transactions undertaken during the period and overall risk management and internal controls.

The internal audit department should audit the transactions in securities on an on-going basis, monitor the compliance with the laid down management policies and prescribed procedures and report the deficiencies directly to the management of the bank. In regard to securitisation transactions depending upon their categorisation i.e. if they are investments then the internal controls as referred hereinabove may be applied otherwise as applicable to advances may be applied.

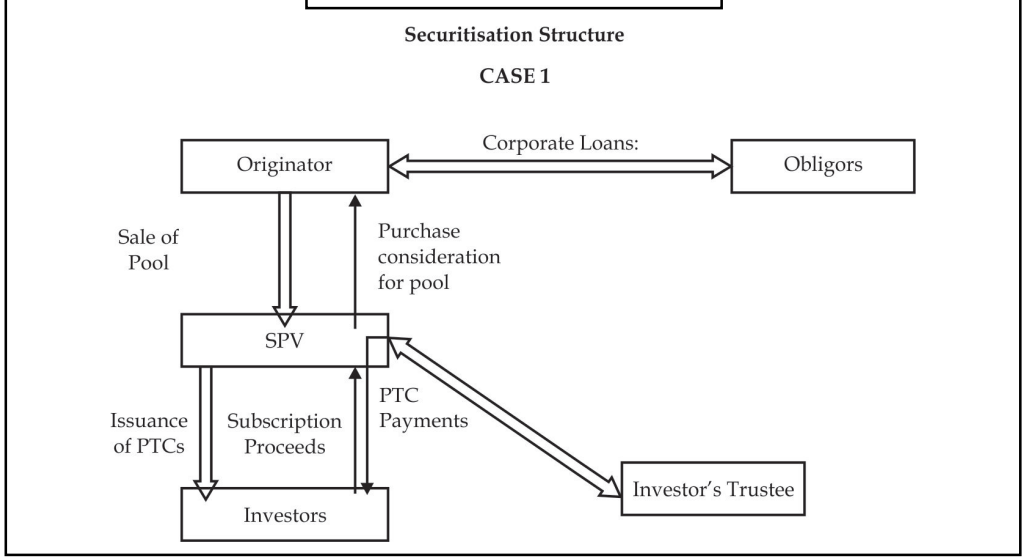
Caution Under no circumstances should an SGL transfer form be issued in favor of another bank, resulting in bouncing back for want of sufficient balances. In such an event the selling bank issuing the form would be liable to penal action by RBI against it.

All Ready-forward deals in Government Securities including Treasury bills are prohibited.

10.9.1 Special Purpose Vehicle (SPV)

An SPV is an entity specially created for doing the securitization deal. It invites investments from investors, uses the invested funds to acquire the receivables of the originator and then uses the realizations from the receivables transferred to it to pay the investors, thereby giving them a reasonable return. An SPV may be a trust, corporation, or any other legal entity. Its activities include holding title to transferred financial assets, issuing beneficial interest, collecting cash proceeds from assets held, reinvesting the proceeds in financial instruments pending distribution to the holders of beneficial interests and otherwise servicing the assets held. Generally, the beneficial interests in the qualifying SPV are sold to investors and the proceeds are used to pay the transferor for the assets transferred. Those beneficial interests may comprise either a single class having equity characteristics or multiple classes of interests, some having debt characteristics and others having equity characteristics.

Figure 10.1: Special Purpose Vehicle



Notes

The cash collected from the portfolio is distributed to the investors and others as specified by the legal documents that establishes the SPV.

The process of securitization of receivables normally has the following two stages, i.e. in the first stage there should be pooling and transferring of homogenous assets to a bankruptcy remote vehicle (SPV) and the second stage comprises of repackaging and selling the security interests represented by the claims on the incoming cash flows from the pool of assets, to the third party investors should be effected.

The micro stages involved are:

1. The originator identifies the assets he wants to securitize for raising funds.
2. The SPV is formed.
3. The SPV is funded by investors and the SPV issues the securities to the investors. This referred to as financial closure.
4. The SPV acquires the receivables under an agreement at their discounted value.
5. The servicer for the transaction is appointed, normally the originator.
6. The debtors are/are not notified depending on the legal requirements.
7. The servicer collects the receivables, usually in an escrow mechanism and water fall arrangement, and pays off the collection to the SPV.
8. The SPV either passes the collection to the investors, or reinvests the same to pay off to investors at stated pre-determined intervals.
9. In case of default, the servicer takes action against the debtors as the SPV agent.
10. When only a small amount of outstanding receivables are left to be collected, the originator may clean up the transaction by buying back the outstanding receivables.
11. At the end of the transaction, the originator's profit, if retained and subject to any losses and expenses to the extent agreed upon by the originator, in the transaction is paid off.

Notes Securitization transactions cannot be undertaken without an SPV.

10.9.2 Independent Assessment of SPV

For ensuring the SPV remaining independent the auditors must ensure the following:

1. The originating bank transferring the assets to the SPV should not hold any interest, direct or indirect in the Trustee Company. The originator should under no circumstances support losses of SPV. The Trust should be non-discretionary. The decision-making or the disguised substance that the originating bank continues to dominate the transactions must be identified. The transactions should be at arm's length, auditors would have a crucial role to play in ensuring that the comparable market quotations are available on records and the investment instruments (PTCs) are independently rated.
2. ***True Sale Compliance:*** For ensuring true sale of the pool by the Originator to the SPV, certain conditions with regard to establishment of no investments in the SPV except limited to 5 %, the originator should not have any interest or commitment whatsoever for repurchase of assets. Except clean up calls and non-maintenance of effective control over transferred assets, all risk and rewards should have been transferred along with the assets.

Notes

3. ***Classification:*** All outflows and PTCs or share in securitized assets may be classified into Investments or Advances. Generally these are instruments, which are independently realizable at will and classified as investments under non-SLR category. The above investment should be carried in the books of the bank/FI at the price as determined above, until its ultimate sale or realization, and on such sale or realization; the loss or gain must be dealt with as under:

   (a) If the sale to SC/RC is at a price below the Net Book Value (NBV) (i.e. Book value less provisions held), the shortfall should be debited to the profit and loss account of that year.

   (b) If the sale is for a value higher than the NBV, the excess provision will not be reversed but will be utilised to meet the shortfall/loss on account of sale of other financial assets to SC/RC.

   All instruments received by banks/FIs from SC/RC as sale consideration for financial assets sold to them and also other instruments issued by SC/RC in which banks/FIs invest, will be in the nature of non-SLR securities. Accordingly, the valuation, classification and other norms applicable to investment in non-SLR instruments prescribed by RBI from time to time would be applicable to bank's/FI's investment in debentures/bonds/security receipts/PTCs issued by SC/RC. However, if any of the above instruments issued by SC/RC is limited to the actual realization of the financial assets assigned to the instruments in the concerned scheme the bank/FI shall reckon the Net Asset Value (NAV), obtained from SC/RC from time to time, for valuation of such investments. There are exceptions where certain bonds or subscriptions to equities for projects are termed as Advances.

4. ***Sub-classification:*** The entire investment portfolio of the banks (including SLR securities and non-SLR securities) should be classified under three categories viz. 'Held to Maturity', 'Available for Sale' and 'Held for Trading'. However, in the Balance sheet, the investments will continue to be disclosed as per the existing six classifications viz. (a) Government securities, (b) Other approved securities, (c) Shares, (d) Debentures & Bonds, (e) Subsidiaries/ joint ventures and (f) Others (CP, Mutual Fund Units, etc.). Banks should decide the category of the investment at the time of acquisition and the decision should be recorded on the investment proposals.

   Held To Maturity: The securities acquired by the banks with the intention to hold them up to maturity will be classified under Held to Maturity. (Banks are allowed to include investments included under 'Held to Maturity' category up to 25 per cent of their total investments). SLR securities up to 25 per cent of their Demand and Time Liabilities (DTL) as on the last Friday of the second preceding fortnight, Non-SLR securities included under HTM as on September 2, 2004, Fresh re-capitalization bonds received by the bank from the Government of India towards their re-capitalization requirement and held in their investment portfolio, Fresh investment in the equity of subsidiaries and joint ventures (holds more than 25 per cent of the equity) and RIDF/ SIDBI deposits.

10.9.3 Available For Sale & Held for Trading

The securities acquired by the banks with the intention to trade by taking advantage of the short-term price/ interest rate movements will be classified under Held for Trading. The securities which do not fall within the above two categories will be classified as 'Available for sale'

1. ***Available For Sale:*** The banks will have the freedom to decide on the extent of holdings under Available for Sale and Held for Trading categories. This will be decided by them after considering various aspects such as basis of intent, trading strategies, risk management

Notes

capabilities, tax planning, manpower skills, capital position. The investments classified under Held for Trading category would be those from which the bank expects to make a gain by the movement in the interest rates/market rates. These securities are to be sold within 90 days.

2. ***Shifting among Categories:*** Banks may shift investments to/from Held to Maturity category with the approval of the Board of Directors once a year. Such shifting will normally be allowed at the beginning of the accounting year. No further shifting to/from this category will be allowed during the remaining part of that accounting year. Banks may shift investments from Available for Sale category to Held for Trading category with the approval of their Board of Directors/ALCO/Investment Committee. In case of exigencies, such shifting may be done with the approval of the Chief Executive of the bank/Head of the ALCO, but should be ratified by the Board of Directors/ALCO. Shifting of investments from Held for Trading category to Available for Sale category is generally not allowed. However, it will be permitted only under exceptional circumstances like not being able to sell the security within 90 days due to tight liquidity conditions, or extreme volatility, or market becoming unidirectional.

   Such transfer is permitted only with the approval of the Board of Directors/ALCO/ Investment Committee. Transfer of scripts from one category to another, under all circumstances, should be done at the acquisition cost/book value/market value on the date of transfer, whichever is the least, and the depreciation, if any, on such transfer should be fully provided for. Banks may apply the values as on the date of transfer and in case, there are practical difficulties in applying the values as on the date of transfer, banks have the option of applying the values as on the previous working day, for arriving at the depreciation requirement on shifting of securities.

3. ***Profit and Loss:*** All Profit on sale of investments should be taken to profit and loss account except in case of HTM which should be first taken to the Profit & Loss Account and thereafter be appropriated to the 'Capital Reserve Account'. Loss on sale to be always recognized in the Profit & Loss Account.

10.10 Audit, Review and Reporting of Investment Transactions

The banks should follow the following instructions in regard to audit, review and reporting of investment transactions:

1. Banks should undertake a half-yearly review (as of 30th September and 31st March) of their investment portfolio, which should, apart from other operational aspects of investment portfolio, clearly indicate amendments made to the Investment Policy and certify adherence to laid down internal investment policy and procedures and Reserve Bank guidelines, and put up the same before their respective Boards within a month, i.e. by end-April and end-October.

2. A copy of the review report put up to the Bank's Board, should be forwarded to the Reserve Bank (concerned Regional Office of DBS) by 15th November and 15th May respectively.

3. Treasury transactions should be separately subjected to concurrent audit by internal auditors and the results of their audit should be placed before the CMD of the bank once every month. Banks need not forward copies of the above mentioned concurrent audit reports to Reserve Bank of India. However, the major irregularities observed in these reports and the position of compliance thereto may be incorporated in the half yearly review of the investment portfolio.

Notes

4. All securitization transactions must be reviewed to ensure the following:
   (a) Controls over receivables on due dates,
   (b) Ratio of non-performing assets in the portfolio in relation to agreed % at the time of takeover (though RBI only permits securitisations of standard assets),
   (c) maintenance and disclosure of cash collaterals,
   (d) compliance with terms of agreement,
   (e) availability of financials of SPV to assess value in books of investors in PTC and reports from collecting agent on recovery transferred to SPV.

10.10.1 Valuation

Held to Maturity

1. Investments classified under Held to Maturity category need not be marked to market and will be carried at acquisition cost, unless it is more than the face value, in which case the premium should be amortized over the period remaining to maturity.
2. Banks should recognize any diminution, other than temporary, in the value of their investments in subsidiaries/joint ventures which are included under Held to Maturity category and should be provided for. Such diminution should be determined and provided for each investment individually.

Available for Sale

The individual scripts in the Available for Sale category will be marked to market at quarterly or at more frequent intervals. Securities under this category shall be valued scrip-wise and depreciation/appreciation shall be aggregated for each classification. Net depreciation, if any, should be provided for. Net appreciation, if any, should be ignored. Net depreciation required to be provided for in any one classification should not be reduced on account of net appreciation in any other classification. The book value of the individual securities would not undergo any change after the marking to market.

Held for Trading

The individual scripts in the Held for trading category will be marked to market at monthly or at more frequent intervals and provided for as in the case of those in the Available for Sale category. Consequently, the book value of the individual securities in this category would also not undergo any change after marking to market.

Investment Fluctuation Reserve

Banks have been advised to build up Investment Fluctuation Reserve (IFR) of a minimum 5 per cent of the investment portfolio within a period of 5 years.

Investment Reserve Account

In the event, provisions created on account of depreciation in the 'Available for Sale' or 'Held for Trading' categories are found to be in excess of the required amount in any year, the excess should be credited to the Profit & Loss account and an equivalent amount (net of taxes, if any and

Notes

net of transfer to Statutory Reserves as applicable to such excess provision) should be appropriated to an Investment Reserve Account in Schedule 2 –"Reserves & Surplus" under the head "Revenue and other Reserves" and would be eligible for inclusion under Tier II within the overall ceiling of 1.25 per cent of total Risk Weighted Assets prescribed for General Provisions/ Loss Reserves.

Banks may utilize Investment Reserve Account for provisions required to be created on account of depreciation in the AFS and HFT categories.

Market Value

The 'market value' for the purpose of periodical valuation of investments included in the Available for Sale and Held for Trading categories would be the market price of the scrip as available from the trades/quotes on the stock exchanges, SGL account transactions, price list of RBI, prices declared by Primary Dealers Association of India (PDAI) jointly with the Fixed Income Money Market and Derivatives Association of India (FIMMDA) periodically. In respect of unquoted securities, the procedure as detailed below should be adopted.

1. ***Unquoted SLR Securities:*** Central Government Securities—the prices/ YTM rates put out by the PDAI/ FIMMDA at periodical intervals. Treasury Bills should be valued at carrying cost.
2. ***State Government Securities***—valued applying the YTM method by marking it up by 25 basis points above the yields of the Central Government Securities of equivalent maturity put out by PDAI/ FIMMDA periodically.
3. ***Other 'APPROVED' Securities***—valued applying the YTM method by marking it up by 25 basis points above the yields of the Central Government Securities of equivalent maturity put out by PDAI/ FIMMDA periodically.
4. ***Unquoted Non-SLR Securities:*** Debentures/Bonds—in the nature of advance should be valued on the YTM basis.
   (a) *Zero coupon bonds:* Zero coupon bonds should be shown in the books at carrying cost, i.e., acquisition cost plus discount accrued at the rate prevailing at the time of acquisition, which may be marked to market with reference to the market value.
   (b) *Preference Shares:* The valuation of preference shares should be on YTM basis.
   (c) *Equity shares:* The equity shares in the bank's portfolio should be marked to market preferably on a daily basis, but at least on a weekly basis.
   (d) *Mutual funds units:* Investment in quoted Mutual Fund Units should be valued as per Stock Exchange quotations. Investment in unquoted Mutual Fund Units is to be valued on the basis of the latest re-purchase price declared by the Mutual Fund in respect of each particular Scheme. In case of funds with a lock-in period, where repurchase price/market quote is not available, Units could be valued at NAV. If NAV is not available, then these could be valued at cost, till the end of the lock-in period. Wherever the re-purchase price is not available the Units could be valued at the NAV of the respective scheme.
   (e) *Commercial Paper:* Commercial paper should be valued at the carrying cost.
   (f) *Investments in RRBs:* Investment in RRBs is to be valued at carrying Cost (i.e. book value) on consistent basis.

Notes

Investment in Securities Issued by SC/RC

All such investments to be valued at lower of cash consideration or redemption value of the investments.

Valuation/Provisioning Norms

When banks/FIs invest in the security receipts/pass-through certificates issued by Securitization Company (SC)/Reconstruction Company (RC) in respect of the financial assets sold by them to the SC/RC, the sale shall be recognized in books of the banks/FIs at the lower of:

1. the redemption value of the security receipts/pass through certificates, and v the NBV of the financial asset.
2. the cash consideration paid.

The above investment should be carried in the books of the bank/FI at the price as determined above until its sale or realization, and on such sale or realization, the loss or gain must be dealt with as under:

1. If the sale to SC/RC is at a price below the net book value (NBV) (i.e. Book value less provisions held), the shortfall should be debited to the profit and loss account of that year.
2. If the sale is for a value higher than the NBV, the excess provision will not be reversed but will be utilized to meet the shortfall/loss on account of sale of other financial assets to SC/RC.

All instruments received by banks/FIs from SC/RC as sale consideration for financial assets sold to them and also other instruments issued by SC/RC in which banks/FIs invest will be in the nature of non-SLR securities. Accordingly, the valuation, classification and other norms applicable to investment in non-SLR instruments prescribed by RBI from time to time would be applicable to bank's/FI's investment in debentures/bonds/security receipts/PTCs issued by SC/RC. However, if any of the above instruments issued by SC/RC is limited to the actual realization of the financial assets assigned to the instruments in the concerned scheme of the bank/FI shall reckon the Net Asset Value (NAV), obtained from SC/RC from time to time, for valuation of such investments.

10.10.2 Non-performing Investments

In respect of securities included in any of the three categories where interest/ principal is in arrears, the banks should not reckon income on the securities and should also make appropriate provisions for the depreciation in the value of the investment. The banks should not set-off the depreciation requirement in respect of these non-performing securities against the appreciation in respect of other performing securities.

A Non-performing Investment (NPI), similar to a Non-performing Advance (NPA), is one where:

1. Interest/installment (including maturity proceeds) is due and remains unpaid for more than 90 days.
2. The above would apply mutates mutandis to preference shares where the fixed dividend is not paid.
3. In the case of equity shares, in the event the investment in the shares of any company is valued at ₹ 1 per company on account of the non availability of the latest balance sheet in accordance with the instructions contained in paragraph 28 of the Annexure to circular DBOD.BP.BC.32/ 21.04.048/ 2000-01 dated October 16, 2000, those equity shares would also be reckoned as NPI.

Notes

4. If any credit facility availed by the issuer is NPA in the books of the bank, investment in any of the securities issued by the same issuer would also be treated as NPI and vice versa.
5. The investments in debentures/bonds, which are deemed to be in the nature of advance would also be subjected to NPI norms as applicable to investments.

State Government Guaranteed Investments: All investments in State Government guaranteed securities, including those in the nature of 'deemed advance', will attract prudential norms for identification of non-performing investments and provisioning, when interest/installment of principal (including maturity proceeds) or any other amount due to the bank remains unpaid for more than 90 days.

10.10.3 Income Recognition

Banks may book income on accrual basis on securities of corporate bodies/public sector undertakings in respect of which the payment of interest and repayment of principal have been guaranteed by the Central Government or a State Government, provided interest is serviced regularly and as such is not in arrears. Banks may book income from dividend on shares of corporate bodies on accrual basis provided dividend on the shares has been declared by the corporate body in its Annual General Meeting and the owner's right to receive payment is established.

Banks may book income from Government securities and bonds and debentures of corporate bodies on accrual basis, where interest rates on these instruments are pre-determined and provided the past interest is serviced regularly and is not in arrears.

Banks should book income from units of mutual funds on cash basis.

Since it is very difficult to condense all the provisions of the RBI guidelines in this article it would be desirable for the auditors examining the investment portfolio of a bank to be thoroughly familiar with these guidelines and also the bank's own policy document on investment before commencing the audit.

10.11 Depreciation

1. Check the depreciation rates as provided in Company's act, 1956.
2. Check whether there is any addition made during the year, if yes then check whether depreciation is correctly charged from the date of purchase till last date of a/c year.
3. Check whether there is sale of any asset and if yes den check its treatment given by the company.
4. Scrutinize all the original documents supporting any additions made by the company in case of fixed assets and cross tally the amount debited to FA a/c with such documents.
5. Also check application of AS-10 & AS-6 whether it has been correctly applied by the management.
6. See whether all the assets added and sold by the management are properly authorized by passing resolution for it.
7. Also check the internal policy if any of the company. These are some of the imp points that you need to keep in mind while doing audit of asset & dep.

10.11.1 Straight-Line Depreciation

Depreciation is an income tax deduction allowance that provides tax payers the ability to recover the cost of a property and is based on an "annual allowance for the wear and tear, deterioration,

Notes

or obsolescence of the property." Most types of tangible property (except land), including buildings, furniture, machinery, and equipment are depreciable. Depreciable intangible property includes patents, copyrights and software. Under straight-line methods, a property's value is depreciated at a constant dollar value per year over its expected life span.

10.11.2 Modified Accelerated Cost Recovery System (MACRS)

The MACRS depreciation model is used for calculating business income taxes and not determining the value of a company. Under this depreciation regime the asset depreciation calculation is based on a staggered formula, whereupon asset classes are designated a life span, such as automobiles and light trucks, whose useful life cycle is 5 years. Then, a certain percentage depreciation allowance is assigned to each year, as given in MACRS depreciation tables. This formula depreciates the asset to zero, with no residual or "salvage" value associated with the asset.

10.12 How to Deduct Office Equipment and Furniture?

This article was created by a professional writer and edited by experienced copy editors, both qualified members of the Demand Media Studios community. All articles go through an editorial process that includes subject matter guidelines, plagiarism review, fact-checking, and other steps in an effort to provide reliable information. When it comes to office equipment and furniture, there are several ways you can deduct the purchase costs as business expenses. Which way you choose may depend how much the equipment or furniture cost or what your financial situation is at the time.

Instructions

1. Keep the receipts for all office equipment and furniture purchased over the taxable year. You will not have to produce these receipts to file your taxes, but they will be necessary to prove your claim should you be audited.
2. Determine whether the new office equipment or furniture you acquired is depreciable. Depreciable assets are defined as having a determinable life span exceeding one year and for which a value can be calculated.
3. Decide whether you want to take a Section 179 deduction. A Section 179 deduction allows you to take a full or partial deduction for the entire cost of the office equipment or furniture in lieu of deducting the depreciated portion. If the financial situation of your business is such that a significant reduction in income would provide needed financial relief, this is a good option.
4. Determine whether you want to take the deduction as a depreciable asset. The benefit of choosing to treat office furniture and equipment as a depreciable asset is that you can spread the deduction over many years. There are usually years in which a business purchases more of such assets than others, and it's nice to be able to count on taking a deduction in future years.
5. Use the MACRS Depreciation model (the most commonly used depreciation model for business property) to calculate the depreciation of the office furniture and equipment you intend to deduct from your income taxes. The IRS gives detailed instructions about how calculate the depreciation on property in its Publication 946 (see Resources below).
6. Use form 4562 to record section 179 deductions and what you deduct as depreciating property. This form is attached to your tax returns.

Notes

Caution Most office equipment and furniture is classified as a five- or seven-year depreciation. Computers and other machinery used in an office usually depreciate in five years. Furniture and fixtures usually depreciate in seven years.

Self Assessment

State whether the following statements are true or false:

9. All cash collections are paid to the holders or lenders of beneficial interests in the SPV.
10. For PMS transactions separate serial number need not be maintained.
11. The objective of Investments are statutory requirements and to deploy surplus liquidity and floats for generating optimum returns.
12. The originating bank transferring the assets to the SPV should not hold any interest, direct or indirect in the Trustee Company.
13. Depreciable assets are defined as having a determinable life span exceeding one year and for which a value can be calculated.

10.13 Summary

- The auditor's report must accompany the financial statements when they are issued to the intended recipients.
- The primary stages of an audit are: Planning and risk assessment; Internal controls testing and Substantive financial procedures.
- An income statement audit can help isolate mathematical errors and ledger discrepancies
- Inventory audit procedures that auditors' may follow: Cutoff analysis; Observe the physical inventory count; Reconcile the inventory count to the general ledger; Test high-value items; Test error-prone items; Test inventory in transit; Test item costs; Review freight costs; Test for lower of cost or market; Finished goods cost analysis; Direct labor analysis; overhead analysis; Work-in-process testing; Inventory allowances; Inventory ownership; Inventory layers, etc.
- In case of share capital issued by the company following points merit consideration of the auditor: Authorization of the issue; Vouching share applications; Legal requirement; Compilation requirements.
- The procedures that are adopted by the auditor for auditing investments include: Internal Control Evaluation; Verification of Transactions; Physical Verification; Examination of Valuation or Disclosures; Analytical Procedures; Management Representations; Documentation by the auditor.
- The fixed asset balance, which deals with assets that can't easily be converted into cash, is a common material account balance on an entity's financial statements. It is audited through procedures that confirm the existence and valuation of the reported account balance.
- The auditors must ensure that the guidelines issued by the RBI in regard to the Internal Control System are strictly adhered to. There should be a clear functional separation of (i) trading, (ii) settlement, monitoring and control and (iii) accounting.

Notes

10.14 Keywords

Fixed Asset: A long-term tangible piece of property that a firm owns and uses in the production of its income and is not expected to be consumed or converted into cash any sooner than at least one year's time. Fixed assets are sometimes collectively referred to as "plant."

Modified Accelerated Cost Recovery System (MACRS): The MACRS depreciation model is used for calculating business income taxes and not determining the value of a company.

10.15 Review Questions

1. Briefly explain the audit procedure of an income statement.
2. What do you understand by audit of financial statements? Why it is needed and give brief notice of various steps involved in carrying out financial statement audit?
3. Discuss Audit procedure for position statement with respect to depreciation of fixed asset.
4. What are the various methods applied by auditors for carrying out valuation of inventory?
5. Briefly explain the audit of share capital, reserve and surplus, current assets and liabilities.
6. Describe audit procedure for investment and securitization of investment.
7. Write short notes on
   (a) SPV's
   (b) Methods of calculating depreciation

Answers: Self Assessment

1. Comparisons between historical and current-year data; evaluations of key ratios; appraisals of financial trends
2. Internal controls testing
3. Credit risk
4. income lines
5. revenue and expenses
6. net realizable value
7. cashbook
8. material account balance
9. True
10. False
11. True
12. True
13. True

10.16 Further Readings

Notes

Books

David Coderre, *Internal Audit: Efficiency through Automation*, John Wiley & Sons, 2009.

Emile Woolf, Moira Hindson, *Audit and Accountancy Pitfalls: A Casebook for Practising Accountants*, Lawyers and Insurers, John Wiley & Sons, 2011.

Iain Gray, Stuart Manson, *The Audit Process: Principles, Practice and Cases*, Cengage Learning EMEA, 2007.

Jeanette Franzel, *Single Audit: Opportunities exist to improve the Single Audit Process and Oversight*, DIANE Publishing, 2009.

Susan Switzer, *Internal Audit Reports Post Sarbanes-Oxley: A Guide to Process-Driven Reporting*, John Wiley & Sons, 2007.

Online links

www.asiatradehub.com/india/tr9.asp

www.auditservices.com/aevidence.html

www.investopedia.com/terms/a/auditing-evidence.asp#ixzz1x6PIvbTg

www.informationbible.com/article-auditing-in-depth-111904.html

Notes

Unit 11: Appointment, Right, Duties and Liabilities of an Auditor

CONTENTS

Notes

Objectives

After studying this unit, you will be able to:

- Discuss procedure for appointment of an auditor;
- Know qualification of a person to become an auditor;
- State disqualifications of an auditor;
- Know about Rights, Duties and Liabilities of an Auditor;
- Discuss about auditor's report.

Introduction

Unit explains the appointment of an auditor and basic qualifications of a person to become an auditor and disqualifications of an auditor under Section 226 and 254. Rights, Duties and Liabilities of an Auditor under Section 255 are also described with suitable examples and cases.

11.1 Appointment of an Auditor

Qualification of an Auditor [Section 226 (1) and (2)]

Following persons are qualified to be appointed as auditor of a company:

1. ***Practicing Chartered Accounts [Sec. 226(1)J]:*** A person shall not be qualified for appointment as auditor of a company unless he is a Chartered Accountant within the meaning of the Chartered Accountant Act 1949. A Chartered Accountant means a person who is the member of the Institute of Chartered Accountant of Pakistan. He will be deemed to be in practice. When individually or in partnership with other Chartered Accountants in practice him for consideration received or to be received.

2. ***Practice of Accountancy:*** He engages himself in the practice of accountancy.

3. ***Verification:*** He offers to perform or performs the services involving the auditing or verifications of the financial transactions, books of accounts or records or the preparation, verification or certification of financial accounting and related statement or holds himself out to the public as an accountant.

4. ***Professional Services:*** He renders the professional services or assistance in or about matters of principal or detail relating to accounting procedure to the recording, presentation or certification of financial facts or data.

5. ***Renders the Services:*** Renders the services as, in the opinion of the council are or may be renders by a chartered accountant in practice.

6. ***Certified Auditor [Sec 226 (2)]:*** A part from practicing chartered accountants, a person holding a certificate under the Restricted Auditor's Certificate Rules, 1965 is also qualified to be appointed as auditor of a company. Such certified auditors are subject to the rules framed in this behalf by the Central Government. The object of the provisions as to qualify is to ensure that only persons of proven worth and standing and under the discipline of a statutory body are appointed as auditor.

Notes

Disqualification {Sec 226 (3)(4)(5)}

The following person cannot become the auditor of the company (Section 254):

1. A body corporate
2. An officer or employee of the company
3. A person who is the employment of an officer or employee of the company.
4. A person who is indebted to the company for an amount exceeding ₹ 1000 or who has given any guarantee of any third person to the company for an amount exceeding ₹ 1000.
5. The spouse of a director of the company.
6. A person who was a director other officer or employee of the company at any time during the preceding three years.
7. A person who is a partner of a director, officer or employee of a company

According to Section 226(4) a person shall not be qualified for appointment as auditor of anybody corporate. Further if the auditor already holds the appointment as auditor in the specified number of companies as per Section {Section 224(1-13)}, he will be disqualified for further appointment as auditor in any other company.

Apart from the disqualifications laid down in Section 226, the Institute of Chartered Accountants of India has prepared its own code of ethics which is mandatory for its members. In order to ensure independence of the auditors and also to prevent conflict of interest and duty, the Council has decided not to permit a Chartered Accountant in employment to certify the financial statements of the concern in which he is employed, or of a concern under the same management as the concern in which he is employed, even though he is holding a certificate of practice and even though such certification can be done by any chartered accountant in practice. This restriction does not apply where the certification is permitted by any law. Further, it has also been decided that a chartered accountant should not by himself or in his firm name: –(1) accept the auditorship of a collage, if he is working as a part-time lecturer in the college. (2) Accept the auditorship of a trust where his partner is either an employee or a trustee of the trust.

11.2 General Rule of Appointment

To ensure compliance with the statutory requirements and accountability to the shareholders, Section 224 of the Companies Act, 1956 makes the appointment of an auditor or auditors by the company in general meeting, before which accounts are laid, mandatory. An auditor thus appointed at a general meeting holds office from the conclusion of that meeting until the conclusion of the next such annual general meeting. The appointment of auditors at the AGM ensures that they are appointed by the shareholders. The exception to this rule of appointment at the annual general meeting is the appointment of the first auditor/auditors by the board of directors of a company. The Board of Directors of the company have to appoint the first auditor within one month from the date of its registration. Such auditors hold office until the conclusion of the first annual general meeting. If the Board fails to appoint the first auditor, the company may do so at the first annual general meeting. The remuneration of the first auditor is fixed by the Board or the general meeting as the case may be. The company may, at a general meeting, remove the first auditor appointed by the Board and appoint in its place another auditor, of whose nomination a special notice has been given. An auditor appointed in the above manner should be informed of his appointment within seven days and he is required to inform the Registrar within thirty days whether or not he has accepted the appointment. The obligation to give notice to the Registrar is cast only on auditors appointed under sub-section (1) of

Section 224. Persons appointed as auditors under other sub-sections need not inform the Registrar. Hence, the first auditors who are appointed by the Board of Directors are under no obligation to inform the Registrar.

Casual Vacancy

A casual vacancy is a vacancy of temporary nature that may occur during the currency of the year after an appointment is made by the company at its general meeting. Thus, a casual vacancy is not one created by a deliberate omission on the part of the company to appoint an auditor at its general meeting. It denotes a vacancy caused by a validly appointed auditor ceasing to act as such, due to death, disqualifications, etc. The auditor appointed in a casual vacancy shall hold office till the conclusion of the next annual general meeting.

Ceiling on Number of Company Audits

Before an appointment or reappointment of auditors is made, a certificate in writing is required by the company from the auditor regarding compliance of ceiling limit on total number of audits. Sub-section (1B) places a ceiling on the number of company-audits which a Chartered Accountant in full time employment, or a firm of Chartered Accountants, can conduct. The limitation on number of company audits vide Explanation I and II is applicable to i) a member of the Institute of Chartered Accountants of India who, while being in whole-time employment elsewhere, also holds operating agency certificate of practice from the Institute, and ii) a practicing firm of Chartered Accountants. In other words, the section does not cover (a) a Chartered Accountant, who, while in part-time employment elsewhere, holds a certificate of practice from the Institute, and (be) a Chartered Accountant who is practicing in his sole capacity (that is, as a proprietor) and not as a partner of a firm of Chartered Accountants. As per the Companies Act, the 'specified number' of company audits which a auditor is allowed to handle, that is, the overall ceiling limit on company audits is twenty. Of these twenty companies, not more than ten should be companies should have a paid up capital of ₹ Twenty-five lakhs or more. In the case of a firm, the specified number is to be calculated with reference to each partner in the firm, who is not in full time employment elsewhere. For the purpose of ceiling on number of company audits in the case of a partner of a firm who is also a partner in another firm, the total number of audits held by him individually or by different firms on his account should be taken into consideration. In computing the number of audits for the above purpose, joint audits are to be taken into account, that is, each of the firms appointed as joint auditors of a company shall count the audit assignment as one company audit. An important question which has arisen is with regard to whether the audit of the branches of Indian companies and the audits of the Indian business of foreign companies which have established places of business in India and are doing business in India are to be taken into account while calculating the specified number of company audits a company can take up. The Department of Company Affairs has clarified that the branch audits are not to be included while calculating the specified number. The Branch auditor of an Indian company appointed under section 28 audits the accounts of the specific branch only for which he is appointed and forwards his report to the auditor appointed under section 224 of the Act. Hence the branch auditor cannot be equated with the company auditor appointed under section 224 of the Act who has to report to the annual general meeting on the accounts of the company as a whole including the accounts audited by the branch auditor. With regard to the auditing of the accounts of foreign companies, the Department has clarified that since the definition of companies under section 3 of the Act does not include foreign companies, they are outside the scope of Section 224 of the Companies Act. Therefore, the accounts of foreign companies are also not to be included within the specified number of twenty. Also, since there is no legal requirement under the Companies Act to prepare consolidated accounts or group accounts and a subsidiary is considered to be a separate legal entity, no responsibility is cast upon the auditors of the holding company in respect of the work of the auditors of the subsidiary company.

Notes

Appointment/Reappointment of Auditor by Special Resolution

Section 224-A was introduced by the Companies Amendment Act, 1974 enumerating the cases in which an auditor can be appointed only by a special resolution. Where twenty-five per cent or more of the subscribed share capital of a company is held jointly or singly by a public financial institution, a Government company, Central Government, any State Government, any institution established by a State Act in which the State Government holds not less than 51% of the subscribed capital, a nationalized bank or an insurance company carrying on general insurance business, the appointment or reappointment of an auditor can be made only be made by a special resolution. Thus, this provision implies that a company in which 25% or more of the subscribed share capital is held by any of the aforesaid institutions can appoint or reappoint auditors only with the concurrence of such institutions. If a company in which 25% or more of the subscribed share capital is held by any of the institutions listed in this Section omits or fails to pass at its annual general meeting a special resolution appointing or reappointing an auditor, it shall be deemed that no auditor has been appointed by the company. Even if an ordinary resolution is passed unanimously, the auditors cannot be deemed to have been validly appointed. In such an event, the company is required to give notice of that fact within seven days to the Central Government as required by Section 224(3) and the Central Government may appoint a person to fill the vacancy.

Tenure of Office of Auditors

An auditor appointed in the annual general meeting holds the office from the conclusion of the annual general meeting at which he is appointed until the conclusion of the next annual general meeting. In any case where an annual general meeting is not held within the period prescribed by the Companies Act, unlike in the case of directors retiring by rotation who will be deemed to have ceased to hold office on the last day of the period within which the annual general meeting should have been held, in the case of an auditor inasmuch as he is appointed to hold office up to the conclusion of the next annual general meeting, he will continue until the next annual general meeting is held and concluded. The auditor cannot be deemed to have retired on the date when the meeting ought to have been held.

Reappointment of Retiring Auditor

At any annual general meeting a retiring auditor is reappointed, except in the following four situations: (1) when he is not qualified for reappointment; (2) when he has given to the company notice in writing of his unwillingness to be reappointed; (3) a resolution has been passed at that meeting appointing somebody instead of him or providing expressly that he shall not be reappointed; or (4) 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 the death, incapacity or disqualification of that person or of all those persons, as the case maybe, the resolution cannot be proceeded with. This provision on reappointment is a step in the direction of ensuring auditor independence as the auditor cannot be replaced except in the specific circumstances enumerated in the Act. However, the retiring auditor cannot be deemed to be reappointed or automatically reappointed at the annual general meeting. The expression "shall be reappointed" used in the provision in the Companies Act postulates some action on the part of the company resulting in the reappointment of the retiring auditor. Thus, the passing of the resolution for this purpose at the annual general meeting is essential for the reappointment of the retiring auditor if he is still qualified and willing to act. For appointing a person other than the retiring auditor or to provide that the retiring auditor shall not be reappointed, a special notice has to be given proposing that such a resolution would be moved at the next annual general meeting. On receipt of the special notice, the company should send a copy thereof to the retiring auditor. The form,

procedure vis a vis special notice has been laid down in section 190 which mandates that the special notice be given to the company at least fourteen clear days before the meeting is to beheld. The day on which the notice is served and the day of the meeting itself are to be excluded in computing the period of fourteen days. The object of giving a special notice is to invite the special or pointed attention of the members to the particular resolution. In the absence of such a special notice being given, the resolution would be rendered illegal and ineffective. And the appointment of a new auditor without complying with the provisions of Section 225 (that is, without special notice required for a resolution appointing as an auditor a person other than the retiring auditor), then the resolution passed for appointing the new auditor would be illegal and in effective. Where at any such meeting no auditor is appointed or reappointed, the Central Government may appoint a person to fill the vacancy. Notice of the fact that the powers of the Central Government have become exercisable has to be given by the company to the Central Government within seven days thereof. Any delay in giving such notice does not affect the jurisdiction or the capacity of the Central Government to appoint the auditor. The auditor so appointed by the Central Government holds office till the next annual general meeting of the company. The Central Government is also authorized to fix the remuneration of the auditors so appointed by it. Also, in cases where the appointment of the auditor is void abinitio, the Central Government may fill the vacancy. Similarly where the person appointed at the annual general meeting is unwilling to accept the appointment, the Central Government would be eligible to appoint the auditor.

11.3 Procedure for Appointment of First Auditor

Appointment of first auditors

As per section 224(5), the first auditor or auditors of a company shall be appointed by the Board of directors by passing a board resolution within one month of the date of registration of the company; and the auditor or auditors so appointed shall hold office until the conclusion of the first annual general meeting. There is no need to file form 23B for the appointment of first auditor.

Notes Appointment of first auditors in general meeting—A company in general meeting may appoint the first auditor by passing an ordinary resolution if the Board of directors fails to exercise its power of appointment of first auditors within one month of the date of incorporation of the company.

Procedure for Appointment of Regular Auditor at the AGM

Section 224 governs the appointment of auditors. The auditors are to be appointed by the shareholders of the company in an annual general meeting by passing an ordinary resolution. Kindly note appointment of Statutory under section 224(1) is an ordinary business read with Section 173 of the Companies Act, 1956.

Section 224(1) state that every company shall, at each annual general meeting, by passing an ordinary resolution appoint an auditor or auditors to hold office from the conclusion of that meeting until the conclusion of the next annual general meeting.

1. Consider the appointment of external auditor in the board meeting and pass a board resolution recommending the candidature of external auditor to the shareholders.
2. Put the agenda for the appointment of external auditor in the AGM notice.
3. On due date pass an ordinary resolution for the appointment of external auditor.

Notes

4. Intimate the auditor regarding his appointment within 7 days of appointment in AGM. After receiving intimation from the company it is duty of the auditor to inform ROC about his appointment through filing of form 23B within 30 days of intimation from company.
5. Do not forget to collect a written certificate from the auditor or auditors proposed to be so appointed to the effect that the appointment or reappointment, if made, will be in accordance with the limits specified in sub-section (1B).

11.4 Auditors in Private Company

A private company which has elected to dispense with the laying of accounts before the company in general meeting must appoint auditors in the general meeting held at least twenty-eight days before copies of the company's annual accounts is sent to the members. It may, however, elect to dispense with the annual appointment of auditors, in which case the auditors are deemed to be reappointed in each succeeding year unless a resolution is passed ending their appointment. Within the accountancy profession, it is a requirement of professional ethics, for the person who is approached on behalf of the company to take the place of retiring auditor, prior to giving assent so to act, to ascertain from the retiring director whether there are any reasons why it might not be proper or desirable to accept the appointment.

Exceptions

The first exception to the above mentioned general rule is that dormant companies that are not required to prepare group accounts may by special resolution exclude the obligation to appoint auditors. Such a resolution may be passed at any general meeting of the company at any time after copies of the accounts, prepared under Section 226 of the Companies Act, 1985, have been sent out in accordance with Section 238 (1), provided that it has been dormant since the end of that financial year. Where the resolution is passed at a general meeting that is not the first such meeting, the company must in addition, be entitled to the benefit of accounting exemptions available to small companies, or must be ineligible for those exemptions only on account of the fact that it is a member of an ineligible group. Alternatively, such a resolution may be passed at any time, provided that the company has been dormant from the time of its formation, and provided that it is not a public company, a banking or insurance company, or an authorized person under the Financial Services Act, 1986. The other exception is with regard to private companies which are exempt from the audit requirement, in which case they are also exempt from the obligation to appoint an auditor.

General Rule of Resignation of Auditor

An auditor may resign before his term of office expires by depositing a notice in writing to that effect at the company's registered office. His resignation becomes effective on the date he lodges such notice or on such later date as may be specified in the notice. The auditor's notice of resignation is not effective unless it is accompanied either by a statement to the effect that there are no circumstances connected with his resignation which the auditor considers should be brought to the notice of members or creditors of the company, or a statement of any such circumstances. The vacancy caused by the resignation of auditors is to be filled by the company in general meeting.

Removal of Auditors

Any auditor appointed under Section 224 except the auditors appointed by the Board of Directors in pursuance of the proviso to Section 224(5) can be removed before the expiry of his term only

by the company in the general meeting. Additionally, a prior approval from the Central Government is also necessary for such removal of the auditors.

Self Assessment

Fill in the blanks:

1. If the auditor already holds the appointment as auditor in the specified number of companies as per....., he will be disqualified for further appointment as auditor in any other company.
2. Practicing chartered accountants, a person holding a certificate under the ..... is also qualified to be appointed as auditor of a company.
3. Disqualification of an auditor is given under section.....
4. The auditors are to be appointed by the ..... of the company in an ..... by passing an ordinary resolution shareholders

11.5 Rights, Duties and Liabilities of Auditor

11.5.1 Powers/Rights of an Auditor (Section-255)

1. Right of access to books of account and vouchers [Section 255(1)].
2. Right to receive information and explanations.
3. Right of access to books and papers of branch [Section 255(2)].
4. Right to receive notices of general meetings and to attend those meetings [Section 255(6)].
5. Right to make representation where another person is being appointed as auditor [Section 253(3)].

11.5.2 Duties and Responsibilities of Auditor

The duties and responsibilities of the auditor are laid down in Section 227 of the Companies Act, 1956. While examining the duties of the auditor, it is important to keep in mind the position of the auditor's within the framework of company law. The role and responsibilities of the auditor's cannot be isolated from the position that the auditor has been assigned by the law and judiciary. Over the years, the position ascribed to the auditor's has changed with the judiciary playing an important role in expanding their role and responsibilities.

Duties of auditor under section [Section 255(3)] are:

1. To give a report to the members on the accounts, books of account, balance sheet and profit and loss account examined by him. [Section 255(3)].
2. Where any matter reported upon is answered in the negative or with a qualification the report shall include reasons for such qualification with factual position.
3. To include in the report of the company such matters as directed by the Federal Government.
4. To attend those general meetings of a listed company, either himself or through authorized person, in which the balance sheet, profit and loss account and the auditors' report are to be considered.

Notes

5. To make report for inclusion in prospectus. (Section 53 read with Part I of Schedule II).
6. To certify receipts and payments account in the statutory report (Section 157).
7. To make report on declaration of solvency in case of voluntary winding up.
8. To exercise reasonable care and skill in carrying out his duties and make such inquiries as considered necessary.
9. Reading and Inspection of Auditors' Report (Section-256): Auditor's report shall be read in general meeting and shall be open to inspection by the members.

Task Students should know the contents of report from examination point of view. Please see section 255(3) of the Companies Ordinance, 1984.

11.5.3 Signature & Date on Auditors' Report (Section 257)

1. The person appointed as auditor shall sign the auditors' report or other documents required under the law.
2. The report should indicate the date and place.

Audit of Cost Accounts

Where a company is required to maintain any records relating to its costs of production etc., it will also get these accounts audited. The auditor, in this case, shall be a Chartered Accountant or a Cost and Management Accountant.

Position of an Auditor

The audit is intended for the protection of the shareholders and the auditor is expected to examine the true financial position of the company. The directors occupy a fiduciary position in relation to the shareholders and in auditing the accounts maintained by the directors the auditor acts in the interest of the shareholders who are in the position of beneficiaries. The auditor is like a trustee for shareholders. Thus, auditors have a fiduciary relationship vis-a-vis the shareholders as a body. The statutory auditors are the watchdogs of the company and they have access to the books of accounts, vouchers and documents which no member of the company has. These powers are given to the auditors to facilitate discharge of their functions and responsibilities. The reason for the fiduciary relationship of the auditors with the company has been explained by the Calcutta High Court in the case of *Deputy Secretary v. S. N. Das Gupta*: A joint stock company carries on business with capital furnished by persons who buy its shares. The owners of the capital are, however, not in direct control of its application, which is left to the executive of the company. In those circumstances, some arrangement is obviously called for by which those who provide the capital know periodically what is being done with their money how the affairs of the company stand? and what the present value of their investment is?

The Companies Act, therefore, provides for the employment of an auditor who is the servant of the shareholder and whose duty is to examine the affairs of the company on their behalf at the end of a year and to report to them what he has found. That examination by an independent agency such as the auditors is practically the only safeguard which the shareholders have against the enterprise being carried on in a business like way or their money being misapplied or misappropriated without their knowing anything about it. The Act provides the safeguard in two forms. It makes the duty of the auditor to give an expression of opinion on certain specified

matters of a vital character and it makes him liable, along with the directors, for misfeasance, if he fails to perform his duties as required by law and the approved audit procedure. The auditor, being an appointee of the shareholders has a duty to take care of their interests and thus any failure to report any major flaws and deficiencies may result in the non-fulfillment of the duties of the Auditors.

11.5.4 Auditor as a Watchdog

The auditor is a watchdog and not a bloodhound. Beginning with In Re *Kingston Cotton Mills* Case, the Courts have held that while it is true that the auditors primary function is to look into the account books of the company, it is also the law of the land that where there is adequate material before the auditor to arouse suspicion, he should probe into the matter in detail and attempt to get under the skin of the problem and thus help resolve the issue. The Court held in this case that "an auditor is not bound to be a detective or .... to approach his work with suspicion. He is a watchdog and not a bloodhound. He is justified in believing the tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest and rely on their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion, he should probe it to the bottom, but in the absence of anything of that kind he is only bound to be reasonably cautious and careful. His duty is verification and not detection. If in the course of his sniffing around he detects something suspicious he must track it down to verify it ." In the recent past, a higher standard has been applied to the auditor's requiring them to apply an "enquiring mind" to their task. This higher standard been discussed in research paper while dealing with the standard of care expected of an auditor. The auditor is an officer of the company only for limited purposes as given in Section 2(30) of the Companies Act, 1956. As far as maintenance of the books of account, preparation of financial statements and their audit is concerned, the auditor is not an officer of the company and therefore cannot be prosecuted for contravention of the provisions of the Company Act, 1956 which are required to be complied with by the management of the company. Numerous duties are owed by the auditors to the company and its shareholders. The foremost of these duties is to check the accuracy of accounts. But this duty is "not confined merely to the task of verifying the arithmetical accuracy of the balance sheet, but also to inquire into its substantial accuracy, and to ascertain that it was properly drawn up, so as to contain a true and correct representation of the state of the company's affairs". The duties of the auditor do not include the giving of advise to the company on the prudence or otherwise of giving loans. Whether or not the business of the company is being conducted prudently is not a concern of the auditor. The sole duty of the auditors is to ascertain the true financial position of the company at the time of the audit. Thus, the auditor is not an adviser to the company or to the shareholders of the company. Neither does the auditor sit in judgment on the management decisions and policies or the commercial prudence of transactions. His primary function is to carry out what is termed a "verificatory audit". This position has been slightly modified by the introduction of the Section 227(1A) and the issuance of the Order under Section 227(4A). The duty has been now extended to include making a statement on various matters involving management functions like inventory control, adequacy of internal audit procedures, etc. The auditor of a company is not the insurer and does not guarantee that the books of account of the company show the true position of its affairs or that its balance sheet is accurate according to its books. It is, however, the duty of the auditors to ascertain and certify to the shareholders the true financial position of the company at the time of the audit.

11.5.5 Classifying Duties of Auditor

In carrying out certain functions of which company audit is a prime example, the auditor is subject to certain duties. The duties of an auditor may be effectively divided into three categories, viz., statutory duties; contractual duties; and duties owed to third parties.

Notes

Statutory duties: The Companies Act, 1956 requires the appointment by a company of an auditor and performance of certain duties by him. Section 227 of the Companies Act specifies the powers and duties of the auditor. Section 209(1) requires every company to maintain 'proper' books of account with respect to matters stated therein. Section 209(3) provides that books of account, to be proper, must provide a true and fair view of the state of the company or its branches, as the case may be, and explain its transactions. To establish if the books of accounts have been maintained as required, and whether the provisions of the Act have been complied with, the auditor is appointed, and is required, *inter alia*, to report on these aspects. The examination by an independent agency such as the auditor is practically the only safeguard which shareholders have against the enterprise being carried on in an unbusiness-like way or their money being misapplied or misappropriated. The purpose of statutory audit is to provide such a mechanism to enable those who have a proprietary interest in the company or are concerned with its management and control, to have access to accurate financial information about the company. When those persons have such information, the statutory purpose is satisfied. It is the duty of the auditor to protect the shareholders by examining the accounts maintained by the directors with a view to informing the shareholders of the true financial position of the company.

While the directors occupy a fiduciary position in relation to the shareholders, in auditing the accounts maintained by them, the auditor acts in the interest of the shareholders who are in the position of beneficiaries. The duties cast upon the auditor are accompanied by certain powers; for example, access to the books of account of the company, to enable him to discharge these functions effectively. Any regulations which preclude the auditors from availing themselves of all the information to which they are entitled are inconsistent with the Act.

Contractual duties: The contractual duties of the auditors depend upon the contract between the auditor and the client. The contract will regulate the nature and extent of the task and the standard of the performance. Even when the nature of the engagement is established as audit, questions may arise as to whether the audit contract requires the taking of certain steps. Where the extent of the audit is described in some detail, whether expressly in the contract of engagement or in the case of statutory audit, in the statute concerned, these questions are less likely to arise.

Duties owed to third parties: Another important duty of the auditors is with regard to third parties. An issue that has been addressed by the Courts in numerous cases is whether the auditors owe any duty and are liable to third parties in the absence of any contractual relationship. This issue has been examined in detail while discussing the liability of the auditors. The prevailing view is that even in the absence of contractual relationship, in certain circumstances the auditor's could be held to be liable. The parameters of such responsibility are limited by the neighborhood principle laid down by *Lord Atkin in Donaghue v. Stevenson*. The three broad aspects that the duties of the auditor's cover are (a) the duty to make certain enquiries; (b) the duty to make a report to the members of the company on the accounts examined by him, and on every balance sheet and profit and loss account including on all documents annexed thereto; and (c) the duty to make statements in terms of the provisions of MAOCARO, 1988. The duties of the auditor can be broadly classified as: General duties and Duty of care.

Duty to prepare auditor's report: These duties are discussed in detail in the following chapters of this research paper. An auditor of a company has, equally, rights and duties, which have to be performed, in order to satisfy the position he is holding in the company. The duties of the auditors has been discussed and elucidated by the Courts in numerous cases. While describing the general duties of an auditor the Courts have opined: "An auditor is not to be confined to the mechanics of checking vouchers and making arithmetical computations. He is not to be written off as a professional adder-upper or a subtractor. His vital task is to take care to see that errors are not made, be the errors of computation or errors of omission or commission or downright untruths. To perform this task, he must come to it with an inquiring mind —not suspicious of dishonesty — but suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there has been none."

Notes

11.5.6 General Duties in carrying out Audit

In exercise of his duty, an auditor must use reasonable care and skill, and must certify to the shareholders only what he believes to be true. Essentially, an auditor should give a true and fair view of the company's annual financial statement. One of the earliest cases establishing this principle is In Re London and General Bank, where the Court held: The duty of the auditor "is to ascertain and state the true financial position of the company at the time of the audit, and his duty is confined to that. He discharges his duty by examining the books the company. But he does not discharge his duty by doing this without inquiry and without taking any trouble to see that the books themselves show the company's true position."

11.5.7 True and Fair view

The phrase "true and fair" was inserted in the Companies Act, 1956 in place of the phrase "true and correct" in the earlier Companies Act. This amendment was introduced since the term "true and correct" could be interpreted as implying that the auditor had to merely examine whether the financial statements were arithmetically correct and corresponded to the figures in the books of account and was not required to examine whether these books reflected a fair view of the affairs of the companies. With this amendment, the burden cast on the auditor is much higher. The Auditor, in his report, has to show whether the accounts reflect a fair view of the company's financial position. The true and fair view may be taken to represent and signify that the auditor gives an opinion as to whether the financial statements represent the actual financial position. Thus, what constitutes a true and fair view is a matter of opinion of the auditor in the circumstances of the case. There are certain broad indicators which the auditors are required to take into consideration while determining whether the book of accounts represent a true and fair view of the company's financial position. These include: The balance sheet and profit and loss account should be drawn up in conformity with the provisions of Schedule VI of the Companies Act and/or as per requirements of the special provisions governing special categories of companies. The balance sheet and profit and loss account should be drawn up in keeping with the generally accepted principles of accounting which should be applied consistently. In the event of any deviation from these principles, the reason and effect should be suitably disclosed. The information should be so disclosed in the balance sheet and the profit and loss account that there is neither an overstatement nor an understatement with regard to the financial position and working results. The Auditor should see the situation as it exists at the end of the accounting period. The audit or must also take into account post accounting period events, if material in making a better assessment of the position as at the date of the balance sheet. The financial statements should convey the requisite information clearly. In this context, it should be understood by the auditor that information and means of information are not the same term. Thus, the duty of the auditor to ascertain and state the true financial position of the company at the time of the audit will be fulfilled if the above considerations are kept in mind while preparing the audit report. "An auditor is not bound to do more than exercise reasonable care and skill in making inquiries and investigations. He is not an insurer; he does not guarantee that the books do correctly show the true position of the company's affairs, he does not even guarantee that the balance sheet is accurate according to the books of the company....he must be honest, that is, he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true....Where there is nothing to excite suspicion very little inquiry will be reasonably sufficient. Where 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 case of suspicion, and he is perfectly justified in acting on the opinion of an expert where special knowledge is required. " Thus, it is not the auditor's duty to give advice to members or directors about giving loans or about the business prudence of the company but the true financial position of the company must be state that the time of the audit. The auditor has the duty to take

Notes

reasonable care to ascertain that accounts books show the true position. The auditor is not a insurer and does not guarantee that the books show the company's position directly. This point was further reiterated in *Trisure India v. A. F. Fergueson & Co.* where it was held that the auditor must be honest and should have reasonable skill and care in ascertaining the accuracy of the company's books of account, balance sheet and profit and loss account. Reasonable care and skill is not exercised when in spite of the presence of unusual features in the accounts which *prima facie*, give reason for believing that the accounts of the company are not in order, the examination is not detailed.

11.5.8 Standard of Care

Neither legislation nor the normal contract of engagement indicates the standard of care required of the auditor. However, this issue has been subject to detailed consideration by the Courts. It has been the law that the auditor must exercise reasonable skill and care in the discharge of his duties. This has been best described in the following words of Romer J. in City Equitable Fire Ins. Co., Re : He must be honest, that is, he must not certify what he does not believe to true and he must take reasonable care and skill before he believes that what he certifies is true. What is reasonable care in any particular case must depend upon the circumstances of that case. Where there is nothing to excite suspicion very little inquiry will be reasonably sufficient. Where 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 case of suspicion and he is perfectly justified in acting on the opinion of an expert where special knowledge is required.

The early cases suggested a standard of care based on the concept of the auditor as a watchdog. *In Re Kingston Cotton Mills* Case , the Court while holding the auditors liable for not personally inspecting the securities, it was opined that while it may be easy to charge the auditors with negligence after the event, the auditor did not have advantage of hindsight. More recent authorities, however, have higher standard of care based on the auditor's applying an 'inquiring mind' to his task. In Fomento Sterling Area Limited Selsdson Fountain Pen Co., Lord Denning observed that "*to perform his tasks properly, he (the auditor) must come to it with an inquiring mind — not suspicious of dishonesty, but suspecting that somebody may have made a mistake somewhere, and a check must be made to ensure that there has been none*". This point was further reiterated in Re Thomas Gerrad & Sons Ltd. , where the auditors failed to detect fraudulent accounting principles although they discovered altered invoices.

They were held liable as "suspicion ought to automatically have been aroused by the discovery". Commonwealth cases have also emphasised that the auditor can no longer limit their investigation to a "watch-dog-role" and a more active inquiring role is required. Thus, it is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonable competent, careful and cautious auditor would use. The particular circumstances of each case determine whether reasonable skill, care, and caution have been exercised. The trend of the Courts seems to be in the direction of enforcing liability on the auditors if they fail to take a degree of care which would be required to ensure that there is no fraud or irregularity. Once the suspicion is raised they must investigate thoroughly and ensure that any discrepancy in the accounts is brought to light.

11.6 Auditor's Report

One of the most important duties of the auditor is with regard to the report on the accounts of the company which the auditor has to submit to the members of the company. "The scheme of the Act....is that the directors must prepare the accounts; the auditor must make a report to the members on the accounts; and this report must contain statements on certain specified matters."

Notes

This report should state whether the accounts are kept in accordance with the provisions of the Act and whether they give a true and fair view of the state of affairs of the company.

11.6.1 Legal Requirement

Sub-section (2) of Section 227 requires the Auditor to make a report to the members on the findings of the Audit done by him. This Report is based on the accounts examined by them and on every balance sheet and the profit and loss account and all group accounts, a copy of which is laid before the company in general meeting during their tenure of office. In this report, the auditors are required to state whether the accounts give the information required by the Companies Act in the manner so required. Thus the duty cast on the auditors is not merely to report on the balance-sheet but on the accounts which they are required to examine; and they are also required to state whether in their opinion proper books of accounts as required by law have been kept by the company. The requirement of law includes the requirement of Section 209 (3), i. e., that the books should be so kept as to give a "true and fair view" of the state of affairs of the company and explain its transactions. Furthermore, the law does not mandate that this Report be sent to each and every shareholder. The Companies (Amendment) Act, 2000 have brought in some amendments affecting the responsibilities of the auditors. Sub-section (3) of section 227 describes the scope of an audit report, and lays down the matters to be stated therein. Clauses (e) and (f) have been inserted in this sub-section which provides that observation or comments of auditors, which may have an adverse effect on the functioning of the company, are required to be stated in thick type or italics in the auditor's report. With this amendment, the responsibilities of the auditor have been widened substantially; it is now not confined only to the accounts but extends to the total functioning of the company. Further, as per this amendment the Report should also state whether any director is disqualified from being appointed as director under Section 274 of the Companies Act. For this, the auditor has to confirm and verify the details of other directorships in public companies of all the directors of the company. Though under Section 227(1A) of the Companies Act the Auditor is not required to make report on the results of his inquiry, he will certainly have to mention in his report anything serious, which the inquiry may have revealed, or give a warning. In his Report, the auditor is required to state the reasons and the justifications if the report is in the negative or is qualified. This report is distinct from a mere certificate. The distinction is that a certificate has no expression of opinion. The report is a formal statement made after inquiry and examination of the records and includes the opinion of the Auditor. In view of the above it is not enough for the report of the auditor merely to repeat the language of the section and barely state that in his opinion and to the best of his information and according to the explanations given to him the accounts of the company give the information required by the Act in the manner so required. Under the Indian Companies Act, 1913, the report made by the auditor was in most cases a mere formality. The requirement in the present Act that the report of the auditor shall state whether in his opinion the accounts give the information required by the Act in the manner required and whether in his opinion proper books of account as required by law have been kept by the company so far as appears from his examination of those books would seem now to require from the auditor a more exacting duty as regards verification than under the previous Act. In this connection, the Ninth Annual Report submitted to the Parliament in pursuance of Section 638 is relevant. In this Report it was explained that the Company Law Board has been of the view that it is necessary to ensure a high standard of audit of companies because it is only by doing so that a high standard of integrity in company affairs could be maintained. In order to attain this required standard it is necessary for auditors to be fully alert and to satisfy themselves by examining such basic materials and documents as they consider necessary, that the accounts which they certify really reflect a true and fair view of the state of affairs of the company concerned Language of the Report.

Notes

The auditor should be careful about the use of language in the report, which should be clear and unambiguous. The Auditor while drafting the report must keep in mind that the shareholders, whose agent he is and to whom he is submitting the report, and with whom he shares a fiduciary relationship are ordinary persons who do not possess technical knowledge and skill of accountancy or auditing. His opinions and observations should, therefore, be communicated in no uncertain terms so that the reader of the report is able to know what they are. In London and General Bank Ltd. the Court held that a person whose duty it 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. Information and means of information are by no means equivalent terms. An auditor who gives shareholders means of information instead of information in respect of a company's financial position does so at his peril, and runs the very serious risk of being held, judicially, to have failed to discharge his duty The duty of an auditor is to convey information, not to arouse inquiry, and although an auditor might infer from an unusual statement that something was seriously wrong, it by no means follows that ordinary people would have their suspicions aroused by a similar statement if, as in this case, its language expresses no more than any ordinary person would infer without it.

Report should be complete The auditor should give a complete report. If he gives his report, subject to separate notes, those notes also should be given simultaneously. In *Hitkarini Mahavidyalaya, Jabalpur v. P.C. Madan* where the auditor made his report on the accounts of an institution subject to separate notes which were not submitted within a reasonable time, the Court held him guilty of gross negligence. The reasoning for this was that any one going through the report would assume that those notes were prepared and were ready at the time when the report was signed by him. It could not be supposed that those notes were not in existence at that time and were written at some later date on some facts, which were still to be verified or ascertained. Though this was not a case of bad or vicious intention, it was still held to be an act of gross negligence.

11.6.2 Qualified Opinion

Where an auditor gives a qualified opinion, that is, he expresses an opinion subject to certain reservations; he should express clearly the nature of the qualification in the report. The reasons for the qualification should also be stated. In the case of companies, this is a legal requirement under Section 227(4) of the Companies Act, which requires that where the auditor answers any of the statutory affirmations in the negative or with a qualification, his report should state the reasons for such answers. Qualified audit reports may be classified into four categories:

1. ***Disclaimer:*** In a disclaimer of opinion the auditor states that he is unable to form an opinion as to whether the financial statements give a true and fair view.
2. ***Adverse:*** In an adverse opinion the auditor states that in his opinion the financial statements do not give a true and fair view.
3. ***'Subject to':*** In a 'subject to' opinion the auditor effectively disclaims an opinion on a particular matter which is not considered fundamental.
4. ***Exception:*** In an 'except for' opinion the auditor expresses an adverse opinion on a particular matter which is not considered fundamental. Auditors who wrongfully fail to qualify company accounts are not liable to the company for subsequent loss if the company did not actually rely upon them and was not misled by the information contained in the accounts. Certification of accounts by auditors does not on the basis of the Caparo principle expose them to the risk of being sued by lenders who may rely on those accounts when considering whether to make finance available to the company.

Notes

11.6.3 Adverse or Negative Opinion

If, based on his examination, the auditor does not agree with the affirmations to be made, the auditor may give an adverse opinion. For example, the opinion given by the auditor is adverse or negative when he states that the financial statements do not represent a true and fair view of the state of affairs and the working results of an undertaking. An adverse opinion is appropriate where the reservations or the objections of the auditor are so material that he feels that the overall view of the accounts is materially distorted. Where the auditor gives an adverse opinion, he should disclose all material reasons therefore.

Example: In case the company is engaged in hire purchase and finance business where provision for doubtful debts was not made in spite of the fact that a sizeable proportions of sundry debtors were not recoverable, the auditor is expected to state that the said accounts do not give a true and fair view of the state of affairs of the company in as much as no provision for bad and doubtful debts has been made.

11.6.4 Disclaimer of Opinion

If an auditor fails to obtain sufficient information which results in his inability to express an opinion, he makes a disclaimer of opinion. The auditor may state that he is unable to express an opinion because he has not been able to obtain sufficient evidence to form an opinion. The necessity of disclaiming an opinion may arise due to many reasons. For example, the auditor may not get access to all the books of account for any reason; there may exist material items, the value of which may be totally uncertain, or, certain material information may not be forthcoming. Whenever an auditor disclaims an opinion, he should give reasons for the same. For example, the auditor could say that "we have not been unable to verify the existence and value of the fixed assets of the company and, therefore, we are unable to state whether the balance sheet shows a true and fair-view". The right of a statutory auditor to give a qualified report is a great deterrent and prevents the management of a company from resorting to accounting practices and methods of disclosure which are not in accordance with the law. A qualified report is normally not necessary, unless the issues involved are material. However, items requiring disclosure under the law such as directors remuneration, whether material or not, have to be specifically disclosed. If this is not done, it is the duty of the auditor to qualify his report. An auditor of a company is appointed by shareholders to perform certain statutory functions and duties and it is expected of him that he will in fact perform these functions and duties. The failure to perform a statutory duty in the manner required is not excused merely by giving a qualification or reservation in auditor's report. In such circumstances, the auditor should, while giving a qualification or reservation indicate clearly the reasons why he was unable to perform the audit in accordance with generally accepted procedures and standards. In a majority of cases, items which are the subject matter of qualification are not so material as to affect the truth and fairness of the accounts, taken as a whole, but merely create uncertainty about particular item. In such cases, the auditor may report that in his opinion, but subject to specific qualifications mentioned, the accounts present a true and fair view. On the other hand there may be cases where the reservations may be so material that it would be meaningless to state that subject to the qualifications, the accounts disclose a true and fair view. The auditor then should make a disclaimer of opinion or give an adverse/negative opinion, as appropriate. In this context, the nature of the facts, their materiality and their bearing upon the truth and fairness of the accounts should be taken into consideration. The auditors must give full information about the subject matter of their qualification and not merely create grounds for suspicion or inquiry and leave it to the shareholders to ascertain the facts by making diligent inquiry. The distinction between "information" and "means of information" made in the London and General Bank's case is still

Notes

valid. A qualification should be clear and precise and the manner in which qualifications are made in the auditor's report should be such as not to leave any room for doubt in the minds of the public. The company's auditor should mention clearly whether in his opinion a particular matter stated in his report is in the nature of a qualification or is merely an explanation. A factual reference in the report does not automatically become a qualification. The use of the expression 'read with the notes thereon' does not qualify the contents of the auditor's report. In any case, the notes are necessarily apart of the accounts and even if the auditor does not make a specific reference thereto, his report automatically covers them

The report prepared by the auditor's should be comprehensive and brief and specify the matters in respect of which the auditors have reservations or qualifications, and the amounts involved in clear and unambiguous manner, leaving no scope for misinterpretation. Full information and if that is not available as much information as is available should be given in the report. Vague statements, the effect of which is not ascertainable on the accounts should be avoided. The auditor should avoid making qualifications in his report, which do not contain any real objection on his report. Further, it is not a good practice to qualify the present Report by reference to a report made in an earlier year because the shareholders may not have access to such reports. Each year's accounts being independent, the essential facts relating to a qualification made in an earlier year must be repeated where appropriate. All qualifications should be contained in the auditor's report itself and should appear at one place in order to give the reader a clear view thereof.

Notes in the Report

Notes appended at the foot of the financial statements normally represent the explanations given by the directors elucidating or clarifying various items of accounts. The notes may include those giving specific information required by Schedule VI to the Companies Act, for example, arrears of dividends on preference shares', computation of managerial Remuneration, etc. If the auditor qualifies his report by making reference to the notes or if the qualifications made by the auditor are also included in these notes, the shareholders may be unable to appreciate the significance of such qualifications. It is, therefore, necessary that the notes to accounts should not contain the opinion of the auditor. Further, the auditor should only reproduce notes of a qualificatory nature in his report to enable the reader to know the importance of the qualifications. The word 'reproduce' does not imply a verbatim reproduction of the qualificatory notes. Where notes of a qualificatory nature appear in the accounts, the auditor should state all qualifications independently of his report in an adequate manner so as to enable a reader to assess the significance of these qualifications. However, where a note has already been given in detail by the management, it is not necessary to reproduce it verbatim in the audit report and a brief self-explanatory statement may be sufficient. The auditor should quantify, wherever possible, the effect of the qualifications on the financial statements, if the same is material. Where it is not possible to precisely quantify the effect of the qualifications, the auditor may do so on the basis of estimates made by the management after carrying out such tests as is possible and he may then indicate that the figures are based on the management's estimates. An auditor should not be satisfied merely by vouchers, apparently formal and regular but should by fair and reasonable examination of them, see that they are not for payments in any way unauthorized or illegal or improper.

Report on Annexed Documents

The report has to deal not only with the accounts and balance sheet and profit and loss accounts, but also every other document declared to be part of or annexed to the balance sheet and profit and loss account. Among the documents required to be annexed is also included a list relating to investments, if any, specified in Section 372(9) of the Companies Act with all the particulars required to be stated therein.

Notes

11.7 Auditors' Liabilities

The liability of Auditors is unique from that of other white collar professionals in so much as they are liable not only to the who has appointed them. Another noteworthy fact is that there have been far lesser cases against accountants than any other professionals. The liabilities of auditors of a company can be studied under following heads:

11.7.1 Civil Liabilities

Civil liabilities mean the disputes over losses caused to one party by acts of another. The civil liabilities of an auditor can be for:

Liability for Negligence (under Law of Agency)

Auditor being agent of the Shareholders is required to carry out his duties with reasonable care and skill. If he fails to do so, he is liable to make good any loss caused to the third party. The first and foremost issue which arises as far as the liability of the auditors are concerned is with regard to the nature of their liability. They may arise from either: (1) Negligent Acts, that is, where the acts of the auditors lead to the damage being suffered by the plaintiffs, or (2) Negligent Statements, that is, the incorrectness of a statement given to the client causing loss or damage to the clients interests. There have been cases which have followed different principles at different points of time as per the circumstances of the case. The case of *Hedley Byrne v. Heller* is a case where the liability had arisen from negligent misrepresentation. The essence of the liability arises from the fact that the parties have a special/contractual relationship and the negligent behaviour results in the breach of the contract. There has been a great discussion on this aspect for a number of years and the legal position seems to have settled that if the misrepresentation was of a very general nature and had not been specific in nature as pursuant to a contract then the tort action would be a better option for the client. Thus, now the narrow scope, which would have been the result of negligence based on contractual relationship has been expanded a great deal. Negligence is a tort in which a breach of duty of care results in damage to person to whom such duty is owed. We now seek to examine the scope and extent of such tortuous liability of the auditor.

Major Legal Decision

Arthur E. Green & Company vs. Central Advance & Discount Corporation Ltd. (1920): It was held that auditor is guilty of negligence. Auditor accepted the schedule of bad debts furnished by the client, though it was apparent that debts were not recoverable.

The London Oil Storage Co. Ltd. vs. Sear Hasluck & Co.: In this case, auditors were held liable for negligence. Auditors failed to verify the physical existence of cash in hand. Cash balance as per books did not agree with the physical balance, the difference was misappropriated by the cashier.

Irish Woolen Co. Ltd. vs. Tyson and Others: In this case auditors were held liable for negligence. Profits were overstated by not recording purchase invoices. He was held liable for having failed to exercise reasonable care and skill.

Kingston Cotton Mills Co. Ltd.: In this case auditors were not held liable for negligence. It was held that it is not the duty of auditors to take stock, if they accept certificate in the absence of any suspicion, he has carried out reasonable care and skill.

In Mckesson V Robbins (American case): It was held that it was duty of auditors to test check the physical stock. Auditors should inspect securities, test check stock wherever it is practicable and

Notes

where it is not he should state in his report that he has accepted a certificate. In the light of Part-A of ddendum to ISA-8, "Attendance at Physical Inventory Counting" and SAP - 3 "Verification of Inventories", the position of auditors as held in Kingston Cotton Mills Co. Ltd. is no longer valid.

Liability for Misfeasance

The term misfeasance means breach of duty. If auditor does something wrong in the performance of his duties resulting in a financial loss to the company, he is guilty of misfeasance.

Example: Auditor's duties are laid down in section 255 of the Companies Ordinance, 1984. If auditor does not perform his duties properly and the company suffers loss he is liable for misfeasance.

Major Case Laws

London and General Bank Ltd.: In this case auditors were held liable for misfeasance. The auditors failed to report that Balance Sheet was not properly drawn: - Large sums were advanced to the customers and interest thereon was accrued, in fact neither advance nor accrued interest was receivable. No provision for bad debts was made and the company paid dividend. Under section 260 of the Companies Ordinance, 1984 if the auditors fail to report to the member's material misstatement of facts or give untrue picture to the members, and the default is willful, auditors shall be punishable with fine which may extend to two thousand rupees.

11.7.2 Criminal Liabilities (Section 260)

If auditor fails to comply with the requirements of Sections 157, 255 or 257, he shall be punishable with fine up to ₹ 100,000/-. If he knowingly makes a false report for profit to himself or to put another person to a disadvantage or loss for a material consideration, he shall also be punishable with imprisonment for a period of one year. If charges of forgery are brought against an auditor, he may be liable to imprisonment for a term which may be extended to 2 years or fine up to ₹ 20,000 or both.

Liability to the Company

To hold the Auditors liable for negligence at common law it is necessary for the company to show that loss has been caused to the company through the failure of the Auditors to perform their duty with reasonable care and skill. This was held in Leeds Estate Building and Investment *Co. v. Shepherd and London Oil Storage Co. v. Seear Has Luck & Co.* amongst other cases. Where an individual is appointed as an auditor and that individual is a partner in a firm of professional accountants, that firm may be held liable for his negligence in performing his duties, atleast where the audit fee is paid directly to the firm. The duty of auditors in case of private companies was considered in *Pendleburys Ltd. v. Ellis Green and Co*. The courts held that where interests of the companies are limited to a very small number of people and there are no outsiders because all interests are held by the Directors themselves, if the auditor has reported to the directors, then there is not much else which he can do. This decision underlines the fact that the negligence of Auditors arises when the issues of public, shareholder interests are paramount. Another factor which is a crucial element in negligence is that of the standards by which the work of the auditors are measured. It has been submitted that standards of skill and care change over time. The standards have become stricter over time and the explanations of directors are no longer

Notes

accepted without making probes and inquiries into the matter in great detail. The report must reflect the fact that they were suspicious of the functioning of the company and were given explanations which were either satisfactory or not for them.

The Cannons of Foreseeability and Proximity

The law in relation to the auditor's duty of care and the liability for negligent misstatement by auditors has been subject of comprehensive analysis in England, in the case *Caparo Industries Plc v. Dickman*. The court held that the auditors owe a duty of care to the members but not to potential investors in the company. They owe a duty of care to the members because they are under a statutory obligation to report to them and because the members have a corresponding statutory entitlement to receive such a report. The Auditors have no duty of care to the lenders and creditors of the company. This is an extension of the same logic which makes them liable to members. The case has laid down the following propositions as regards the auditor's duty of care and liability: In cases of negligent misstatement, foreseeability that the plaintiff or someone in a similar position will rely upon the statement is a necessary but not sufficient condition for liability. In addition, it is necessary to establish a nexus or relationship between the parties sufficient to create a duty of care. That relationship can only be determined by a close analysis in each case. The label applied to such a relationship is 'proximity', but there is no single definitive test. In some cases, it may be useful to consider whether there has been a voluntary assumption of responsibility in the others, whether the relationship is 'equivalent to contract'. The necessary relationship exists between the auditors and the members because there is a statutory duty to send reports to the later by the former and a corresponding entitlement of the members to receive such a report. The relationship may also exist if the circumstances are such that the auditors can be taken implied to have represented the accuracy of the accounts to the plaintiff, and perhaps whenever they provide the accounts to the company with the intention, or in knowledge that it is the company's intention, that they are to be supplied to the plaintiff or to persons in a class of which the plaintiff is one. It is not necessary that the auditors should have any particular transaction in contemplation, or should intend the recipient of their report to rely upon it in any such transaction. If the necessary relationship exists, it is enough if it is foreseeable that the recipient of the report may rely upon it in some future transaction, whether contemplated by the auditors or not, and whether with reference to his existing shareholding or not. The necessary relationship does not exist between a company's auditors and potential investors who are not existing shareholders in the company. The fact that it is foreseeable that their report may come into their hands and be relied upon by them is not sufficient in itself to create a relationship.

Did u know? In order to establish the existence of duty of care owed to the plaintiff, who claims damages, by auditor who is alleged to have made a negligent misstatement, three requirements must be satisfied. These are: (i) It must be reasonably foreseeable by the defendant that the statement will be relied on by the plaintiff; (ii) There must exist the relevant degree of proximity between the parties; and (iii) It must be just and reasonable in all circumstances to impose a duty of care on part of the defendant to the plaintiff. This however, leads us into the issue of liability to third parties.

Liability to Third Parties

There was formerly the prevailing view that there is no liability for negligent misrepresentation made by one person to another who had relied upon it to his detriment, in the absence of any contractual or fiduciary relationship between the parties or the fraud. This position was overruled in *Hedley Byrne & Co. v. Heller & Partners* where it was held that in certain circumstances contractual

Notes

liability could be incurred for a negligent misstatement made by one person to another, even in the absence of any contractual or fiduciary relationship. The parameters of such responsibility were limited by the "neighbourhood principle" laid down by Lord Atkin in *Donaghue v. Stevenson*. In *Jeb Fastners v. Marks Bloom & Co.*, the appropriate test for establishing whether a degree of care exists was laid down to be whether the defendant knew or reasonably should have foreseen at the time the accounts were audited that a person might rely upon those accounts for the purpose of deciding whether or not to take over the company and, therefore could suffer a loss if the accounts were inaccurate. Firstly, they must have relied upon the accounts and secondly, they must have done so in circumstances where either the auditor's knew they would, or ought to have known, that they might. The decision in Hedley Byrne v. Heller held that liability for negligent statements resulting in the financial loss is not limited only to cases where there is an existing contractual or fiduciary relationship. This raised the question of the limits of such liability. The test of a reasonable man would not make the auditors liable. The rule thus was that the auditors would not be liable to third parties unless the facts of the case showed otherwise. Thus, in *Candler v. Crane, Christmas and Co*, where the accounts were prepared specifically for the purpose of inducing the plaintiff to invest in the company, to the knowledge of the auditors, there was a duty of care even though the plaintiffs were not members or shareholders of the company. This can however, be negated by a clear clause expressly disclaiming liability. There are recent cases which state that the auditors should have foreseen that the accounts may be relied on by future investors for the purpose of making decisions regarding their investments.

Caselet

Report by London Economics on Auditor's Liability

An independent study prepared by London Economics at the request of the European Commission summarized the auditors' liability and the impact of the community regulations related to the conditions of liability insurance in the member states. The study, which was published in October, highlights that the current regulations related to liability involve system risk and predicts that within five years after Arthur Andersen's downfall due to the Enron scandal, another Big4 will follow the same fate as AA. Such an event would have unpredictable consequences on world economy and on the stock markets. It would probably result in capacity gap and in the considerable increase of the service prices, due to which large companies may not be able to comply with their reporting requirements. The situation would shake the investors' confidence and would probably cause the dissolution of further audit firms.

The Commission presented four options to the member states on the basis of the London Economics study: According to the first option, there would be one single monetary cap with respect to the indemnification payable by auditors (there is such a cap in 5 member states: it is EUR 12 million in Belgium and Austria, EUR 4 million in Germany, and EUR 150 thousand in Slovenia; according to the Greek regulation, the cap corresponds to either a year's audit fee or to five times the salary of the head of the supreme court). According to the second option, the cap would depend on the audited company's size (as measured by its market capitalization). In the third option, the cap would be a multiple of the audit fees charged to the company. The fourth option follows the principle of proportionate liability, which means that each party is liable only for the portion of loss that corresponds to the party's degree of responsibility. It is possible that Brussels will not enact a law the scope of which applies to all member states but will leave it to the member states to define the means and extent of restricting the liability. Our experts do not know about plans in Hungary to limit the auditors' liability.

Self Assessment

Notes

Choose the appropriate answers:

5. Mr. Narayan, a Charted Accountant, has nineteen audits, Out of following audits which audits should he accept to ensure he doesn't violate provisions of section 224(IB) __
   (a) Audit of Zeba Ltd. a private company
   (b) Audit of branch of Pointec Ltd. a foreign company
   (c) Audit of two branches of Virtue Ltd. an Indian company
   (d) All of them
6. Who is responsible for the appointment of statutory auditor of a limited company?
   (a) Directors of the company
   (b) Members of the company
   (c) The Central Government
   (d) All of the above
7. Which of the following statement is not true?
   (a) A partnership firm can be appointed as a statutory auditor of limited company
   (b) Appointment can be made in the name of the firm
   (c) Majority of the partners should be practicing in India
   (d) All partners should be chartered accountants
8. As per the requirements of section 226(3) and 226(4) a person is disqualified from being appointed as a statutory auditor if he holds
   (a) Equity shares or debentures of the company
   (b) Equity shares carrying voting of the company
   (c) Shares carrying voting rights of the company
   (d) Security carrying voting rights of the company
9. The Board of Directors shall appoint first auditor of a company
   (a) With in one month of completion of capital subscription state of the company
   (b) With in one month of the promotion of the company
   (c) With in one month of the commencement of the business of the company
   (d) With in one month of incorporation of the company
10. The term of the auditor ship of first auditor would be from the date of appointment till.....
   (a) the conclusion of statutory meeting
   (b) the conclusion of first annual general meeting
   (c) the conclusion of next annual general meeting
   (d) the date of removal

Notes

11. The independence of an internal auditor will most likely be assured if he reports to the
    (a) President Finance
    (b) President System
    (c) Managing Director
    (d) CEO
12. Proper segregation of duties reduces the opportunities in which a person would both
    (a) establish controls and executes them
    (b) records cash receipts and cash payments
    (c) perpetuate errors and frauds and conceals them
    (d) record the transaction in journal and ledger.
13. Life Insurance Corporation of India holds twenty five percent of subscribed capital of XYZ Ltd. The appointment of statutory auditor in XYZ Ltd. Would be by.....
    (a) Ordinary resolution
    (b) Special resolution
    (c) (a) or (b)
    (d) None of the above
14. ICICI prudential, a life insurance company, holds thirty two percent of subscribed share capital of Delta Ltd. The statutory auditor of Delta Ltd. would be appointed by.....
    (a) Ordinary resolution
    (b) Special resolution
    (c) Either of the above
    (d) None

11.8 Rights of Auditor

In order to carry out the duties as laid down with regard to the accounts presented to the members, the Companies Act has also given the auditors certain rights. These rights, enshrined in Sub-section (1) of Section 227 of the Companies Act, 1956, are primarily:

1. The right to call for information and explanations;
2. The right to have access to the books of accounts; and
3. The right to notices and to attend meetings.

The scope and ambit of these rights of the auditor are given below.

11.8.1 Right to Call for Information and Explanations

An auditor has the right to require from the officers of the company such information, as the auditors may think necessary for the performance of their duties. The auditor can call for any explanations or information that he considers necessary. It is obligatory on the part of the officers of the Company to furnish the relevant information to the auditor. In the event of the information not being furnished or explanation given, the auditor is required to report the same

in his report. This is to ensure that the shareholders are made aware of the fact and such awareness may give critical clues to them and indicate that all is not well with the Company. The power to ask for information includes the exercise of such powers over the officers of the company and includes the Directors and Managing Directors. This power is not extinguished by the winding up of the Company. Where a Company is under Liquidation, the courts can call upon the directors to appear before the Auditors to submit explanations to the questions raised by them. This is based on the logic that while directors may cease to enjoy powers, the obligations and liabilities incurred by them in the time when they were directors are not extinguished with the passing of the order of winding up. This was held in Bhawnagar Vegetable Products Ltd., In Re. Under English law, an officer of the company who makes to an auditor (orally or in writing) a misleading statement which conveys, or purports to convey, any information or explanation which the auditor requires, or is entitled to in his capacity as auditor is guilty of a statutory offence and may be liable to fine or imprisonment or both. For the officer to be guilty of an offence, the statement must be misleading, false or deceptive in a material particular and made knowingly or recklessly.

Notes The power to ask for information includes the exercise of such powers over the officers of the company and includes the Directors and Managing Directors.

11.8.2 Right to have Access to the Books of Accounts

Section 227 confers on the auditors the right of access to the books of accounts of the company at all times for the performance of his duties. The auditor's powers cannot be limited or abridged in anyway. A Company Articles may not limit the auditor's statutory right to information. In Newton v. Birmingham Small Arms the Court held that," *The auditor has the right to access to books of accounts of a company. Any provision in the company's articles precluding auditors from obtaining or availing themselves of the information they are entitled to by statute is void. They must have free access to all the material necessary for their report. A resolution limiting the powers of the auditor or a provision to this effect in the effect in the articles will be void."* The auditor is also entitled to request access to other documents necessary for audit. The books of accounts of the company may be kept in the headquarters of the Company or elsewhere. The right of access to the books can be enforced by mandatory injunction but not where litigation is pending between the company and the auditors. This right is inclusive of the right to see vouchers also. The term vouchers includes all documents, correspondence, agreements and evidence which support any transaction or data disclosed in the financial statements whether directly or indirectly. The term book also includes the financial, statutory and statistical books including cost records. The auditor can also examine the books which record quantities of production, stock, sales, etc. The inspection is inclusive of the minutes of the general meetings and the Directors meetings. It has been held as early as 1906, in England that any regulation precluding the Auditors from availing all the information required by them is invalid. Such a rule is also valid in India and is essential to protect the sanctity of the Auditors Report. The term "at all times" enables the auditor to check the records without waiting for financial year to end, but it means the examination only during office business hours. The auditor can visit any branch office at any time for his purposes. There is a limitation to this power and that is with regard to the foreign branches of Banking Company, under section 228(2) of the Companies Act, 1956.

Caution The right of access to the books can be enforced by mandatory injunction but not where litigation is pending between the company and the auditors.

Notes

The auditors of a company are entitled to attend any general meeting of the company and to receive notice of, and communications relating to, any general meeting which any member of the company is entitled to receive. Thus, the Auditor has the right to receive notices and other communications relating to the general meetings. The auditors also have the right to attend the meeting and speak on any part of the business of such meetings which concerns them as auditors. Where a company is proposing a resolution as a written resolution, they are entitled to receive copies of all communications supplied to members. However, the mere fact that the Auditor has said something in the meeting does not mean that he is absolved of all responsibilities to say material facts in the Report. In *Woolworth v. Conroy*, the Court of Appeal held that '*accountants in the course of doing the in ordinary professional work of producing and auditing accounts, advising on financial problems and carrying on negotiations in relation to taxation have at least a particular lien over any books of accounts, files and papers which their clients have delivered to them, and also over documents which have come into their possession in the course of acting as their clients' agents in the course of their ordinary professional work.*'

Self Assessment

State whether the following statements are true or false:

15. It is not obligatory on the part of the officers of the Company to furnish the relevant information to the auditor.
16. The Right of an auditor to have access to the books of accounts is not extinguished by the winding up of the company.
17. The term "at all times" enables the auditor to check the records without waiting for financial year to end or office business hours.

11.9 Summary

- Qualification of an Auditor [Section 226 (1) and (2)]: Practicing Chartered Accounts (Sec 226 (1) J): Verification: He offers to perform or performs the services involving the auditing or verifications of the financial transactions, books of accounts or Professional Services; Renders the Services: Renders the services as, in the opinion of the council are or may be renders by a chartered accountant in practice or Certified Auditor [Sec. 226 (2)]
- Person cannot become the auditor of the company according section 254 is a body corporate; an officer or employee of the company; person who is the employment of an officer or employee of the company; person who is indebted to the company for an amount exceeding ₹ 1000; the spouse of a director of the company; a person who was a director other officer or employee of the company at any time during the preceding three years; a person who is a partner of a director, officer or employee of a company.
- Disqualification of an auditor are as per {Sec 226 (3)(4)(5).
- As per section 224(5), the first auditor or auditors of a company shall be appointed by the Board of directors by passing a board resolution within one month of the date of registration of the company.
- Section 224 governs the appointment of auditors. The auditors are to be appointed by the shareholders of the company in an annual general meeting by passing an ordinary resolution
- Powers/Rights, Duties and Liabilities of an Auditor are described under Section 255.

Notes

- The person appointed as auditor shall sign the auditors' report or other documents required under the law. The report should indicate the date and place, as per Section 257.
- The liabilities of auditors of a company can be studied under following heads: (a) Civil Liabilities, and (b) Criminal.

11.10 Keywords

Auditor: A qualified accountant who inspects the accounting records and practices of a business or other organization. An auditor (audit) examine carefully for accuracy with the intent of verification; "audit accounts and tax returns."

Auditor's Report: The Auditor's report is a formal opinion, or disclaimer thereof, issued by either an internal auditor or an independent external auditor as a result of an internal or external audit or evaluation performed on a legal entity or sub-division thereof (called an "auditee").

Certified Auditor [Sec. 226 (2)]: A part from practicing Chartered Accountants, a person holding a certificate under the Restricted Auditor's Certificate Rules, 1965 is also qualified to be appointed as auditor of a company.

11.11 Review Questions

1. What is the nature of negligence as one of the liability of an auditor?
2. Enumerate different rights of auditor.
3. Write short notes on:
   (a) Liability to Third Parties
   (b) Liability to the Company
   (c) Civil Liabilities
4. Explain the procedure for appointment of an auditor.
5. What are the qualifications of a person to become an auditor? Who are disqualify to be an auditor?
6. Explain different duties and powers of an auditor under different heads.
7. How auditors work as a watchdog?
8. What are mandatory components of an auditor's report?

Answers: Self Assessment

1. Section 224(1-13)
2. Restricted auditor's certificate rules, 1965
3. Sec 226 (3)(4)(5)
4. Shareholders; Annual General Meeting
5. (d)
6. (b)
7. (c)

Notes

8. (d)
9. (b)
10. (b)
11. (c)
12. (c)
13. (b)
14. (a)
15. False
16. True
17. False

11.12 Further Readings

Books

David Coderre, *Internal Audit: Efficiency through Automation*, John Wiley & Sons, 2009.

Emile Woolf, Moira Hindson, *Audit and Accountancy Pitfalls: A Casebook for Practising Accountants, Lawyers and Insurers*, John Wiley & Sons, 2011.

Iain Gray, Stuart Manson, *The Audit Process: Principles, Practice and Cases*, Cengage Learning EMEA, 2007.

Jeanette Franzel, *Single Audit: Opportunities exist to improve the Single Audit Process and Oversight*, DIANE Publishing, 2009.

Susan Switzer, *Internal Audit Reports Post Sarbanes-Oxley: A Guide to Process-Driven Reporting*, John Wiley & Sons, 2007.

Online links

www.asiatradehub.com/india/tr9.asp

www.auditservices.com/aevidence.html

www.investopedia.com/terms/a/auditing-evidence.asp#ixzz1x6PIvbTg

www.informationbible.com/article-auditing-in-depth-111904.html

Notes

Unit 12: Cost Audit

CONTENTS

Objectives

After studying this unit, you will be able to:

- State the meaning and procedure for cost audit;
- Discuss about MAOCARO to CARO;
- Discuss about management audit;
- State the procedures and benefits of management audit.

Notes

Introduction

At present, the Companies Act contains provisions relating to maintenance of Cost Records under section 209 (1) (d) and Cost Audit under section 233B of the Companies Act in respect of specified industries. The Audit Committee felt that Cost Records and Cost Audit were important instruments that would enable companies make their operations efficient and exist in a competitive environment. The Committee noted that the present corporate scenario also included a sizeable component of Government owned enterprises or companies operating under administered price mechanism or a regime of subsidies. It would be relevant for the Government or the regulators concerned with non-competitive situations to seek costing data. The Committee, therefore, took the view that while the enabling provision may be retained in the law providing powers to the Government to cause Cost Audit; legislative guidance has to take into account the role of management in addressing cost management issues in context of the liberalized business and economic environment. Further, Government approval for appointment of Cost Auditor for carrying out such Cost Audit was also not considered necessary.

12.1 Cost Audit

It is an audit process for verifying the cost of manufacture or production of any article, on the basis of accounts as regards utilization of material or labor or other items of costs, maintained by the company. In simple words the term cost audit means a systematic and accurate verification of the cost accounts and records and checking of adherence to the objectives of the cost accounting. Cost audit is the verification of the correctness of cost accounts and of the adherence to the cost accounting plan. In cost audit, auditor has to perform the following duties:

1. Examine the correctness of the cost records maintained by the concern and
2. To report as to whether the cost accounting plans have been adhered to or not.

12.1.1 Procedure for Cost Audit (for Financial Year 2011-2012 Onwards)

Applicability of cost audit is based on turnover of the total company or meeting the other conditions laid down in the respective Cost Audit Orders issued by the Cost Audit Branch, Ministry of Corporate Affairs. Subject to meeting total turnover criterion or other criteria laid down in the respective Cost Audit Orders, if any activity of a company is covered under cost audit dated 2nd May 2011 or 30th June 2011 or 24th January 2012, the cost audit will be applicable to that company irrespective of the turnover of that particular activity.

It may please be noted that according to revised system of cost audit as above, individual Cost Audit Orders for the companies or products are now not issued by the Cost Audit Branch, Ministry of Corporate Affairs.

The procedure for appointment of Cost Auditor has been modified by the Cost Audit Branch, Ministry of Corporate Affairs. The revised procedure is affected from the financial year commencing on or after the 1st day of April, 2011.

As per provisions of section 233B (2), the Board of Directors of a Company can appoint a cost auditor after obtaining prior approval of the Central Government.

As per the revised procedure, the first point of reference will be the Audit Committee to ensure that the cost auditor is free from any disqualification as specified under section 233B (5) read with section 224 and sub-section (3) or sub-section (4) of section 226 of the Companies Act, 1956.

Notes

The Audit Committee should also ensure that the cost auditor is independent and is at arm's length relationship with the company. After ascertaining the eligibility, the Audit Committee will recommend to the Board of Directors for appointment of the Cost Auditor.

Cost Auditor to provide a certificate under Section 224 (IB) of the Companies Act, 1956. Board Resolution to be passed by the Company for appointment of Cost Auditor. Form 23-C to be filed by the Company, with Cost Audit Branch, Ministry of Corporate Affairs seeking approval for appointment of Cost Auditor.

Caution Further, Government approval for appointment of Cost Auditor for carrying out such Cost Audit was also not considered necessary.

12.1.2 Enclosure with Form 23-C

1. Certified Copy of Board Resolution passed by the Company sanctioning the proposal for which the Central Government approval has been sought.
2. Copy of Certificate obtained from cost auditor regarding compliance of Section 224 (1B). Any other information can be provided as an optional attachment. For example:
3. In case of change in cost auditor, letter to the previous auditor informing him about the change.
4. In case there is extension of financial year, approval letter for such extension.
5. Payment of Application fee is through ON LINE Mode: Credit Card/Debit Card. The amount fee payable as on date is as follows:

Task Identify different steps carrying out by cost auditor in performing cost audit.

Self Assessment

State whether the following statements are true or false:

1. Government approval for appointment of Cost Auditor for carrying out such Cost Audit was earlier considered necessary.
2. Cost audit is an audit process for verifying the cost of manufacture or production.
3. Individual Cost Audit Orders for the companies or products are issued by the Cost Audit Branch, Ministry of Corporate Affairs for year 2011-12.

12.2 MAOCARO to CARO

Through Notification No G.S.R. 480(E) of June 12, 2003, the Department of Company Affairs (DCA) has replaced MAOCARO with the Companies (Auditor's Report) Order, 2003 — CARO. The new order does merely remove the MAO in the old order — it appears much more expansive in scope. Effective from July 1, 2003, it applies to all companies save banking and insurance companies, Section 25 companies and private limited companies with paid-up capital and reserves of less than ₹ 50 lakh which have not accepted public deposits and do not have a loan liabilities in excess of ₹ 10 lakh and whose turnover does not exceed ₹ 5 crore.

Notes

12.2.1 Clauses Removed

The clauses removed from the old order include those with regard to: revaluation of fixed assets; valuation of stocks; unserviceable or damaged stores; sale and disposal of scrap; personal expenses charged to revenue account; and special clauses applicable to service and trading companies

12.2.2 Clauses Expanded

The following clauses have been expanded:

1. While commenting on Section 301 of the Companies Act, the auditor is to state whether the transactions entered into have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time. Benchmarks have been set that these transactions should exceed ₹ 5 lakh in respect of any party and in any one financial year.
2. The auditor also needs to investigate into transactions relating to loans and advances, whether reasonable steps have been taken by the company for recovery/payment of the principal and interest.
3. While commenting on fixed assets, the auditor needs to comment whether the going concern is affected in case a substantial part of the fixed assets have been disposed of during the year.
4. In cases of contraventions of Section 58/58A of the Companies Act, the nature of the contraventions should be expanded upon and compliance with orders of the CLB need to be seen.
5. In cases wherein there are disputed statutory dues, such as sales tax/income-tax/Customs tax/excise duty and cess, the amounts involved and the forum where the dispute is pending need to be mentioned.
6. With the impending death of the BIFR, the incipient signs of sickness have been defined to mean accumulated losses at the end of the financial year being not less than 50 per cent of net worth and where cash losses have been incurred for the financial year under report and the immediately preceding one.

12.2.3 New Clauses

The following are the new clauses that the auditor needs to comment on:

1. Default by the company in repayment of dues to a financial institution or bank is to be mentioned. The period and the amount of default are to be quantified.
2. In case a company has granted loans by way of pledge of shares, debentures or other securities, whether adequate documents and records are maintained is to be reported and deficiencies pointed out.
3. Provisions of any special statute applicable to a chit fund are to be reported.
4. Specific points regarding ratios, prudential norms, appraisal of credit proposals and repayment schedules are to be reported.
5. In case of companies dealing in shares, whether proper records have been maintained of transactions and contracts and whether timely entries have been made therein is to be reported.

Notes

6. The auditor is also required to comment whether the company has given any guarantee for loans taken by others and whether the terms and conditions are prejudicial to the interests of the company.
7. The auditor is also required to comment on whether the term loans were applied for the purpose for which they were obtained.
8. The auditor is also required to comment whether the funds raised on short-term basis were use for long-term purposes.
9. Whether securities have been created in respect of debentures issued.
10. Whether the management has disclosed on the end use of funds in case of public issues and whether the same has been verified.
11. Whether any fraud on, or by the, company has been noticed or reported during the year. The nature and the amount are to be indicated
12. In case the auditors' report is unfavorable or qualified in respect of any of the matters above, the report shall also state the reasons for the unfavorable or qualified answer. In case the auditor is unable to express an opinion on any of the matters stated, he should expressly state this fact.

12.2.4 Pros and Cons

It seems to have missed a good opportunity to simplify the auditors' report. It would seem impertinent to keep repeating the same clauses year after year. For instance, if the company has details about fixed assets and procedures for physical verification in place, it would be hard to understand why this would not be maintained in any particular year. Similar would be the case for maintenance of cost records and the internal control system for purchases of fixed assets and stores. It would have been useful if all the clauses had been given as broad guidelines and only exceptions to be reported. This system would ensure that the ordinary shareholder gets to know the deviations instead of wading through all the fine print. This system would also take care of situations wherein companies slip on certain areas in particular years. It is also seems to be under the impression that only disposal of a substantial portion of the fixed assets would threaten the going concern concept. This concept could be threatened by a host of other factors. By being so restrictive, the auditor would not comment if a substantial portion of the fixed assets has been disposed of in the normal course of business.

Notes This system would ensure that the ordinary shareholder gets to know the deviations instead of wading through all the fine print. This system would also take care of situations wherein companies slip on certain areas in particular years.

It could also have barred the parking of grey transactions in the notes to accounts. The notes often contain many a landmine, which could blow up. It could take a cue from a recent RBI guideline for banks, wherein it has been expressly stated that accounting disputes need to be mentioned in the audit report or the financial statements, altered. With the introduction of CARO, the responsibility of the auditors as well as the companies to which this report applies has increased. This article makes an attempt to compare the reporting requirements in MAOCARO with that prescribed in CARO. This will help the practicing members as well as members in industry to understand the new requirement and comply with it.

Notes

Table 12.1: Clause by Clause Comparison of MAOCARO with CARO

Sr. No.	Particulars	MAOCARO	CARO
1.	**Full name**	Manufacturing and Other Companies (Auditor's Report) Order 1988	Companies (Auditor's Report) Order 2003
2.	**With effect from**	Accounting periods ending on any day on or after 1st November 1988	Accounting periods ending on any day on or after 1st July 2003
3.	**Applicability**	The order does not apply to Banking, Insurance Company and Company formed u/s. 25 of Companies Act	The order does not apply to Banking, Insurance Company, Company formed u/s. 25 of Companies Act and private limited company if: paid up capital and reserves not more that ₹ 50 Lacs and has not accepted any public deposits and does not have outstanding loan of ₹ 10 Lacs or more from any bank or financial institution and does not have turnover exceeding ₹ 5 Crs.
4.	**Clause relating to Fixed Assets**	Maintenance of proper records of fixed assets, physical verification of fixed assets and accounting of material discrepancies on physical verification	Same as MAOCARO
		Whether any fixed assets have been revalued during the year and if so the basis of revaluation should be indicated	No such reporting is required
		No such reporting is required	If substantial part of fixed assets have been disposed off during the year whether it has affected the going concern
5.	**Clause relating to Inventories**	Whether physical verification carried out at reasonable intervals in respect of finished goods, store, spare parts and raw materials	Same as MAOCARO. However, instead of mentioning finished goods, stores, spare parts and raw materials CARO mentions the word "inventory". Thus, now WIP can also be included in the list which earlier was not there.
		Whether procedures relating to physical verification of stocks reasonable and adequate in relation to the size of and nature of the business of the company. If not inadequacies to be reported	Same as MAOCARO

Contd...

Notes

		Whether material discrepancies relating to physical verification properly accounted for	Same as MAOCARO. However, one aspect added here is whether the company is maintaining proper records of inventory
		Whether stock valuation has been done in accordance with accepted accounting principles	Deleted
6.	**Clause relating to Loans granted and taken from parties listed in register maintained u/s. 301and Companies under the same management as defined u/s. 370 (1B)**	No such reporting required	The number of parties and amount involved in the transactions has to be reported only for parties listed in register maintained u/s. 301. No reporting for companies under same management
		Whether rate of interest and other terms and conditions are prima facei prejudicial to the interests of the company	Same as MAOCARO. However, no reporting required for loans granted to /taken from companies under the same management
7.	**Clause relating to other loans or advances in the nature of loans granted or taken by the company**	Whether the parties to whom loans or advances in the nature of loans are given is regular in repayment	Same as MAOCATO.
		No such reporting required	Whether the rate of interest and other terms and conditions of loans (secured or unsecured) are prima facei prejudicial to the interest of the company
		If the parties are not regular in repayment, whether reasonable steps have been taken by the company for recovery/payment of the principal and interest.	Same as MAOCARO. However, reporting required only if overdue amount is more one lakhs
8.	**Clause relating to Internal Control procedures**	Is there an adequate internal control procedure commensurate with the size of and the nature of the business of the company relating to inventory and fixed assets and for the sale of goods.	Same as MAOCARO. However, one very important additional thing to be reported is whether there is a continuing failure to correct major weaknesses in internal control
9.	**Clause relating to transactions entered with parties mentioned in register mentioned u/s. 301**	No such reporting required	Whether transactions that need to be entered into a register in pursuance of section 301 have been so entered

Contd...

Notes

		Whether transactions are effected at market prices. Reporting required only for transactions exceeding ₹ 50,000/-	Same as MAOCARO. However, the limit of ₹ 50,000/- has been increased to ₹ 5,00,000/-
10.	**Clause relating to unserviceable or damaged stores, raw materials or finished goods.**	Whether any unserviceable or damaged stores, raw materials or finished goods are determined and whether provisions for the loss, if any, have been made in the accounts	Deleted
11.	**Clause relating to acceptance of public deposits**	If the company has accepted Public Deposits, whether directives issued from RBI, provisions of section 58A of the Companies Act 1956 and the rules framed there under have been complied with. If not, the nature of contravention's have to be reported	Same as MAOCARO. However, if an order has been passed by CLB in respect of contraventions made by the company, whether the same has been complied with or not has to be reported.
12.	**Clause relating to maintenance of records for sale and disposal of by-products/scrap**	Whether the company is maintaining reasonable records for sale and disposal of realizable by-products/scrap	Deleted
13.	**Clause relating to Internal Audit System**	Whether the company has adequate internal audit system. Applicable only for companies with paid-up capital exceeding ₹ 25 lakhs or having an average annual turnover exceeding ₹ 2 Crs. for a period of 3 consecutive financial years immediately preceding the financial year concerned.	Same as MAOCARO. However, applicable only for companies with paid-up capital and reserves exceeding ₹ 50 lakhs as at the commencement of the financial year concerned or having an average annual turnover exceeding ₹ 5 Crs. for a period of 3 consecutive financial years immediately preceding the financial year concerned
14.	**Clause relating to Cost Accounting Records**	Where maintenance of cost records has been prescribed by the Central Government under clause (d) of sub-section (1) of section 209 of the Act, whether such accounts and records have been made and maintained;	Same as MAOCARO

Contd...

Notes

15.	**Clause relating to deposit of Statutory Dues**	Whether the company is regular in depositing PF and ESI dues and if not, the extent of arrears of PF and ESI should be indicated. Also undisputed outstanding statutory dues for a period of more than 6 months has to be reported	Whether the company is regular in depositing undisputed statutory dues including PF, Investor Education and Protection Fund, ESI, Income Tax, Sales Tax, Wealth Tax, Customs Duty, Excise Duty, cess and any other statutory dues and if not, the extent of arrears of outstanding statutory dues for a period more that 6 months from the date they become payable should be indicated.
16.	**Clause relating to deposit of Statutory Dues (contd.)**	No such reporting required	In case dues of sales tax/income tax/custom tax/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
17.	**Clause relating to personal expenses**	Whether personal expenses have been charged to revenue account, if so, the details thereof should be reported	Deleted
18.	**Clause relating to Sick Industrial Companies**	Whether the company is a sick industrial company as per SICA and if yes whether a reference has been made to BIFR	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 preceding such financial year also;
19.	**Clause relating to default in repayment of dues to banks / FI/ Debenture holders**	No such reporting required	Whether the company has defaulted in repayment of dues to a financial institution or bank or debenture holders? If yes, the period and amount of default to be reported.
20.	**Clause relating to maintenance of records for loans or advances granted**	No such reporting required	Whether adequate 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.
21.	**Clause relating to guarantees given for Loans**	No such reporting required	Whether the company has given any guarantee for loans taken by others from bank or financial institutions, the terms and conditions whereof are prejudicial to the interest of the company.

Contd...

Notes

22.	**Clause relating to usage of loan funds**	No such reporting required	Whether term loans were applied for the purpose for which the loans were obtained.
		No such reporting required	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.
23.	**Clause relating to preferential allotment of shares**	No such reporting required	Whether the company has made any preferential allotment of shares to parties and companies covered in the Register under sec 301 of the Act and if so whether the price at which shares issued is prejudicial to the int. of the company.
24.	**Clause relating to creation of securities for debenture holders**	No such reporting required	Whether securities have been created in respect of debentures issued?
25.	**Clause relating to usage of equity funds**	No such reporting required	Whether the management has disclosed on the end use of money raised by public issues and the same has been verified.
26.	**Clause relating to frauds**	No such reporting required	Whether any fraud on or by the company has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated.

Self Assessment

State whether the following statements are true or false:

4. Default by the company in repayment of dues to a financial institution or bank is to be mentioned under new clause.
5. With the introduction of CARO, the responsibility of the auditors as well as the companies to which this report applies has not changed much.
6. Clause relating to unserviceable or damaged stores, raw materials or finished goods has been removed from CARO.

12.3 Management Audit

Management audit refers to analysis and assessment of competencies and capabilities of a company's management in order to evaluate their effectiveness, especially with regard to the strategic objectives and policies of the business. The objective of a management audit is not to appraise individual executive performance, but to evaluate the management team in relation to their competition. Management audits are often necessitated by major changes in a business. Some of the events that call for a management audit are top management changes, mergers and acquisitions, and succession planning.

Notes

12.3.1 Concept of Management Audit

Management audit is an emerging concept of auditing. It has been originated from America. Management audit is an act of evaluation of all the activities of all the departments with a view to provide appropriate suggestions to the management to help their work. In other words, management auditing is a future oriented task which evaluates timely in all the levels of management like production management, sales management etc. The main objective of management audit is to improve the profit earning capacity, work of management, objectives of program, social objectives and human resource development so that organizational goal can be easily attained. It refers to the existence of control system, compliance of rules and regulations, process of managerial decisions etc.

Three basic evaluation methods exist for any work activity: inspection, compliance auditing and management auditing. The first method, inspection, measures a process's output against certain characteristics. These characteristics, generally identified as form, fit and function, are specified, and the process output either possesses those characteristics or it doesn't. As a result, an inspection's outcome is always binary: pass or fail.

In contrast, compliance audits check on the implementation of written manuals, procedures and work instructions. The compliance audit evolved in the 20th century as business practices became more complex. The first use of compliance auditing appeared in financial transactions, because tax collectors and bank examiners needed assurance that the financial data were correct. This concept of verifying compliance was picked up by the quality profession in the 1960s and applied to the military and the nuclear power industry. Compliance audits are still used in high-risk activities; where there is a desire to verify that the activities are being performed in strict compliance to approved requirements. Third-party registration audits, regulatory inspections and most supplier audits measure compliance. The application of a compliance audit results in stability and assurance that rules are being followed.

The management audit is a more recent concept. It focuses on results, evaluating the effectiveness and suitability of controls by challenging underlying rules, procedures and methods. Management audits, which are generally performed internally, are compliance audits plus cause-and-effect analysis. When performed correctly, they are potentially the most useful of the evaluation methods, because they result in change.

Management Audit is the systematic recognition, analysis and assessment of competencies and the actual behavior of both individual executives as well as complete executive teams particularly with regard to the business' strategic requirements. The basis of Management Audit is structured interviews and reference checks conducted by external experts to be documented in expert opinions.

Management Audits focus on personal attributes and business skills. Personal attributes can be sub-divided into:

1. Ethical values and attitudes
2. Intellectual Capability
3. Charisma

Business skills can be sub-divided into:

1. Professional and methodical competencies
2. Leadership behavior
3. Entrepreneurship

Notes

As psychological tests cannot adequately cope with above mentioned criteria (issues) the Management Audit should be conducted by experienced and well-trained interviewers. It is the objective of the process not to assess the individual manager in isolation but in context to their competitors and comparable roles outside the company. This benchmark information is most valuable and delivers conclusions as to the effectiveness of the management team.

Simply defined, the management audit is a comprehensive and thorough examination of an organization or one of its components. The audit is implemented to identify problems or significant weaknesses in the organization or corporation, thus providing management with a tool to address and repair the problem area.

Did u know? The audit is not a new or recent idea. History tells us of the presence of auditors in Pharaoh's Egypt and the classical periods of Greek and Roman history. As businesses developed and grew over the centuries of recorded history, the need for controls became increasingly important. Financial auditing became a standard in American businesses and, following the lead of New York State, certification for accountants was enacted as legislation in many states. The financial audit is now fully integrated into business practices.

The internal audit follows the spirit of financial auditing and surpasses it to examine operational matters as well. Another natural extension is operational auditing. While internal auditing is conducted by employees within the organization, an operational audit is generally completed by an internal task force or external analysts.

Caution As psychological tests cannot adequately cope with above mentioned criteria (issues) the Management Audit should be conducted by experienced and well-trained interviewers.

The management audit is now widely accepted in the business field. For more than 40 years, corporations and nonprofit organizations have utilized the management audit as a comprehensive tool. In 1932 T. G. Rose, a lecturer in management at Cambridge University and former manager for Leyland Motors, embraced the concept of an annual organizational and management audit; Queens University School of Business professor William P. Leonard followed suit, urging a comprehensive examination of the business entity. Additional credibility stemmed from the General Accounting Office of the federal government, an office charged with independent audits of government agencies.

The management audit is defined by its scope and objectives. The scope is broad and generally includes all functions of the organization, including objectives and strategy, corporate structure, organizational planning, the budgeting process, human and financial resources management, decision making, research and development, marketing, equipment and operations, and management information systems. This breadth extends to recent, present, and future operations and covers external issues as well as internal concerns. Objectives of the management audit include the development of recommendations and improvements, as well as increased awareness of the credibility and acceptance of the audit's results. The process is more an audit of management, in order to enhance corporate profits and financial stability.

The audit follows a logical, step-by-step format, including initial interviews with key managers. A study team uses the interview process to define the scope of the audit, including the areas or functions to be studied. Next, the team requests various forms of documentation, including budgets, planning documents, corporate reports, financial statements, policy and procedure manuals, biographical material, and various other documents. Following this stage, the study

Notes

team then prepares a schedule and detailed plan of study, all aimed at proceeding to the internal fact finding step. Fact-finding relies once again on interviews, documentation, and personal observation of facilities and organizational work patterns. By the time these steps are completed, the study team develops a thorough understanding of organizational structure and operations.

The team generally turns next to an external review, using interviews to determine the opinions and attitudes key people outside the organization have about its operations. Examples of those interviewed are customers, representatives of financial institutions, and employees of federal agencies having contact with the audited organization. These interviews provide the team with more objective evaluations, and lead to an analysis of all the information and data now gathered. Organizational performance is profiled, then efficiency and effectiveness are evaluated and compared against industry norms. While many criteria can be measured quantitatively, team members have to use sound judgment and objectivity when evaluating issues that cannot be measured. In turn, the organization's management has to be receptive to the audit process and demonstrate clear acceptance of audit findings.

The study team then develops conclusions and recommendations which are communicated to the organization's management. These final two stages—conclusions/recommendations and communication—are essential to the management audit process. The audit is expected to identify corporate strengths and weaknesses, sources of problems, and potential problem areas. Recommendations for correction are presented to top management. The final report comes in the form of an overall plan of action, which includes prioritized recommendations, the specific units and individuals expected to carry out the recommendations, a schedule for action, and expected results. When conducted with thoroughness, objectivity, and timeliness, the management audit becomes a powerful tool for corporate and organizational executives who seek to improve effectiveness and efficiency.

An important aspect of the management audit is the composition of the study team. Both internal and external analysts are frequently used on audit teams; the composition depends on several factors, including the need for independent appraisal, the lack of human or financial resources to conduct the audit, and the need to provide an external audit to contrast against internal findings. In some instances, associations such as the American Institute of Management (AIM) provide audit teams. The AIM has developed ten categories of the management audit, and many audits apply these same categories. They include:

1. Economic function
2. Corporate structure
3. Health of earnings
4. Service to stockholders
5. Research and development
6. Directorate analysis
7. Fiscal policies
8. Production efficiency
9. Sales vigor
10. Executive evaluation

Management audits are not limited to business corporations. Non-profit organizations—including educational institutions, hospitals, and churches—often use the management audit to attempt to improve operations. When conducted effectively, and when recommendations are applied properly, the management audit has proved its usefulness as a management technique

Notes

Table 12.2: Compliance Audits vs. Management Audits

Compliance Audits	Management Audits
Requirements are accepted as given	Requirements are challenged
Auditor assesses whether requirements are implemented	Auditor assesses whether requirements are effective and suitable.
Emphasizes stability	Emphasizes results
Designed for high-risk ad third-party applications	Generally limited to internal applications

12.3.2 Functions of Management Audit

Management audit is a difficult and complex task. It performs the following functions:

1. Management audit identifies the objectives of an organization if such objectives are not set up.
2. Management audit allocates the overall objectives of an organization in small parts.
3. Management audit reviews the structure of organization and asset of the organization and decides whether goals can be obtained or not.
4. Management audit examines all the scope of work and liability centers.
5. Management audit provides valuable suggestions to the management after the evaluation of all above facts.

12.3.3 Objectives of Management Audit

Main objectives of management audit are as follows:

1. To formulate the goal of an organization.
2. To ensure the fulfillment of goals.
3. To help management to improve the activities and procedures.
4. To help all the members of management to make effective discharge of their duties.
5. To help in the improvement of profits.

12.3.4 The Audit Team

Normally the Management Audit Team consists of two Executive Search Consultants. It is prerequisite to the success of the process that the consultants involved are industry and management- as well as executive search experienced. They must be capable to understand the client's business and strategy and the need to have a good view as to the market and competitive scenario. It is important to give clients and candidates confidence and trust in process and people. If these preconditions are met, Management Audits will bring remarkable added value to companies.

12.3.5 Needs for Management Audit

Management audit is essentially a review of the performance of various managers. It does not examine whether the procedures have been followed or not or whether all the formalities are

Notes

completed or not. It evaluates the actual performances and compares them with the pre-determined targets. It concentrates on results and not on the files. It can be particularly useful in many situations like the following:

1. A progressive management may conduct management audit periodically to assess the performances of various managers- and link a system of incentives with such an assessment. This appraisal may be conducted on the basis of objective and predetermined standards.
2. Such an audit is highly oriented. It does not question whether the procedures have been followed or not. It concerns itself primarily with the results and with the ratios of inputs and outputs.

   It measures in quantitative terms, the various inputs that a manager uses in terms of man-hours, wages, materials, overheads, or capital resources. The outputs are measured in terms of quantity, return or performance targets. The performances are evaluated by relating inputs with outputs.
3. In many circumstances an outside agency may be interested in getting a management audit conducted. Thus the government may order a management with a view to examine the efficiency of the management of a particular industrial unit.
4. Similarly, a bank or a financial institution may like to get a management audit conducted before advancing loans or before agreeing to participate in the equity capital of an undertaking.
5. Foreign collaborators may also like to get management audit conducted periodically. This would help them in assessing the management potential of their associates.
6. In case of government organizations also, there is an urgent need to review the methods of audit.

Notes Management audit evaluates the actual performances and compares them with the pre-determined targets.

The present system of audit may be replaced by a suitable form of management audit so that the basic outlook of government officials is changed and they become result-oriented rather than procedure-bound. Management audit, if properly undertaken, can be an excellent tool of management control in many situations. Whether performing a compliance or a management audit, auditors must obey four basic rules. First, audits must provide information for a defined need, that is, the customer's need. Second, auditors must be capable of performing their duties. Third, audits must measure performance against agreed criteria. Fourth, audit conclusions must be based on fact.

Rule 1: Serve your Customers

Audits provide information: All affected parties need to know if product, process and system controls are present and being applied, and obviously it doesn't hurt to know whether these controls actually work. An auditor evaluates the controls against requirements and produces a report. If controls are present and working, all parties' confidence in the process is increased. If controls are missing or not working, then resources can be applied to fix the problems.

Auditors serve three customers: The auditee, the client and the organization. Auditees' primary goal may be to simply pass the audit, but auditees trying to derive the most benefit from the audit will also want to know whether the organization is functioning effectively. In this case, an

Notes

auditor's outside perspective can be quite valuable. The client (the person who commissions the audit), in contrast to the auditee, is accountable for the auditors' actions and reports. Committees cannot generally perform this function; an audit boss should schedule the audits and make assignments. Finally, auditors must serve the organization's needs. Business values are important and the auditors can assist by determining whether the enterprise is actually achieving its goals.

Rule 2: Use Qualified People

Auditors must be able to carry out their assignments in an impartial and objective fashion. This means that they cannot have a vested interest in the activity being audited. If they developed the rules, they cannot impartially evaluate the effectiveness and application of those rules. Although an auditor can never be totally independent of the auditee, some separation must be maintained. It's fine to audit within your group, but you can't audit your own job.

Auditors must also be capable of doing their jobs. They need certain emotional, intellectual and mechanical skills, which they can obtain by attending a course, reading a book or observing others. Often, all three methods are used. In addition to knowing how to conduct an audit, auditors must be familiar with the technical processes being examined. A good way to demonstrate this familiarity is to flowchart the activity to be audited—if a person can't flowchart it, he or she can't audit it. Finally, auditors need to be able to communicate well, both orally and in writing.

Rule 3: Measure against agreed criteria

Auditors are not allowed to make up the rules—they must audit against performance standards that are already in place and accepted by the auditee. This is the planning part of the plan-do-check-act loop. The highest level of requirements includes corporate policies, management system standards and regulatory requirements. Usually originating from outside the auditee's organization, these requirements establish the goals and objectives to be achieved. National and international standards, such as QS-9000 and ISO 9001, fall into this highest category. Next comes the local approach, often called a quality manual or quality plan, for implementing these high-level requirements. It gives the framework for achieving the concepts and should be fairly compact. This document is then followed by a number of process-specific procedures. Further detail can be provided in work instructions, such as drawings, traveler sheets and sampling plans. One of an auditor's challenges is to obtain and become familiar with the many levels of requirements forming the basis for the audit.

Rule 4: Use facts to Form Conclusions

Auditing is fact-based; conclusions are drawn from the data. Facts can be good (a requirement was met) or bad (a requirement wasn't met), but no judgment or opinion should taint them. These facts, also known as objective evidence, can come from five sources. They can be physical properties, such as flow rates and dimensions; sensory-derived input from seeing, hearing, smelling or tasting; documents or records; information drawn from interviews with auditee staff members; or patterns such as percentages or ratios. Auditors use checklists and other tools to determine the facts to be gathered, and then they perform the fieldwork to gather these facts.

The output of the audit process, be it a management or compliance audit, is a report. The client (audit boss) receives the report from the auditor and delivers it to the auditee. To prepare a report, the auditor must take all of the positive and negative facts and make some sense of the data. In other words, the auditor must analyze the data.

The first step is to list all of the positive and negative observations (data), then sort those data into controls or problem areas. Generally, there will be a large number of negative observations associated with just a few control items. This natural chunking of the data allows the auditor to

Notes

see the patterns, rather than the individual events. For a compliance audit, these patterns are then reported as either conformities or non-conformities.

Management audits require some additional work. The auditor needs to identify the pain associated with those groups of bad facts. (It's important to identify business problems, such as scrap, rework and overtime, as pain.) Then the auditor combines the missing control (the system error that's causing the problems) and the business pain into one statement, called a finding. The finding will reveal cause-and-effect patterns occurring within processes. Because the business pain is identified, there will be a tremendous desire to do something about it.

By associating the negative facts with missing or weak controls, the auditor rises to the system level of analysis. This has lasting value, because the system affects the process, which affects the product or service.

12.3.6 Instilling a Desire to Improve

Audits measure actions against requirements; they examine the product, process or system against performance standards. This has value when the requirements have been thoroughly tested and scientifically proven, but, unfortunately, this is rarely the case.

Management Auditor's Rules

Most manuals, procedures and work instructions are imperfect; they're the result of a small number of individuals assembling some rules with limited resources. By focusing on results, the management audit can determine whether those plans and approaches are any good. If they aren't, the developers and users are compelled to improve their methods because they can see the adverse consequences of not doing so. When employees and managers begin to see audits as opportunities to improve, they begin to see auditors not as police officers but as productive members of the organization.

1. Be prepared
2. Dig for threads and patterns
3. Look for cause and effect
4. Use the language of business

   (e.g., cost, risk and opportunity)

12.3.7 Management Audit Procedure

Management audit procedure include following steps:

Initial Steps of the Audit – Notification, Planning, Opening Meeting and Fieldwork

Notification: The audit process begins with notification. The notification process alerts the party to be audited of the date and time of the process. The notification also will list the documents that the order wishes to review in order to understand the organization of the company. Main points that need to be considered are:

1. ***Establishing the objects of organization:*** The first job in the management audit is to identify the objectives of the business organization.
2. ***Evaluation of the organization structure:*** Next step in the management audit is to evaluate the organization structure. To find out that whether the structure enough to achieve the goals of the organizations.

Notes

3. ***Observation:*** In many cases the management auditor may have to rely upon his won observation of pertinent activities and conditions in the organisation. A management auditor may prepare organisational charts and flowcharts as a result of his observation of pertinent activities and conditions.

4. ***Evaluating the policies of the organization:*** Evaluating the policies of the organization is very important is very important. Any scope of improvement in it should be reported.

Planning: The next step, planning, is the steps the auditor takes, before the audit, to identify key areas of risk and areas of concern. This step is usually accomplished in a series of meetings with auditing staff. This leads up to the opening meeting between the auditing staff and senior management of the auditing target as well as administrative staff. The auditors will describe the process they will undertake. Management will describe areas of concern to them and the schedule of the employees that must be consulted.

Fieldwork: The next step, fieldwork, begins after the results of the meeting are used to adjust the final audit plans. Employees are notified of the audit, schedules are drawn up regarding the activities of the audit staff, and initial investigation is begun after learning of business procedures, interviewing key staff, testing current business practices by sampling, reviewing the law and testing internal rules and practices for reasonableness. Main points that need to be considered are:

1. ***Inquiry:*** A management auditor collects most of the evidence required by him by asking relevant questions and obtaining satisfactory answers to these questions. Proper framing of questionnaire is one of the first steps in conducting management audit. The main value of questionnaires lies in the fact that a good question is often a key to uncover a hidden problem.

2. ***Examination:*** In many cases, the management auditor may have to conduct an examination of documents and records. This may be necessary in case of inquiry process yields certain information which needs collaboration or which suffers from internal contradictions.

3. ***Confirmation:*** A management auditor may also obtain written or oral statements.

4. ***Developing Audit Questionnaire:*** Select a procedure to audit. Define the scope and intent, identify the participants and pull together a plan of action. Create an audit questionnaire to accompany and document each audit. This questionnaire should help to automate and formalize certain audit procedures. Include audit procedures on the questionnaire, and provide a place for the name of the procedure at the top of the questionnaire; this will help to focus the audit.

5. ***Providing Weights:*** Procedures should also include an explanation for audit responses. In general audit responses are as follows: yes, no, and N/A. "No" answers identify a procedural performance issue and "yes" answers identify areas of procedural effectiveness. "N/A" signifies that the questions are not applicable to the situation. Audit procedures should also provide a weighting system. Assign a weight to each question. For instance, each question can be rated on a scale from 1 to 5 with "1" signifying less risk and "5" signifying more risk.

6. ***Conclusion Framework:*** In addition to a questionnaire and explanation for audit responses, audit procedures should include a format for writing a conclusion. Once answered, summarize the responses (i.e., how many were yes, no, or N/A). Procedures must outline a way to calculate performance scores, generalize conclusions, and provide a framework for implementing recommendations.

The Audit Itself – Communication, Draft Audit and Management Response

1. Communication is the next step. The audit team should consistently be in contact with the corporate auditor to clarify processes, gain access to documents and clarify procedures. At the completion of the audit, the next step, the draft audit, is prepared.

Notes

2. The draft audit will detail what was done and what was found, a distribution list of parties to receive preliminary results, and a list of concerns. The draft is given to management to review, edit and suggest changes, probe areas of concern and correct errors. Upon making final corrections, the report is given to management for the seventh step, the management response.
3. Management is requested to answer the report by stating whether they agree with the problems cited, the plan to correct noted problem and the expected date by which all issues will have been addressed.

Ending the Auditing Process–Final Meeting, Report Distribution and Feedback

1. The final meeting is designed to close loose ends, discuss the management response and address the scope of the audit.
2. ***Reviewing the actual performance-*** Auditor should review the actual performance of the various work centers. The performance should be carefully and critically evaluated. Any scope of the improvement or inefficient working should be reported.
3. The next step is the report distribution, where the final audit report is sent to appropriate officials inside and outside the audit area.
4. ***Report:*** On the basis of the above steps, auditor should prepare a report and submit to the appointing authority. The report should point out all the weak and inefficient points present in the organization.
5. ***Feedback:*** The last step is the audit feedback whereby the audited company implements the recommended changes and the auditors review and test the quality, adherence and effects of the adopted changes. This continues until all issues are adopted and the next audit cycle begins.
6. ***Correlation of Information:*** The information collected through various techniques has to be correlated so that proper conclusions can be arrived at. The management auditor has to compare the actual performances with the standards laid down.

12.3.8 Conduct Management Audit

Management audit requires an inter-disciplinary approach since it involves a review of all aspects of the management function. It should be conducted by a team of experts because the variety of skills required cannot be mustered by one individual.

This team may consist of the accountant, the operations research specialist, the industrial engineer, and the social scientist. Each member of the team should have an analytical mind and an ability to look at a management function from the point of view of the organisation as a whole.

The members of the management audit team should have proper training. They should have an expert knowledge of the science of management. They should also be acquainted with salient features of various functional areas. Experience of actual work situations would also be useful.

To conduct its work properly, the management audit team should have a clearly defined authority from the management. Management audit cannot be conducted unless it is supported fully by the top management.

12.3.9 Keys Areas in which Management Audit can be undertaken in Co-operatives

Organizational Structure: In a service institution like cooperatives, organizational structure should have a strong basis. The extent of accountability of each functionary, the areas of

Notes

responsibility and the power of delegation at each level should be clearly spelt out. A clearly defined organizational structure ensures tight system and procedures with minimum loopholes and gaps. Management audit will have to focus on this and try to determine to what extent executives and managers at medium and lower level have utilized the authority vested in them. Remedial measures can consequently be suggested for appropriate delegation to achieve the desired results.

Decision-making: Correct and prompt decision making, can help in improving profit and services of cooperatives. Decision making comprises a series of acts at different levels in a hierarchy. Assessment of the quality of the decisions taken will have to take into account several factors-some controllable and some uncontrollable. Although, it is the effort of every organization to appoint right man at the right position to ensure quality decision-making. It is not always possible. Management audit will have to take into account the executive caliber of people at different levels, especially in sensitive areas like personnel department, credit appraisal and public relation. In credit cooperatives management audit will be required to ascertain as to what extent the power of writing off bad debts, sanctioning credit limit and various types of loans, settlement of disputes between banks and staff should be delegated to middle and lower level staff.

Management audit will examine situations critically and poet out faults and whether these are at top level or lower level. Finally this will help in deciding as to what extent power should be delegated to middle and lower level for effective and quick decision making. The expectations of the clients of the bank regarding services to be rendered should be the guiding factor for delegating power. The audit should reach conclusions keeping in mind the capacity, capability and expertise of the person who has been delegated powers. It should also be able to assess whether failures are due to deficiency at individual eve or due to lacunae in organizational policies.

Notes Management audit will have to take into account the executive caliber of people at different levels, especially in sensitive areas like personnel department, credit appraisal and public relation.

Human Resource Development: The employees of a cooperative contribute significantly to its development. Hence if employees are expected to make tangible contribution it is necessary that their morale is kept high. Management audit should take into an account the morale is kept high. Management audit should take into account the employee's level of motivation, the infrastructure developed for personnel in the areas of training, promotional prospects and incentives available for exemplary performance. A review of the cooperatives personnel policies in respect of transfer, placements and promotion will indicate the important areas where management audit may be conducted. Management audit will generate conducive atmosphere in the 'Organization by which good results will be ensured.

Financial Viability: The present day problem of cooperative banks is primarily that of profitability and viability which calls for a definite orientation in management audit exercise. Cooperative banks business essentially comprises lending to non-farm sector and also agriculture financing. Besides; these banks are required to undertake higher priority sector lending as compared to private and public sector banks, and also have to implement government sponsored programmes which affects their profitability. Being placed in such a position the cooperative banks are a not able to extend desired lending services to their customers, and as a result they are not able to generate sufficient income beyond their routine earning of interest.

These banks could undertake the business of bills of exchange and foreign exchange also. With the help of management audit it is possible to determine at what level profitability is being

Notes

eroded and what is the extent of cross-subsidization of non-viable services including opening of new branches. Management audit can help to identity clearly factors which are contributing to the profitability and viability to the bank, as also those which are not making any contributions in this regard. The management and administrative costs should be analyzed thoroughly by the audit to apprise the management of the impropriety in expenses.

The total income of the bank should match its managerial, financial and administrative expenses and save a certain quantum as met profit. Management audit is a very suitable device for suggesting remedial measures to improve the profitability and viability of the bank. A factual and analytical management audit can be an effective test for stimulating action to correct the weakness underscored by the auditor. Management audit will be able to pinpoint weakness in control and identify vulnerable areas for suggestion and improvement. The auditor's task is not score points by adopting a fault finding approach but to deep the interest of the organization in mind.

Notes Management audit can help to identity clearly factors which are contributing to the profitability and viability to the bank. The management and administrative costs should be analyzed thoroughly by the audit to apprise the management of the impropriety in expenses.

12.3.10 Benefits of Management Audit

Benefits of Management Audit are given below:

1. Management audit attests the quality of the management in the similar fashion as financial audit attests the accuracy of the records and financial statements.
2. It permits more objective and complete evaluation of the total management and operating structure.
3. It enables the management to find specific .problem areas where managers are unable to come out with fruitful solutions.
4. Identification of major areas needing shoring up is made possible by the management audit.
5. A check can be made on new policies and practices for both their suitability and compliance.
6. It provides adequate measure for the extent to which the current managerial controls are effective. .
7. It provides mechanism for continually updating the total management and operating structure of the firm.
8. Management audit does not concentrate on individual performance.
9. Management audit provides information about strong and weak points of the management after reviewing policies and programs. So, it helps to the smooth operation of an organization.
10. Management audit provides suggestions to the management which helps to maintain effective management.
11. Management audit helps the management providing suggestions to attain goal of an organization.

Notes

12.3.11 Management Audit & Report — Presentation Transcript

According to William P. Leonard, "*A comprehensive and constructive examination of an organizational structure of a company, institution or branch of government, or of any component thereof, such as a division or department and its use of human and physical facilities*" According to Leslie. R. Howard, "*Management audit is an investigation of business from highest level downward in order to ascertain whether sound management prevails throughout, thus facilitating the most effective relationship with the outside world and the most efficient organization and smooth running internally.*"

1. ***Business managed efficiently:*** Improvements and recommendations. Plans and programmes executed. Increasing managerial efficiency. Effective and efficient discharge of duties and responsibilities. Assess whether it can achieve the overall business objectives or not.
2. ***Scope:*** The present organizational structure is reviewed in relation to current and prospective demand of business and study must related to aims and objectives of enterprise. It includes the study of present return on investor capital. Whether the return is adequate, fair of poor. Management audit also requires the study of relationship of business with shareholders and investing public in general the performance of the concern should be compared with that of the other firms in the same field. By comparing the different ratios we can get the comparative position of the business. The aims, objectives, duties should also be kept in mind of the auditor. Financial planning and control also is a part of the management audit. The reviews of the production and sales function are also an important part of the management audit.
3. ***Types of information required for management audit:*** Objectives Planning Organization Control Functional areas, Purchase Methods of purchase, quantities procured , problems on procurement and discount earned etc; Production policy schedules of production, actual quantity produced at different levels , variances in production schedule, input-output ratios, ideal time etc; Distribution organization of sales department, budgeted sales, actual performance, incentives offered for sales, promotional offers, effectiveness of distribution channels etc; Personnel policy, method of recruiting and training, cost of man power, promotion policy, appraisal policy , labor welfare activities. Finance and accounting financial structure followed, sources of raising funds, effectiveness of raising finances, extent of working capital needs, financial controls followed, systems of accounting, effectiveness of cost control devices;

12.3.12 Management Reporting

"*A good business report is a communication that contains factual information, organized and presented in clear, correct and coherent language.*"

—Johnson and savage.

Essentials of Effective Reporting Good Form and Content

The report should be given proper title, headings, sub-headings and paragraph divisions. Simplicity The report should be presented in a simple, unambiguous and clear language. Promptness in submitting a report is an essential element of a good report. The reports should be sent at the earliest and should not be delayed.

1. ***Relevancy:*** The reports should be presented only to the persons who need them. Sometimes the reports are sent to various departments and the secrecy will not be maintained and expenditure will be more. Consistency There should be a consistency in the preparation of reports. The comparability of reports will be possible only if they are consistent.

Notes

2. ***Accuracy:*** The reports should be reasonably accurate. A report sometimes will be approximated but approximation should not be done up to the level where information loses its form and utility. Controllability The report should be addressed to appropriate persons in respective responsibility centers and its variance should be mentioned.
3. ***Cost Consideration:*** The cost of preparing and presenting the report should also be considered and it should not exceed the advantage derived from such reports.
4. ***Comparability:*** This reporting system is meant to help management in taking correct decisions and improving operational efficiency of organization. This information helps in finding out deviations or variances.
5. ***Frequency of reports:*** Along with promptness, the frequency of reporting is also significant. The timing of reporting will depend upon the nature of information and its purpose. These reports are prepared for appropriate persons.

Self Assessment

Fill in the blanks:

7. The objective of a management audit is not to appraise individual executive performance, but to evaluate the management team in relation to their.....
8. Three basic evaluation methods exist for any work activity includes inspection, compliance auditing and .....
9. Management audits, which are generally performed internally, are compliance audits plus .....

12.4 Summary

- Cost audit means a systematic and accurate verification of the cost accounts and records and checking of adherence to the objectives of the cost accounting.
- At present, the Companies Act contains provisions relating to maintenance of Cost Records under section 209 (1) (d) and Cost Audit under section 233B of the Companies Act in respect of specified industries.
- In cost audit, auditor has to perform the following duties: Examine the correctness of the cost records maintained by the concern and to report as to whether the cost accounting plans have been adhered to or not.
- If any activity of a company is covered under cost audit dated 2nd May 2011 or 30th June 2011 or 24th January 2012, the cost audit will be applicable to that company irrespective of the turnover of that particular activity.
- Through Notification No G.S.R. 480(E) of June 12, 2003, the Department of Company Affairs (DCA) has replaced MAOCARO with the Companies (Auditor's Report) Order, 2003 — CARO. The new order does merely remove the MAO in the old order — it appears much more expansive in scope.
- Effective from July 1, 2003, it applies to all companies save banking and insurance companies, Section 25 companies and private limited companies with paid-up capital and reserves of less than ₹ 50 lakh which have not accepted public deposits and do not have a loan liabilities in excess of ₹ 10 lakh and whose turnover does not exceed ₹ 5 crore.
- Three basic evaluation methods exist for any work activity: inspection, compliance auditing and management auditing.

Notes

- The management audit is a more recent concept. It focuses on results, evaluating the effectiveness and suitability of controls by challenging underlying rules, procedures and methods.
- Management audits, which are generally performed internally, are compliance audits plus cause-and-effect analysis. When performed correctly, they are potentially the most useful of the evaluation methods, because they result in change.

12.5 Keywords

CARO: Companies (Auditor's Report) Order, 2003.

Financial Audit: A financial audit, or more accurately, an audit of financial statements, is the review of the financial statements of a company or any other legal entity (including governments), resulting in the publication of an independent opinion on whether those financial statements are relevant, accurate.

Management Audit: Simply defined, the management audit is a comprehensive and thorough examination of an organization or one of its components. The audit is implemented to identify problems or significant weaknesses in the organization or corporation, thus providing management with a tool to address and repair the problem area.

MAOCARO: Manufacturing and other Companies (Auditor's Report) Order, 1988.

12.6 Review Questions

1. What is cost audit? Explain in brief.
2. What functions are performed by auditor in cost audit?
3. Explain procedure for cost audit.
4. What clauses are removed, clauses that are expanded and new clauses added while changing MAOCARO with CARO? Explain pros and cons of this revision.
5. Compare MAOCARO with CARO.
6. What is management audit?
7. How management audits focus on personal attributes and business skills?
8. How management audit can be defined by its scope and objectives?
9. Explain the composition and role played by an audit team.
10. What is the need for management audit?
11. How to conduct management audit?
12. What are the key areas in which management audit can be undertaken in co-operatives?

Answers: Self Assessment

1.	False	2.	True
3.	False	4.	True
5.	False	6.	True
7.	Competition	8.	Management auditing
9.	cause-and-effect analysis		

12.7 Further Readings

Notes

Books

David Coderre, *Internal Audit: Efficiency through Automation*. John Wiley & Sons, 2009.

Emile Woolf, Moira Hindson, *Audit and Accountancy Pitfalls: A Casebook for Practising Accountants, Lawyers and Insurers*, John Wiley & Sons, 2011.

Iain Gray, Stuart Manson, *The Audit Process: Principles, Practice and Cases*, Cengage Learning EMEA, 2007.

Jeanette Franzel, *Single Audit: Opportunities exist to improve the Single Audit Process and Oversight*, DIANE Publishing, 2009.

Susan Switzer, *Internal Audit Reports Post Sarbanes-Oxley: A Guide to Process-Driven Reporting*, John Wiley & Sons, 2007.

Online links

www.asiatradehub.com/india/tr9.asp

www.auditservices.com/aevidence.html

www.investopedia.com/terms/a/auditing-evidence.asp#ixzz1x6PIvbTg

www.informationbible.com/article-auditing-in-depth-111904.html

Notes

Unit 13: Audit of Banking and Insurance Company

CONTENTS

Notes

Objectives

After studying this unit, you will be able to:

- Discuss about audit of Banking companies;
- State audit of cooperative banks and institutions;
- Discuss about audit of general insurance business companies.

Introduction

There are several areas in banking, cooperative banking and insurance accounting and finance, both at the corporate level and operational level that need an auditor's focused attention and critical review.

13.1 Audit of Banking Companies

A banking company requires maintaining the books of account in accordance with section 209 of the Companies Act, 1956. Banking generally includes a sound internal control system in their day to day transaction. The auditor has to evaluate such system carefully. The fundamental requirement of an audit, as regards reporting on statement of account can be discharged from the examination of the internal checked and verification of assets and liabilities by making a comparison and reconciliation of balance with those in the year and that of amount of income and expenses by application of test checks. The Banking Regulation Act casts greater responsibilities on the directors of banks as compared to those of other companies in the matter of supervision over their working. Therefore, they exercise, or are expected to exercise greater supervision over the affairs of bank. The auditor is entities to rely on such supervision and to limit his checking to test checks. The financial position of a bank is depended on the condition of assets, loan, investment, cash balanced and those of its liabilities and fund. Their verification forms an important part of the balance sheet. Most of the banks have their own internal audit or inspection department entrusted with the responsibilities of checking the account of various branches. The statutory auditor may not, therefore, duplicate work.

Caution The Banking Regulation Act casts greater responsibilities on the directors of banks as compared to those of other companies in the matter of supervision over their working.

It would be fitting to conclude that Auditing is an art as well as a Science in as much as one need to apply the principles to the actual realities in an innovative manner. While the regulatory prescriptions and bank's own policy guidelines form the boundaries within which the bank's investment operations are required and expected to be carried out, it is the auditing process that culls out and highlights the bubbles and weaknesses in the procedures adopted by the bank's operating personnel and forewarn the management about the likely risks which have the potential to undermine the Corporate Objectives of the bank.

Procedure of Allotment of Bank Audit

1. The large PSBs having balance sheet size (assets + liabilities) of above ₹ 1 lac crore each to exercise managerial autonomy in regard to appointment of SBAs also from the year

Notes

2008-09 onwards. Thus, State Bank of India, Allahabad Bank, Bank of India, Bank of Baroda, Canara Bank, Central Bank of India, Indian Overseas Bank, Oriental Bank of Commerce, Syndicate Bank, Punjab National Bank, UCO Bank and Union Bank of India would be required to select/appoint their SBAs from the year 2008-09. In addition, Andhra Bank and Punjab & Sind Bank which have opted to exercise autonomy in the matter of appointment of statutory auditors will also select/appoint their SBAs in 2008-09.

2. For the remaining PSBs, the existing practice of RBI providing the list of audit firms to be appointed as SBAs would continue during the years 2008-09.

3. In respect of the banks identified above, RBI to provide the list of eligible auditors/audit firms. The existing categorization norms for empanelment of SBAs to continue.

4. The auditors/audit firms who got statutory audit of branches of PSBs in the year 04-05 and afterwards will continue to get the audit of same bank except in certain exceptional cases. Banks do not have any authority to remove the audit firms during this period without prior approval of the Reserve Bank of India.

5. The concept of one audit firm for one PSB to continue. The consent given by an audit firm will be treated as irrevocable.

6. The number of eligible auditors/audit firms is more than the number of branches to be audited at the following 33 centres (viz. Mumbai, Kolhapur, Pune, Solapur, Thane, Kolkata, Chennai, Coimbatore, Delhi/New Delhi, Ajmer, Bikaner, Jaipur, Kota, Udaipur, Ahmedabad, Vadodara, Surat, Hyderabad, Chandigarh, Raipur, Faridabad, Gurgaon, Panchkula, Panipat, Sonipat, Bangalore, Ernakulam, Indore, Nagpur, Ludhiana, Jodhpur, Bhilwara, and Ghaziabad). In such centres, the auditors/audit firms will be put to a period of compulsory rest for two years. In other centres, where the number of eligible auditors/audit firms is less than the number of branches to be audited, the branch auditors will be subjected to the principle of rotation.

7. After the selection of branch auditors, PSBs will be required to recommend the names of both continuing and new branch auditors to seek the approval from RBI before their actual appointment

Caselet

Auditor's Report (Indian Bank) Year End : Mar '12

Audited Balance Sheet of INDIAN BANK as at 31st March 2012, the Profit and Loss Account and Cash Flow Statement annexed thereto for the year ended on that date, in which are incorporated the returns of 20 Branches and 34 Zonal Offices audited by us, 1608 Branches audited by statutory branch auditors, and 3 foreign branches audited by local statutory auditors for the sole purpose of inclusion in the consolidation. The branches audited by us and those audited by other auditors have been selected by the Bank in accordance with the guidelines issued to the Bank by the Reserve Bank of India. Also incorporated in the Balance Sheet and the Profit and Loss Account are the returns of 327 branches and 26 other offices, which have not been subjected to audit. These unaudited branches account for 1.12 % of advances, 5.74 % of deposits, 1.69 % of interest income and 5.29 % of interest expenses. These financial statements are the responsibility of the Bank's Management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the auditing standards generally accepted in India. Those standards require that we plan and perform the audit to obtain reasonable

Contd...

Notes

assurance about whether the financial statements are free from material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The Balance Sheet and the Profit and Loss Account have been drawn up in Form ''A'' and ''B'' respectively of the Third Schedule to the Banking Regulation Act, 1949.

As required by the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 and subject to the limitations of disclosures required therein and the limitations of the audit indicated in Para (1) above, we 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 and have found them to be satisfactory.
2. The transactions of the Bank, which have come to our notice, have been within the powers of the Bank.
3. The returns received from the branches and offices of the Bank as supplemented with the information furnished by the Management, have been found adequate for the purpose of our audit.

In our opinion the Balance Sheet, Profit and Loss Account and Cash Flow Statement comply with the applicable accounting standards.

Without qualifying our opinion, we draw attention to Note 9.2 of Schedule 18 to the financial statements, which describes deferment of pension and gratuity liability of the bank to the extent of ₹ 587.53 crore pursuant to the exemption granted by the Reserve Bank of India to the Public Sector Banks from application of the provisions of Accounting Standard (AS) 15, Employee Benefits, vide its circular no. DBOD.BPBC/80/21.04.018/2010-11 dt.09.02.2011 on Reopening of Pension Option to Employees of Public Sector Banks and Enhancement in Gratuity Limits - Prudential Regulatory Treatment.

In our opinion, as shown by books of bank, and to the best of our information and according to the explanations given to us:

1. The Balance Sheet read together with Significant Accounting Policies and Notes thereon is a full and fair Balance Sheet containing all the necessary particulars and is properly drawn up so as to exhibit a true and fair view of state of affairs of the Bank as at 31st March 2012 in conformity with accounting principles generally accepted in India.
2. The Profit and Loss Account read with the Significant Accounting Policies and notes thereon shows a true balance of the Profit for the year covered by the account in conformity with accounting principles generally accepted in India; and
3. The Cash Flow Statement gives a true and fair view of the cash flows for the year ended on that date.

Self Assessment

Fill in the blanks:

1. A banking company requires maintaining the books of account in accordance with section 209 of the Companies Act .....

Notes

2. The financial position of a bank is depended on the condition of assets, loan, investment, cash balanced and those of its .....

3. The large PSBs having balance sheet size (assets + liabilities) of above ₹ ..... can exercise managerial autonomy in regard to appointment of SBAs from the year 2008-09 onwards.

13.2 Audit of Co-operative Credit Societies & Co-operative Banks

13.2.1 Role of Co-operatives

Co-operatives today, play a prominent role in our economy. From modest beginnings in the early part of this century they have grown into gigantic enterprises covering virtually all fields of activity in our everyday life, all over the country. Even though, co-operation is a voluntary movement of the public at large, there has been considerable state participation in the development of Co-operative movement in the post-independence period. Apart from forming part of national planning, the Co-operatives are today, taking an active and constructive role in the implementation of the 20-Point Program me and in the upliftment of the weaker sections of the community and the Scheduled Castes and Scheduled Tribes. They cover such diverse areas as agricultural credit, marketing, processing, storage of agriculture produce, consumer goods, etc., The types of Co-operatives like Agricultural Credit Societies, Land Development Banks, Urban Banks, Marketing and Processing Societies, Sugar Factories, Spinning Mills, Milk supply Societies, Farming and Irrigation Societies, Weavers Societies, Industrial Societies, Consumers' Societies, Labor and Transport Societies, Electric Societies, Housing, Poultry and Printing, etc.

In its initial stages, Co-operation formed a Central subject. The first legislation on this subject was the Co-operative Credit Societies Act of 1904 based on the report submitted by Sir Fredrik Nicholson. This Act confined itself only to Primary Credit Societies. In order to bring the non-credit societies also within its ambit, the Co-operative Societies Act, 1912 was enacted. The Act of 1912 aimed at formation of Co-operative Societies for the promotion of thrift, self-help among agriculturist, artisans and persons of limited means. Consequent upon the recommendations of the Maclagon Committee on Co-operation in 1915, Co-operation became a transferred subject in 1919 and each state began to enact its own legislation for its co-operatives. In the post-independence period, in the light of the recommendations of the All India Rural Credit Survey Report in 1954, a special role was assigned by Government to the Co-operative movement in the process of national planning. In its enlarged role, the co-operative apart from its primary role of helping its members, also assumed a larger responsibility of developing national economy and promoting the objectives embodied in the Constitution. For this purpose the State accepted and the co-operators conceded the responsibility of imparting strength to Co-operatives wherever necessary by means of State Assistance and partnership, In 1959 Karnataka State passed a separate Act entitled "The Karnataka Co-operative Societies Act, 1959" (KCS Act, 1959). The basic principles, however, confirmed to the two parent Central Co-operative Societies Acts. The first of which was modeled after the Friendly Societies Act, 1793 of England. The 1959 Act has been amended from time to time with a view to accommodating the needs of changing times and the aspirations of the people. The State Act contains comprehensive provisions for audit of Co-operative Societies and makes it obligatory for the Director of Co-operative Audit to audit or cause to be audited the accounts of every society at least once in a year.

13.2.2 Brief Features of the Financial Provisions of the K.C.S. Act

A Co-operative Society which has for its objects the promotion of the economic interests or general welfare of its members, or of the public, in accordance with Co-operative Principles, or a Co-operative Society established with the object of facilitating the operations of such a society

Notes

may be registered under KCS Act (Section 4). The aims of the society should not be inconsistent with the principles of social justice, and its byelaws not contrary to the Provisions of the KCS Act and Rules. It should comply with the requirements of sound business and have reasonable chance of success before it could be considered for registration (Section 7). Thus a Co-operative Society is a business organization with a special mode of doing business, in a strictly business like manner tempered by a high moral purpose of encouraging in its members, habits of honesty, industry, thrift, prudence, punctuality and mutual help. The liability of a Co-operative Society may be limited or unlimited subject to the provisions of Section 4 read with Section 5. The registration of a society shall render it a body corporate by the name under which it is registered having perpetual succession and a common seal and with power to hold property, enter into contracts, etc., (Sec.9). The Act provides for compulsory audit by the Director of Co-operative Audit or a person authorised by him (Sec. 63).

Did u know? Under sub-section (4 A) of Section 63 of the Act every Co-operative Society shall submit for each Co-operative year, to the Registrar and the Director of Co-operative Audit, statements showing the receipts and disbursements, Profit and Loss and the Balance Sheet for the year and such other statements and returns as the Registrar or the Director of Co-operative Audit may direct. According to Rule 51 of KCS Rules every Society has to keep Books of Accounts and Registers in connection with the business of the society in such form as the Director of Co-operative Audit may from time to time require.

13.2.3 Salient Features concerning Accounts

1. ***Restrictions on Loans:*** Under Section 60 of the K.C.S. Act a Co-operative Society shall not make a loan to any person other than a member. With general or special sanction of the Registrar, however, a co-operative society can make loans to another co-operative society. A co-operative society may also make a loan to a depositor on the security of his deposit.

2. ***Restrictions on Borrowings:*** According to Section 59 of the K.C.S. Act a co-operative society may accept loans and deposits subject to the restrictions and limits prescribed, or specified in the bylaws and further within the limit, fixed in Rule 25 of the K.C.S. Rules. With sanction of State Government, Co-operative societies may also borrow from credit agencies subject to the limits and conditions prescribed.

3. ***Investment of Funds:*** According to Section 58 of the K.C.S. Act a Co-operative society may invest or deposit its funds (a) in a Government Savings Bank, (b) in any of the securities specified in Section 20 of the Indian Trust Act, 1882 (c) in the shares or securities of any other co-operative society or (d) with any Co-operative Bank or with any Scheduled Bank approved by the Registrar. With special sanction of the Registrar, a co-operative society may invest its Reserve Fund in its own business or in the construction or purchase of buildings or lands required for carrying on the objects of the society. (Rule 23).

4. ***Provident Fund:*** According to Section 62 of the K.C.S. Act a society may establish a Provident Fund for the benefit of its employees. Such provident fund cannot be used in its business or for creating any assets for the society. The provident fund is also not liable for any attachment or be subject to any other process of any courts or other authority.

Audit or auditing is a critical and intelligent examination of the books of accounts and verification of correctness of accounts with relevant vouchers and documents in order to ensure that the entries in the books have been made correctly so as to constitute a true record of the transactions and that the Profit and Loss account and the Balance Sheet have been properly drawn up so as to exhibit a true and fair view of the state of affairs of the institution at the end of the year and the profit or loss for the financial year ended on that date.

Notes

Notes Such examination should not be confined to a mere arithmetical check of the books of accounts. It should go beyond the books of accounts to ensure that the transactions recorded therein are genuine, properly authorized and correctly entered.

13.2.4 Need for Co-operative Audit

Co-operative Audit serves the following purposes:-

1. The members of the Society are to be satisfied that the affairs of the society are managed properly and on sound business principles. This is possible by the Co-operative Auditor undertaking a detailed check of the voluminous transactions taking place during the entire year and making a report of his findings as a result of this check, to the members.
2. A large number of societies borrow funds from outside. The creditors would be keen to satisfy themselves of the financial soundness and credit worthiness of the society. For this purpose they would depend upon the Co-operative Auditor's report.
3. A large number of persons are employed by Co-operatives for managing their affairs. In order to ensure that there is proper check on efficiency and integrity of employees, the managements would require a systematic and thorough check of their accounts. This purpose is served by Co-operative Audit.
4. Non-members who deposit their funds with the Co-operative Banks would like to satisfy themselves that their funds are safe with the Bank, This is possible by the Co-operative Auditor's report.

13.2.5 Salient Features of Co-operative Audit

The audit of a Co-operative Society is different from that of a joint stock company because the objects of a Co-operative Society are quite different from those of a Joint Stock Company. While the main object of a Joint Stock Company is to earn profit, the object of a Co-operative Society is to render service to its members. Service rather than profit is the motto of a Co-operative Society Opinions has been expressed from time to time on the nature, extent and scope of Co-operative Audit.

According to the Maclagan Committee, Co-operative Audit extends somewhat beyond the bare requirements of the Act and should embrace an enquiry into all the circumstances which determine the general position of the society. It is the duty of the Co-operative Auditor to notice any instance in which the Act, rules or byelaws have been infringed, to verify the cash balance and certify the correctness of the accounts, to ascertain that loans are made fairly for proper periods and objects and on adequate security to examine repayments in order to check book adjustments and improper extensions and generally to see that the society is working on sound lines and that the committee, the officers and the ordinary members understand their duties and responsibilities.

According to the Mirdha Committee, Co-operative Audit should include scrutiny of the extent of benefit accruing to the weaker sections of the society's members. Thus a Co-operative Auditor should not confine his enquiry to the books of accounts but should go beyond the books and make enquiries into the working and general functioning of the society. His enquiry according to the Maclagan Committee should embrace all circumstances which determine the general position of the society and should aim at seeing that the society is working on sound lines. The audit of Co-operative Society has to be conducted specially in the background of Co-operative Principles

Notes

and guidance is to be given by the Co-operative Auditor for improvement of the Co-operative Institution in the light of this background. The Co-operative Audit is thus not merely a financial audit. It involves Administrative Audit also.

13.2.6 Statutory provisions relating to Co-operative Audit

Audit of Co-operatives is conducted as per provisions of Section 63(1) of the Karnataka Co-operative Societies Act, 1959. According to this section:

"Every Co-operative society shall get its accounts audited at least once in each year by the Director of Co-operative Audit or by a person authorized by him by general or special order in writing in this behalf."

Section 63(4) provides that every person who is or who has at any time been, an officer or employee of the society and every member and past member of the society, shall furnish such information in regard to the transactions and working of the society, as the Director of Co-operative Audit or the authorized person may require.

Under sub-section (3) of Section 63 the Director of Co-operative Audit or the authorized person shall at all times have access to all the books, accounts, documents, papers, securities, cash and other properties belonging to or in the custody of the society and may summon any person in possession or responsible for the custody of any such books, accounts, documents, paper, securities, cash or other properties, to produce the same at any public office, at the headquarters of the society or any branch thereof.

According to section 63(2)(12)(13)(14) of the KCS Act, 1959 read with Rule 22 and Rule 29(1) of the KCS Rules, 1960 the audit of the accounts of every Co-operative Society should include the following:

1. Examination of overdue debts, if any, verification of the cash balance and security and genuineness of advances, ensuring of personal expenses not being charged to revenue account valuation of the assets and liabilities and an examination of the working and the other prescribed particulars of the society.
2. To certify that whether the financial statements prepared by the society gives a true and fair view about the state of affairs of a co-operative society as at the end of the year. And also to report those proper books of accounts have been kept by the society so far as appears from his examination of those books and proper returns adequate for the purpose of his audit.

Any of the matters referred to in sub-section (13) and (14) is answered in the negative or with a qualification, the auditor shall state the reason for the answer in his audit report.

Section 63(5) of the KCS Act requires communication of the result of audit to the society, the Registrar and to the financing Bank or Credit Agency and if the society is affiliated to any other society, to such society.

Under Rule 30 of the KCS Rules every Co-operative Society shall pay to the State Government a fee for the audit of its accounts for each Co-operative year in accordance with the scale fixed by the Director with the previous approval of the State Government in respect of the class of societies to which it belongs.

13.2.7 Main Features of Co-operative Audit

The main features of Co-operative Audit relate to the following:

1. Adherence to Co-operative Principles
2. Observance of provisions of Act, Rules and bylaws.

Notes

3. Valuation of assets and Liabilities and Verification of Cash Balance and Securities.
4. Verification of balances of Depositors and Creditors.
5. Examination of overdue debts and classification of bad debts.
6. Personal verification of members and examination of their pass books.
7. Discussion of draft audit report with Managing Committee.
8. Audit classification of society.
9. Examination of the working and other prescribed particulars of the society.

Apart from the general processes of auditing like posting, vouching, verification of assets and liabilities etc., the special features of Co-operative Audit are briefly mentioned below.

13.2.8 Examination of Overdue Debts

Overdue debts affect the working of a society seriously. They affect the Working Capital position of the society. As such it is necessary to make a detailed analysis of the overdue debts with a view to ascertaining the chances of their recovery and classifying them as good or bad. It is also necessary to compare the percentage of overdue debts to working capital and loans and advances with that of last year and ascertain whether the trend is decreasing or increasing, whether adequate action is being taken for recovery, and whether necessary provision is being made for doubtful debts.

Adherence to Co-operative Principles

It has to be ascertained in general whether and if so, to what extent the objects for which the society was set up have been fulfilled. The assessment need not be only in terms of profit made. It could also be in terms of benefits given to members. The benefits could be in terms of sales effected at lower prices to members, economy achieved in operations, avoidance of wastage of funds, avoidance of middlemen in purchases etc.

Observance of the provision of the Act and Rules

Infringement of the provisions of the KCS Act and Rules and the bylaws of the society, if any, should be pointed out in audit. Financial implications of the infringement should also be assessed and indicated. As per Section 57(2A) of the KCS Act and Rule 22(2) of the KCS Rules, the maximum dividend a society can pay to a share holder is 25 percent.

Personal Verification of Member's Loan and Examination of their Pass Books

This is necessary in Co-operative Societies in order to ensure that books of accounts are free from manipulation, since in many Rural and Agricultural Societies a considerable number of members could be illiterate and as such personal verification provides a safeguard against any manipulation. Personal verification will however be on the basis of a test check.

13.2.9 Audit Classification of Society

Audit classification made by the Auditor indicates the overall performance of the society.

Discussion of the Draft Audit Report with Managing Committee

The draft audit report should be discussed by the Auditor with the management before finalizing the Audit Report. If the management desires.

Notes

13.2.10 Objectives of Co-operative Audit

1. Verification of the accuracy of the books of accounts and ascertaining correctness of accounts.
2. Detection of clerical errors and errors of principles and prevention of such errors.
3. Detection and prevention of frauds.
4. Examination of the affairs of the society in order to ascertain whether they have been carried on in accordance with the provisions of the Co-operative Law and the Principles of Co-operation and on sound business principles.
5. (a) Assessment of the extent to which the conditions of the members, particularly their economic conditions, have improved by the operations of the society.

   (b) Certification of actual profit realized or loss incurred.

13.2.11 Main Aspects of Co-operative Audit

There are two main aspects: firstly, Co-operative Audit is an audit conducted under the statute and therefore, it is statutory in character and, secondly, it is undertaken by Government and it is therefore, state controlled audit.

State, today, is a major partner in a majority of Co-operative undertakings and the state has acknowledged the agency of Co-operatives as an instrument of economic growth. The State as such, takes active part in the administration and management of Co-operatives. It is therefore vitally interested in getting the accounts of Co-operative Society audited regularly. The success of Co-operative movement depends on proper management of Societies. There are chances of the funds of the societies being mismanaged if the relevant transactions are not properly and promptly checked and prompt follow-up action taken on the findings of Audit. Control exercised through audit thus serves a very valuable purpose and enables effective weeding out of the unscrupulous and undesirable elements from the Co-operative movement.

The audit of Co-operative Societies which is compulsory under the Act has been entrusted to the Director of Co-operative Audit. This statutory requirement ensures proper management of operatives which are public organizations.

13.2.12 Duties, Responsibilities and Powers of Co-operative Auditor

The main duties and responsibilities are the following:

1. It is the duty of the auditor to verify the cash balance and securities, examine the overdue debts, if any, value assets and liabilities of the society, verify balances at the credit of the depositors and creditors and the amount due by the society's debtors (Section 63(2) of the KCS Act read with rule 29(1) of the KCS Rules).
2. The Auditor should satisfy himself that the Co-operative Society has kept all account books and registers in connection with the business of the society as required by the Director of Co-operative Audit, properly and up-to-date (rule 51 of the KCS Rules).
3. The accounts have been prepared by the Co-operative Society for each separate year in such form as specified by the Director of Co-operative Audit (Rule 53(1) of the KCS Rules).
4. Verify whether the provisions of all the bylaws have been strictly observed and the bylaws are in accordance with the provisions of the Act and Rules framed there under.

Notes

5. Among other things he should verify for example:

   (a) In respect of Credit Societies and Banks, whether loans have been sanctioned for proper objects and periods and on adequate security as per conditions applicable to grant of such loans to proper persons. He has also to examine the repayments in order to ascertain book adjustments, improper renewals etc., and examine whether prompt action has been taken for recovery of dues and over dues.

   (b) In respect of marketing societies whether the society has undertaken pooling and grading before sale of produce of members etc., and

   (c) In respect of other societies whether the business of the society has been conducted according to the Co-operative principles and sound business practices

6. Verify genuineness and adequacy of securities, mortgage and other bonds, adequacy of provision made for depreciation of assets and other items of expenses including interest payable on borrowings and deposits.

7. (a) Conduct personal verification of members accounts and examination of their pass books with a view to preventing manipulation of accounts by dishonest employees and office bearers.

   (b) Verify whether investments of funds made are in accordance with provisions Of section 58 of K.C.S. Act read with Rule 23 of K.C.S. Rules and borrowings made are as laid down in Section 59 of the Act read with Rule 25 of the Rules, and loans made are in accordance with Section 60 of the Act.

8. Verify whether net profit arrived at is in accordance with the provisions of Rule 22 of K.C.S., Rules and appropriations made out of net profits are in accordance with Section 57 of the K.C.S. Act.

   (a) Analyze the reasons for losses incurred by the society and assess after careful examination, deficiency or loss, if any, arising out of negligence or misconduct on the part of any employee or member of the committee, or of the society and after giving due opportunity to the persons whose actions are likely to be adversely commented upon in the Audit Report to explain why responsibility should not be fixed on them for the said deficiency or loss.

   (b) Certify the balance sheet subject to qualifications if any indicating the state of: Accounts and Affairs of the society and award audit classification to the societies on the basis of instructions issued by the Director of Co-operative Audit by other competition from time to time.

   (c) Government have been relying on the Co-operative Sector to a great extent in the implementation of their schemes for the upliftment of the weaker sections of society. The schemes include provision of cheap houses, providing credit to farmers, encouragement to small scale and cottage industry, reduction in and easy availability of essential consumer goods etc., Audit has a positive role to play in the implementation of these schemes, by ensuring that the interests of the weaker sections of the society are taken care of by the management. During audit it should be seen, for example, that loans are given in right amounts, at right time and for right purposes, increased profits reach the masses in the form of reduced prices etc.

The above constitute some of the important duties/responsibilities of the Auditor and are, as such not exhaustive. In general the Auditor's examination of accounts and affairs of the society should be such as to enable him to certify that the balance sheet of the society exhibits a true and fair view of the affairs of the society at the end of the year and the profit or loss for the financial

Notes

year ended on that date. The auditor should always be kind and courteous in his relations with both officials and non-officials. His reports should be in polite, courteous and clear language. He should act without fear or favor.

Powers

Sub-sections (3) and (4) of Section 63 of the K.C.S. Act contain provisions relating to the powers of auditors.

Under Section 63(3) of the K.C.S. Act, the Director of Co-operative Audit or the person authorized by him shall at all times have access to all the books, accounts, documents, papers, securities, cash and other properties belonging to, or in the custody of the society and may summon any person in possession or responsible for the custody of any such books, accounts, documents, paper, securities, cash or other properties, to produce the same at any public office at the headquarters of the society or any branch thereof.

Under Section 63(4) of the K.C.S. Act, every person who is or has at any time been an officer or employee of the society and every member and past member of the society shall furnish, such information in regard to the transactions and working of the society as the Director of Co-operative Audit or the person authorized by him may require. Failure of an officer/employee/member of a Co-operative Society in possession of any information, books or records to furnish such information or produce such books or records or to give assistance to the person authorized to audit the accounts of the society under section 63 of the Act is an offence and is punishable under Section 109 of the Act.

Under Section 66 of the K.C.S. Act, if any officer or person conducting audit under Section 63 of the K.C.S. Act, has reason to believe that any books or other property of the society have been tampered with or are likely to be tampered with, if left with the society with a view to eliminate or efface or change or manipulate any evidence which may be deemed necessary by such officer or person in connection with the proof of any defect or irregularities noticed by him during the course of audit, he shall have the power to seize and impound such books or property in such manner and for such period as may be prescribed. The manner for seizure and the period for which they could be impounded are laid down in Rule 53 A of the K.C.S. Rules.

13.2.13 Supervision of Audit

A system of supervision of audit is in vogue in the Department. This is not in the nature of test audit in as much as it not a re-audit. Special feature of supervision of Audit is that the work done by the Auditors and the Audit Report prepared by him are being scrutinized by visiting to the society before the Audit Report is issued.

The supervising officer should verify the draft audit report and financial statements with reference to the relevant records maintained in the society in order to ensure the correctness of the draft audit report. Any modifications if required, to be informed in writing to the concerned auditor. Apart from this, he should also ensure the following:

1. Supervising Officer should review the action taken by the Institution to rectify the mistakes and omissions pointed out in previous audit reports and make a comment if the action taken has not been satisfactory.
2. He should see whether the Auditor has verified the investments and securities and sought confirmation letters from various Debtor and Banker of the society/Institutions and conducted personal verification of loans.

Notes

3. He should see whether the Auditor has verified the adequate provisioning of depreciation at prescribed rate, and valued the closing stock correctly.

4. In respect of Banking Institutions the Fluid resources should be examined by supervising officer with reference to the provisions of the KCS Rules as well as rate fixed under the B.R. Act.

5. Proper classification of assets and provisioning thereon as IRAC Norms. In respect of societies other than these provisions made for bad debts should be examined.

6. The supervising officer should go through the draft audit report and make necessary corrections and get the draft signed by the Secretary or the Managing Director in token of his having seen it at draft stage. In case the Managing Director or Secretary wishes to his own version regarding any particular transaction that may be incorporated in the audit report together with the Auditor's comment thereon.

7. In respect of audits which can not be supervised locally by the supervising officer, a general scrutiny will be exercised by the audit report releasing authority, when audit reports are received from the Auditors concerned.

8. On receipt of the audit reports relating to audits which are not supervised on the spot the releasing authority will exercise the following checks in addition to the checks stipulated in Head Office Circular No. ADT/2/78-79, dated: 18th May 1978.

   (a) Whether the Auditor has furnished as many details as necessary regarding shortages or misappropriations if any, and explained them clearly.

   (b) Whether the language of the report is impersonal and objective.

   (c) Whether the Auditor has given opportunity to the persons concerned to furnish their versions regarding transactions which are adversely commented upon in the audit report and their comments regarding assessments made against them.

   (d) Whether necessary schedules and statements have been attached to the final accounts.

   (e) Whether there is any apparent omission on the part of the Auditor to look into any aspects of the working of society, as can be gathered by a perusal of the final accounts and his report.

   (f) The arithmetical accuracy of the final accounts should be got checked in the Assistant Director's Office.

9. The sub-divisional Assistant Director of Co-operative Audit, and the Deputy Director of Co-operative Audit are required to supervise certain audits conducted by the Auditors. For the purpose they have to select for every month, a prescribed number of societies whose audit is in the final stage of completion. The societies selected should generally be important institutions. They should visit the institution at the end of the audit. So that the draft audit report is available for is perusal During the course of their supervision they should look into the following points apart from perusing the draft audit report prepared by the auditor.

   (a) Whether the Auditor has seen that the society has fulfilled the objectives for which it was set up.

   (b) If there are shortages or misappropriations whether the Auditor has furnished as many details as necessary and whether he has avoided vague statements and explained the shortages and misappropriation clearly. (Note: Supervising officer should also look into the relevant documents wherever he suspects shortages or misappropriations)

Notes

(c) Whether the Auditor has used impersonal and objective language in his report without mentioning individuals by name except while reporting shortages or misappropriations or dues outstanding against individuals.

(d) Whether it is evident that the Auditor has seen all the receipts vouchers and challans, all books of accounts and all the statements or the final accounts and whether there is any apparent omission on the part of the Auditor to look into any aspect of the working of the society as can be gathered by a perusal of the final accounts and his report.

(e) Whether the Auditor has given opportunity to the persons concerned to furnish their versions regarding transactions which are adversely commented upon in the audit report and obtained their comments regarding assessments made against them

Self Assessment

Fill in the blanks:

4. The aims of the society should not be inconsistent with the principles of social justice, and its bylaws not contrary to the provisions of the.....
5. With sanction of....., Co-operative societies may also borrow from credit agencies subject to the limits and conditions prescribed.
6. While the main object of a ..... is to earn profit, the object of a ..... is to render service to its members.
7. Proper classification of assets and provisioning of cooperative institutions are based on.....

13.3 Audit of General Insurance Business Companies

General Insurance sector is next only to the banking industry in terms of importance among the economic barometers of the nation. While the banking industry is creating assets and consequently national wealth, the insurance industry is 'protecting' such wealth to the tune of several millions of rupees. The industry is also very unique in the sense that it thrives in selling promises and marketing uncertainties and making good money in the process, cycling such money back in to the nation building process. Cash-rich, again next only to banking, it is also the only industry that is global, both by design and default, in its reach and perspectives and hence its numbers are also massive.

The industry, which was opened up for private sector participation with a defined limit of foreign equity, after three decades of public sector monopoly, is in the process of rediscovering itself. It has become the cynosure of all discerning eyes, with more than a dozen private companies sponsored by the top industrial empires of the country teaming up with some of the best international names, have sprung in the horizon to increase the size of the cake several fold and then to take their due slices of it.

Task How audit procedure for banks are different from insurance company?

13.3.1 Accounts and Audit

The various stakeholders in the general insurance companies such as the Government (as the owners of the PSU companies), Indian shareholders and the JV partners (in case of private

Notes

companies), policyholders, reinsurers who do business with the companies etc. consider the published financials of the Insurance Companies as the symbol of the strength and more so because such financials bear the attestation of the Chartered Accountants, who 'audit' the companies.

The excitement among Chartered Accountants that is perceptible in late March and early April in connection with Bank Audits, their eagerness to get acquainted with the latest on NPA provisioning norms and their self-propelling attitude to attend the Bank Audit seminars in huge numbers are all normally not very pronounced even among those who get the insurance audit allotments. For some unfathomable reasons, the auditors do not display any enthusiasm in acquiring the necessary domain expertise of this industry, the financial concepts of which are riddled with unique and specialized concepts such as heavy influence of the bottom lines by various estimations, statutory limitation on management expenses, relationship between the capitalizations and risk bearing capacities, protection of policyholders' interests vis-à-vis expectations of stakeholders etc.

This lack of domain expertise sometimes leads to an auditor's performing his role in lesser dimension than he normally should. There are several areas in insurance accounting and finance, both at the corporate level and operational level that need an auditor's focused attention and critical review. However, before embarking on the core area, let us briefly go over the metamorphosis in the area of financial reporting and disclosure requirements of general insurance companies.

13.3.2 Pre-IRDA Scenario

The provisions of the Insurance Act, 1938 were governing the formats, reporting and disclosure requirements. Besides the financial statements in the pre-designed formats that were to be published for the benefit of the stakeholders, returns were prescribed for submission to the Controller of Insurance. On nationalization of the general insurance industry, the de jure supervisory authority continued to be the Controller of Insurance but the de facto supervisory authority was the General Insurance Corporation of India. In fact, GIC's roles were multi fold. It was the holding company, the first reinsurer, industry's policy maker, supervisor, de facto regulator et al.

13.3.3 Post-IRDA Scenario

Came 1999, the IRDA was born. Insurance Act was suitably amended to give IRDA the powers to regulate the industry that was soon to be thrown open to private players. Among the many supplementary regulations that were issued covering many aspects of functioning, the IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2000 subsequently replaced by Version 2002, was the one to govern the reporting and disclosure aspects of financials of the insurance companies Premium accounting Now, to see how the financials get affected by the changes of (a) and (b) above and how the auditors so far have dealt with them can be seen below:

For time immemorial, the premium accounting was done after providing the Unexpired Risks Reserve at ad-hoc percentages indicated in the Solvency Margin requirements {Sec. 64V(1)(ii)(b)}, which were 40% for Fire, Marine Cargo & Misc and 100% for Marine Hull of "Net Premium". [However, as the Income Tax Act & Rules, allowed insurers to provide up to 50% for Fire & Misc and 100% for Marine, many insurers (and, after nationalization, all PSU insurers) took advantage of the same and so provided]. Essentially, this meant that the companies recognized the revenue, by making adjustments for URR in their Net Premium Income (Premium less reinsurances), calling this as Net Earned Premium Income.

Notes

IRDA set out to change this. In the first set of Regulations that came out in 2000, it was required that the companies recognized the Premium income over the contract period or the period of risk, which, simply meant, proportionately.

Example: If ₹3,650/- is collected for a vehicle insurance policy that commenced on 18th Sept, 2003 to expire on 17th Sept, 2004, the revenue recognizable is ₹ 1,950/- for the financial year ending 31st Mar, 2004, as the policy runs its course for 195 days out of 365 days in the current financial year. The balance of ₹ 1,700/- is to be kept as unearned premium, as it is attributable and allocable to the succeeding accounting period.

Perhaps, the idea germinated from the perception that in the days of high-end computers and sophisticated methods of accounting, any percentage adhocism in provisioning was not necessary and that the revenue accounting could be almost realistic.

IRDA's fresh set of regulations of 2002, possibly realizing that the earlier Regulations on this score were found 'complicated' by the existing and the new insurers alike, sought to grant an escape route by bringing back the 'adhoc regime', by saying that though the premium recognition should still to be on 'accrual' basis, the minimum of URR should be at percentages prescribed. However, the problem is far from over. First of all, there is an all important point that has been missed by the rule-framers and not also queried by rule-followers. The URR provision, basically, is on the "Net" basis. For this, only percentages, however adhoc they may seem, can work. Pro-rata recognition of revenue is possible only on "Gross" premiums.

This is, essentially because, the Reinsurance programmes are not policy wise, except for very major ones. They are, mostly, on treaty basis and the underwriting year for reinsurance markets will be blatantly different from the financial year basis that we might be following.

The actual manner in which the whole premium accounting and RI cessions accounting works is too mind boggling to be wished away with any simplistic solutions in the name of bringing in any 'seeming realism'. Many insurers, taking advantage of the situation that 'actual accrual' can never be worked out correctly, simply continue adopting ad-hoc percentages, claiming that they are the 'minimum'.

Now, there are myriad practical problems that are encountered by the companies in recognizing the revenue but, the responsibility of auditors is to see that the Regulation is followed scrupulously or if not followed, reported accordingly. If one peruses the published annual reports of the insurance companies for 2002-03, it can be seen that most of the auditors have conveniently maintained silence on this. What is worse, some nationalized insurers have blatantly changed the rules of the game to suit their convenience during 2001-02 and 2002-03, resulting in huge difference to bottom lines, without eliciting any adverse comment from the auditors. This is perhaps the only industry, where lower business volume in a year can actually result in higher profits because of the 'reserve release' factor. Unless the auditors understand the tricks that can be played by the managements in this, it will not be possible for them to be true and fair to themselves let alone to the shareholders.

For the first time, a new concept called 'Premium Deficiency' was brought in by IRDA. Again a measure for augmenting policyholders' funds, it mandated that if the sum of expected claims costs, related expenses etc. exceed the URR, the said excess is to be recognized as Premium Deficiency. It is a fact that neither IRDA has attempted to explain the concept of this Premium Deficiency or the methodology of providing the same nor any Insurance Company really appeared to be unduly bothered on this. Some companies have opined that there was no premium deficiency in their companies while some simply 'disclosed' certain sums, even though the regulatory need was to recognize the same in accounts. However, the interesting aspect is that in most

Notes

cases, the auditors have looked the other way on this issue or simply have gone by the averments made by managements in this regard.

13.3.4 Estimation of Outstanding Claims

The most pronounced drain of an insurance company's resources is the Claims cost (also known as Incurred Claims), which is the actual claims paid less adjustments for reinsurance recoveries on them and provisions for claims outstanding as on the date of financial reporting. On the Direct side, the operating offices of the insurance companies are expected to make the provisions based on the available information and create a liability as on the date of closing of books. The sum total of such 'direct' figures, tempered by the Reinsurance recovery adjustments and added by the Outstanding Claims figures received from the Reinsurers, in respect of 'acceptances' would be the total 'net' outstanding claims, which will form the integral and major part of the "Claims Cost". However, these are based on estimations based on information in possession of the insurance companies on the date of closing the books. Such information could include surveyor's assessments, spot survey reports, insurers' guesstimates based on the available documents and sometimes even simply on the data given, not given or short given by the claimants themselves in the claim forms. There are really no hard and fast rules on how to make these provisions and it is left to the discretion and judgment of the claims personnel as also pruning by the managements and hence unlike the URR, which will be a structured estimate, the provision for outstanding claims will always be an unstructured estimate. This not only significantly influences (sometimes, even unduly) the bottom lines but also has the potential to distort the company's liabilities in the Balance Sheet on a given date. The auditors' responsibility (both at operational office level and at the central office level) is very pronounced in this area. Only subject knowledge and experience can lead auditor's right in their 'audit' of this area.

13.3.5 Commissions and Brokerage

At the operational office level, one of the major items of expense is the 'business procurement cost'. In the pre-IRDA days, there were agency commission payments at structured rates and though the system per se was abused to the hilt by the employees of the companies, nothing much could be done by the auditors as everything used to be alright on papers. In the post-IRDA scenario, the private insurance companies resort to ingenious methods of remunerating people, who help them procure business. Though there are official agents and brokers, the outgo towards procurement costs take different forms such as referral fee, consultancy fee etc. Unofficial rebating is also done to grease the palms of decision makers of the insured. If auditors can be vigilant in this area, many such cases can be brought to light. The auditors, especially at the operational offices, would do well to analyse this account and seek clarifications on payments made to persons other than agents and brokers.

13.3.6 Current Assets and Liabilities

When we come to Current Assets and Current Liabilities, it will become necessary to put the concerned accounts under magnifying lens, to understand what the individual balances could broadly contain within them, as it is just possible that anything inconvenient could have been parked in the hazy sub-headlines.

For instance, every company will show both in Current Assets and Current Liabilities, the balances with "other persons/entities carrying on insurance business". Insurance, being a global business by nature, is all about spread of risks far and wide and hence every insurer parts away certain shares of his premium with other insurers, by way of co-insurance (where the preference of the customer plays a role) as well as by reinsurance, both at home and abroad.

Notes

Reciprocally, he also accepts risks ceded to him. Wider the spread, better it is for all. However, such transactions between insurers (and reinsurers) mostly take place by way of correspondence and accounting entries only. While the Balance Sheet items refer to the 'net' balances as on a date, the relative effect should have gone to the revenue. There are always some transactions pending accounting for want of full information and especially when the number of transactions is huge, there can be understandable differences in balances between entities having such transactions. If periodical reconciliations take place and such pending items are accounted in the way they should be, then there will be some excuse in hiding behind the concepts such as going concern and consistency. But, in reality, such reconciliations never happen and balances are always allowed to mount, with differences ever swelling, resulting in massive sums that should have found their rightful places in the revenue accounts and in P&L accounts of the insurance companies being held captive in "capital" accounts.

Example: A claim settled by company A on behalf of company B is debited to Company B without charging it off to Revenue and because full details are not made available, even the company B does not account it as Claim).

Though, every insurance company has such transactions with hundreds of their counterparts across the globe and such problems are not unique to our country and our insurers alone, certainly it is no excuse that "Due to /Due from Insurers" continues to be a perpetual legacy of lethargy. However, in the matter of such non reconciliation of balances, charity does not begin at home itself. There are always transactions of (a) claims settled -mostly Marine Cargo & Motor TP claims- by one office of the company on behalf of the other and (b) expenses incurred on behalf of another office. There are eternal issues of non-reconciliation between offices of the same company and at any point of time, significant amounts stand wrongly 'capitalized' in these accounts, commonly called as Inter Office Accounts.

Likewise, there is another item called as Agents' balances, both in Current Assets and in Current Liabilities. There is no official sanction in the Insurance Act or from IRDA that insurance companies can have running balances with agents. In fact, no agent is authorized to collect any money on behalf of the company. At best, there can be one month's commission dues that may stand as credit balances. Or there could be continuing aberrations of what has long since been prohibited viz., balances under Agents' bank guarantees. But, the actual extents of such balances defy such perceptions. Whether these balances are what they are really supposed to be or whether the head of account is a convenient parking place for several Para-revenue items, pending (for ever?) accounting as revenue etc. are but kept as closely guarded secrets, even from auditors, who will be constantly pressurized to complete the audits in the time frame set by the managements. Yes, the only 'reconciliation' appears to be in the attitude of the statutory auditors, as it is seen that they are reporting this as non-chalantly as possible year after year. As many of the readers of the financials do not realize the impact, no serious questions are asked from any quarters.

13.3.7 Other Issues

Some of the other important issues at the operational office level are verification of compliance of Sec. 64VB of the Insurance Act, which deals with collection of premium prior to assumption of risk, bank reconciliations, operation of Bank Guarantee Premium Control account, Cash Deposit Premium Control account, refunds accounting, verification of fixed assets, cash, policy stamps etc. The Audit programme will have to factor in all of the above issues for detailed scrutiny.

Investments & Reinsurance

Audit of the investment as well as reinsurance activities happen only at the Corporate Office levels and here, the scope for auditors is well defined by the relevant Regulations of IRDA.

Notes

However, the objective of the IRDA's regulations on Investments is only the protection of policyholders' funds. IRDA has stipulated that every insurer shall constitute an Investment Committee and shall draw up an annual Investment Policy which shall be placed before the Board for approval after being vetted by the Investment Committee. The Investment Policy, as approved by the Board shall also be filed with the IRDA. Schedule B of Regulation 3 of the IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, detailing the accounting principles for preparation of financial statements provided for the procedure for valuation of investments, provisioning and impairment norms, recognition of income, disclosures forming part of financial statements etc. which reflect the intention of the Regulators to bring in more transparency in presentation. Audit of investments will have to be a very detailed one and critical areas like 'investment in unapproved investments' (within the permissive limits), 'disinvestments' and 'selling the traded securities' etc. will have to be brought under careful scrutiny.

Reinsurance is a highly technical area and unless the auditors get very well versed in verification of Bordereaux (a spreadsheet kind statement detailing risks ceded/accepted, commission's claims etc.), checking of quarterly statements of individual treaty reinsurers, profit commission statements etc. it may not at all be possible to do justice in this area. The one important thing that needs to be borne in mind by the auditors is that reinsurance transactions operate between companies at the international level based on a very high level of trust (concept of utmost good faith fortified) and the reinsurers place heavy reliance on the quality of the auditors who attest the financials of the Indian companies, which fact only increases the responsibility of the auditors.

Audit Empanelment Requirements

Prior to the private sector entry, the appointments of auditors for the four PSU companies were made by the CAG. In the current scenario where private insurers have begun operating, the appointment of auditors appears to have come within the ambit of functions of the IRDA, in terms of the regulations on preparation of financial statements and auditor's report under the IRDA Act. Here, the IRDA Act does not make any distinction between Public Sector and Private Sector Insurance Companies. (However, to what extent the said Regulations notified under the sanction given under Sec. 114 A of the Insurance Act, which in itself does not specifically state anything on auditors' appointment, can overrule the provisions of Companies Act is not clear.)

Accordingly, IRDA has started compiling a panel of Chartered Accountants and for the purpose, has also prescribed certain exacting parameters for such empanelment. Of course, in such parameters, the longevity, size etc. of a firm seems to be only given importance rather than the specialized qualifications in the field or the domain expertise of the partners. This is rather sad. An industry that is so unique and important cannot be 'audited' casually and generally, when specialization is the order of the day. Realizing the importance of the need to create and develop 'domain expertise' in this industry that is all set to take a giant leap in the years to come, our Institute has newly introduced a specialized post qualification course on insurance and risk management.

Providing assurance services to the people who are themselves in the business of assuring others is a serious affair and the responsibility of the members of our profession to provide comfort (by doing 'an informed audit') to the stakeholders, regulator, reinsurers, tax authorities can hardly be overemphasized.

Self Assessment

Fill in the blanks:

8. Co-operative Society shall not make a loan to any person other than a.....
9. ..... main role is preparation of financial statements and auditor's report of insurance companies.

Notes

10. ..... is the actual claims paid less adjustments for reinsurance recoveries on them and provisions for claims outstanding as on the date of financial reporting.

11. A new concept called 'Premium Deficiency' was brought in by IRDA as a measure for augmenting policyholders' funds, it mandated that if the sum of expected claims costs, related expenses etc. exceed the ..... the said excess is to be recognized as Premium Deficiency.

13.4 Summary

- A banking company requires maintaining the books of account in accordance with section 209 of the Companies Act, 1956.
- The fundamental requirement of an audit, as regards reporting on statement of account can be discharged from the examination of the internal checked and verification of assets and liabilities by making a comparison and reconciliation of balance with those in the year and that of amount of income and expenses by application of test checks.
- The large PSBs having balance sheet size (assets + liabilities) of above ₹ 1 lac crore each to exercise managerial autonomy in regard to appointment of SBAs also from the year 2008-09 onwards.
- The concept of one audit firm for one PSB to continue. The consent given by an audit firm will be treated as irrevocable
- Several financial concepts came under major revision and a sea change not only in the reporting and disclosure requirements but in the very area of concept of premium accounting for insurance companies are: Revenue Recognition visà-vis URR provisioning; Premium Deficiency; Investment Income bifurcation between Policyholders funds and Shareholders funds; IBNER (Incurred but not enough reported) Claims; Cash flow under 'Direct Method'; Adherence to Accounting Standards with specific modifications; Concept of "Management Report" to stress adequate disclosures; Auditors' report – Revision in Format, etc.
- Various Laws Applicable to Co-op. Banks & Co-op. Credit Societies: The Banking Regulation Act, 1949 as modified by Banking Laws (Application to Cooperative Societies) Act, 1965 effective from 1st March 1966 for the purpose of regulating the banking business of certain co-operative societies and the Banking Regulation (Co-op. Societies) Rules, 1966 effective from 3rd December, 1966; the Reserve Bank of India Act; the Foreign Exchange Management Act, 1999; the Income Tax Act, 1961 and Rules (the income is taxable, but certain deductions are available u/s 80P); the Service Tax Act and Rules; the Bombay Stamp Act, the Indian Stamp Act; the Indian Contract Act 1872, Transfer of Property Act 1882 & Sale of Goods Act 1930; Law of Limitation; Byelaws of the Society.
- IRDA has started compiling a panel of Chartered Accountants and for the purpose, has also prescribed certain exacting parameters for such empanelment.

13.5 Keywords

An insurance premium is the amount of money charged by a company for active coverage. The sum a person pays in premiums, also referred to as the rate, is determined by several factors, including age, health, and the area a person lives in.

Banking company means any company which transacts the business of banking (5(i)(c).

Banking means accepting for the purpose of lending or investment of deposits of money from public repayable on demand or otherwise and withdraw able by cheque, drafts order or otherwise (5 (i) (b)).

Notes

Insurance Regulatory & Development Authority, a body constituted under the Ministry of Finance to deal with licensing, regulating and monitoring all activities relating to the insurers, brokers, agents, corporate agents and the TPA's.

13.6 Review Questions

1. Write short note on "Unexpired Risks Reserve".
2. State the procedure for verification of Agents' Balances in the course of Audit of GIC.
3. Write short notes on (i) Co-insurance; (ii) Re-insurance; (iii) Management Expenses of Insurance Companies; (iv) Valuation of Investments in GIC and (v) Solvency Margin.
4. What observations an auditor of a GIC is required to make in compliance of CAG directions u/s 619(3) of the Companies Act, in respect of (i) System of financial control; and (ii) Investments?
5. Part IV of Schedule B of IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2000, requires a Management Report to be attached to the financial statements. What are the contents of such management report?
6. "In an audit of an insurance company, the Receipts and Payments Account is also subjected to audit". Comment on this statement in brief.

Answers: Self Assessment

1. 1956
2. Liabilities and fund
3. 1 lac crore
4. KCS Act and Rules
5. *State Government*
6. Joint Stock Company; Co-operative Society
7. IRAC Norms
8. Member
9. IRDA
10. Incurred Claims
11. URR

13.7 Further Readings

Books

David Coderre, *Internal Audit: Efficiency Through Automation*, John Wiley & Sons, 2009.

Emile Woolf, Moira Hindson, *Audit and Accountancy Pitfalls: A Casebook for Practising Accountants, Lawyers and Insurers*, John Wiley & Sons, 2011.

Iain Gray, Stuart Manson, *The Audit Process: Principles, Practice and Cases*, Cengage Learning EMEA, 2007.

Notes

Jeanette Franzel, *Single Audit: Opportunities exist to improve the Single Audit Process and Oversight*, DIANE Publishing, 2009.

Susan Switzer, *Internal Audit Reports Post Sarbanes-Oxley: A Guide to Process-Driven Reporting*, John Wiley & Sons, 2007.

Online links

www.asiatradehub.com/india/tr9.asp

www.auditservices.com/aevidence.html

www.investopedia.com/terms/a/auditing-evidence.asp#ixzz1x6PIvbTg

www.informationbible.com/article-auditing-in-depth-111904.html

Notes

Unit 14: Audit of a Partnership Accounts and Government Company

CONTENTS

Notes

Objectives

After studying this unit, you will be able to:

- Know about audit of partnership accounts;
- State the appointment procedure of auditor by individual partners;
- Discuss audit of government companies;
- State functions of audit committee.

Introduction

Auditing procedure for a partnership firm and partner account is carried out by study the partnership agreement carefully. Agreement should be signed by the partners. Auditors study the partners' contribution, amalgamation with another firm, review the internal controls and study the organizational structure of the firm. Unit also includes detailed auditing procedures for a government owned company.

14.1 Audit of Partnership Account

The rules governing the taxation of partners and partnerships are intended to permit taxpayers to conduct joint business and investment activities through a flexible economic arrangement without incurring an entity-level tax. A partnership "is generally said to be created when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses." *Bona fide* partnerships entail the joint contribution of capital or services for the purpose of carrying on a business or investment activity in which the partners share profits and losses. Unlike a corporation, which is taxed as a separate entity, a partnership is not a taxpaying entity. The partners report the partnership's income, gain, loss, deductions, and credits on their own individual tax returns. Partnership firm is a firm registered or unregistered as per the Partnership Act, 1932. It turnover exceeds 40 lakhs/annum, its subject to Tax Audit u/s 44 AB of Income Tax Act.

14.1.1 Advantages of Audit to Partnership Firms

1. Building Mutual Trust and Mitigates chances of disputes
2. Partners who do not take active part in affairs of the firm

Ancillary Services

1. Strengthening of Internal controls
2. Advisory service on taxation policy
3. Over Draft
4. Other banking facilities

Audit Procedure

1. Study the Partnership Agreement Carefully
2. Agreement should be signed by the partners
3. Study the partners contribution

Notes

4. Amalgamation with another firm
5. Review the Internal Controls
6. Study the Organizational structure of the firm

14.1.2 Appointment of Auditor by Individual Partners

According to the Companies Act (Section 224), 1956 every company shall, at each annual general meeting, appoint an auditor or auditors to hold office from the conclusion of that meeting until the conclusion of the next annual general meeting and shall, within seven days of the appointment, give intimation thereof to every auditor so appointed. Every auditor appointed under sub-section (1), shall within thirty days of the receipt from the company of the intimation of his appointment, inform the Registrar in writing that he has accepted or refused to accept, the appointment.

Provided that in the case of a firm of auditors "specified number of companies" shall be construed as the number of companies specified for every partner of the firm who is not in full-time employment elsewhere:

Provided further that where any partner of the firm is also a partner of any other firm or firms of auditors, the number of companies which may be taken into account, by all the firms together, in relation to such partner shall not exceed the specified number in the aggregate:

Provided also that where any partner of a firm of auditors is also holding office, in his individual capacity, as the auditor of one or more companies, the number of companies which may be taken into account in his case shall not exceed the specified number, in the aggregate.

Provided also that the provisions of this sub-section shall not apply, on and after the commencement of the Companies (Amendment) Act, 2000, to a private company.

Caution Every auditor appointed under sub-section (1), shall within thirty days of the receipt from the company of the intimation of his appointment, inform the Registrar in writing that he has accepted or refused to accept, the appointment.

Self Assessment

State whether the following statements are true or false:

1. Bona fide partnerships entail the joint contribution of capital or services for the purpose of carrying on a business or investment activity in which the partners share profits and losses.
2. Like a corporation, which is taxed as a separate entity, a partnership is also taxpaying entity.
3. Partnership firm is a firm registered or unregistered as per the Partnership Act, 1932.
4. If turnover of a partnership firm exceeds 40 Lakhs/annum, it is subject to Tax Audit as per 44 AB of Income Tax Act.

14.1.3 Key Audit Partner

"The engagement partner, the individual responsible for the engagement quality control review, and other audit partners on the engagement team, such as lead partners on significant subsidiaries

Notes

or divisions, who are responsible for key decisions or judgments on significant matters with respect to the audit of the financial statements on which the firm will express an opinion." The term is used not only in the provision on partner rotation, but also with respect to employment relationships and compensation, where it is concluded that such provisions should apply to additional audit partners. The definition of key audit partner focuses on whether a partner is responsible for key decisions or judgments on significant matters with respect to the audit of the financial statements on which the firm will express an opinion.

Example: In the case of an audit of consolidated financial statements, if the audit partner of a significant subsidiary is responsible for key decisions or judgments on significant matters with respect to the consolidated financial statements, that individual would be considered to be a key audit partner.

14.1.4 Audit Procedure

1. ***Partnership deed:*** Auditor must study the partnership deed before starting the audit. The clauses containing the working of the firm should be carefully studied.
2. ***Explanations:*** If the partnership deed is silent about any important matter, it should be clarified with the partners of the firm.
3. ***Powers and duties of partners:*** Auditor should inquire about the powers and duties of the partners. It should be checked that they work within their powers.
4. ***Division of work:*** Division of work among the partners should be studied carefully. It should be checked that the partners work for the allotted work to them.
5. ***Study the financial clauses:*** Auditor should carefully study the clauses of the deed regarding the salary of partners, interest on the capital, and interest on drawings.
6. ***Checking of the books of account:*** After studying the special points in the partnership deed, auditor can start checking the books of account as in any other routine audit.
7. ***Report of the audit:*** Auditor should submit the report to the partners of the firm.

14.2 Audit of Government Companies

Section 617 of the companies act defines a Government company as a company in which not less than fifty-one per cent of the paid up share capital is held by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Government. It also includes a company which is a subsidiary of a Government company.

Certain special provisions have been laid down in the Act regarding a Government company. They are discussed below:

The 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. The Comptroller and Auditor General of India will have the power to direct the manner in which the company's accounts shall be audited by the auditor. He shall also have the power to conduct a supplementary or test audit of the company's accounts by such person or persons as he may authorize in this behalf.

The auditor will submit a copy of the audit report to the Comptroller and Auditor General of India who may comment upon or supplement the audit report in such manner as he may think

Notes

fit. Such comments or supplementary report shall be placed before the annual general meeting along with the audit report.

Where the Central Government is a member of the Government company it shall cause an annual report on the working and affairs of the company to be prepared and laid before both Houses of Parliament along with the audit report and the comment, if any, of the Comptroller and Auditor general or India. The report shall be prepared within 3 months of the annual general meeting. Where the State Government is also a member, the report shall also be laid before the state legislature. But where the Central Government in not a member of the Government company, the State Government concerned shall cause the above documents prepared and laid before the state legislature.

Task Elaborate with example laws governing the audit of Government companies. Identify its scope.

The Companies' Amendment Act 1974 has enlarged the concept of Government company for the purposes of audit. Section 619-B has been inserted and it provides that the provisions of section 619 for the purposes of audit shall apply to a company in which at least 51% of the paid up share capital is held by the one or more the following or any combination thereof:

1. The Central Government and one or more Government companies;
2. Any State Government or governments and one or more Government companies;
3. The Central Government, one or more State Governments and one or more Government companies;
4. The Central Government and one or more corporations owned or controlled by the Central Government;
5. The Central Government, one or more State Governments and one or more corporations owned or controlled by the Central Government;
6. One or more corporations owned or controlled by the Central Government or any State Government;
7. More than one Government company.

Notes The Central Government may by notification in the Official Gazette direct that any of the provisions of the Act (except the above noted provisions) shall not apply to any Government company or shall apply with such exceptions, modifications and adaptations as may be specified in the notification. A copy of every such notification shall be laid in draft before both Houses of the Parliament for a period of not less than 30 days while they are in session. Since the said period of 30 days cannot, sometimes be completed in one session, section 620 has been amended by the Companies' Amendment Act, 1977 to permit the period of 30 days to be completed in one session or in two or more successive sessions.

14.2.1 Objectives of Government Audit

The concept, content and scope of Government audit have developed in tune with the political, social and economic development of the country. It aims to ensure accountability of the executive in respect of public revenue and expenditure. Initially government auditing in India is primarily expenditure oriented. Gradually, audit of receipt tax and non tax is taken up.

Notes

The objective of Government auditing is that of systematic, professional and independent examination of financial, administrative and other operations of a public entity made subsequently to their execution for the purpose of evaluating and verifying them, presenting a report containing explanatory comments on audit findings together with conclusions and recommendations for future actions by the responsible officials and in the case of examination of financial statements, expressing the appropriate professional opinion regarding the fairness of the presentation.

Following are the main objectives of government accounting:

1. To record financial transactions of revenues and expenditures related to the government organizations.
2. To avoid the excess expenditures beyond the limit of the budget approved by the government.
3. To make expenditures according to the appropriate act, rules and legal provisions of the government.
4. To provide reliable financial data and information about the operation of public fund.
5. To prevent misappropriation of government properties by maintaining the systematic records of cash and store items.
6. To facilitate for making auditing of the books of accounts.
7. To help for preparing different financial statements and reports.
8. To facilitate for estimating the annual budget by providing historical financial data of government revenues and expenditures.

Audit Jurisdiction

The organizations, subject to the audit of the Comptroller and Auditor-General of India are:

1. All the Union and State Government departments and offices including the Indian Railways and Posts and Telecommunications.
2. About 1500 public commercial enterprises controlled by the Union and State governments, i.e. government companies and corporations.
3. Around 400 non-commercial autonomous bodies and authorities owned or controlled by the Union or the States.
4. Over 4400 authorities and bodies substantially financed from Union or State revenues.

Notes Further, the Committee took the view that the holding companies should be required to maintain records relating to consolidation of financial statements for specified periods. Presentation of consolidated financial statements by the holding company should be in addition to the mandatory presentation of individual financial statements of that holding company.

14.2.2 Preservation of Records by the Companies

At present, Section 209 (4A) of the Act requires companies to preserve the books of accounts, together with the vouchers relevant to any entry in such books of account, in good order, relating to a period of not less than 8 years immediately preceding the current year. The

Notes

Committee felt that the rules may provide for preservation of books of account and records of the company for a period of 7 years to bring it in harmony with Income Tax Act.

Form of Accounting Records and Accounting Standard

In order to bring about more transparency and uniformity in the maintenance of accounts, the Committee felt that the companies should continue to be mandated to maintain their books of accounts on accrual basis and double entry method of book keeping. The question arose before the Committee as to whether the form and content of the financial statements needs to be specified separately in the Act or should be left to the Accounting Standards prescribed by the Central Government in consultation with NACAS. After considerable deliberations, it was decided that the form and content of the financial statements and the disclosures required therein need to be provided for under the Act/Rules. Any changes made in the Accounting Standards could be factored in the Act/Rules from time to time. It was also decided that the companies should be given the option to maintain the records in electronic form capable of conversion into hard copy.

Maintenance of Records outside the Country

The companies should have an option to keep records outside the country provided financial information in compliance with the Companies Act is available within the country and written notice is given to the Registrar of the place where the records are kept. However, such a Company should be obligated to produce the records that are kept outside the country, if and when required to do so as specified in the Rules.

Cash Flow Statement to be made Mandatory

World over, the importance of Cash Flow Statement is being specifically recognized. At present, the listed companies are mandated to include a Cash Flow Statement in the Annual Report and the Standards of Accounting prescribed by ICAI also requires in specified cases a Cash Flow Statement to be submitted along with the Balance Sheet and Profit & Loss Account with a view to make Cash Flow Statement mandatory. The Committee felt that there was a need to include the definition of the term Financial Statement in the Act, to include Profit & Loss Account, Balance Sheet, Cash Flow Statement and Notes on Accounts.

Relaxation/Exemption to Small Companies

The Committee was of the view that Small Companies need not be subject to the costs of a regime suited to large companies with a wide stakeholder base. Relaxations to small companies with regard to the format of accounts to be prescribed in the Act/Rules may also be considered. If necessary, a separate format for small companies may be devised. Exemptions from certain disclosures may also be considered and relaxations, if any required, in respect of compliance with Accounting Standards may be provided for while notifying the Accounting Standards. If necessary, a separate Accounting Standard may be framed for small companies.

Financial Year

The Companies Act at present does not contain any provision relating to the minimum period of a Financial Year. The Concept Paper has defined the Financial Year with the minimum period of six months. The Committee dwelt on the subject and came to the conclusion that the first financial year should begin from the date of incorporation and end on the immediately

Notes

succeeding 31st March and the subsequent Financial Years should also end on 31st March every year. The definition of Financial Year may be modified to indicate that the duration of the first Financial Year should be minimum three months instead of the six months proposed in the Concept Paper (2004). It was also suggested that the present provisions regarding laying down of the accounts before the shareholders within six months of the end of the Financial Year should continue.

Self Assessment

Fill in the blanks:

5. Audit of consolidated financial statements, if the audit partner is responsible for key decisions or judgments on significant matters with respect to the consolidated financial statements, that individual would be considered to be.....
6. Auditor should carefully study the clauses of the deed regarding the salary of partners, interest on the capital, and interest on .....
7. The auditor of a Government Company shall be appointed or reappointed by the Central Government on the advice of the .....
8. The Companies' Amendment Act ..... has enlarged the concept of Government Company for the purposes of audit.
9. Section 620 has been amended by the Companies' Amendment Act, 1977 to permit the period of ..... to be completed in one session or in two or more successive sessions.

14.2.3 Directors' Responsibility Statement

The Committee noted that the Companies Act was amended by inserting section 217 (2AA) by the Companies (Amendment) Act, 2000, which has brought about inclusion of Directors' Responsibility Statement in the report of the Board of Directors. The Committee was of the view that in addition to the existing requirements, the Responsibility Statement should include that the related party transactions and have been entered into at arm's length, and if not, the relationships of the directors in such transactions along with the amounts involved have been disclosed as a part of the Director's Report along with management justification thereof. The existing requirement in Section 217 (2AA) requiring a Director Responsibility statement indicating that the Directors have taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of the Act and that the books of accounts comply with the accounting standards and policies should continue.

Law needs to recognize a modified approach for providing depreciation to the assets coming under the category of infrastructure assets. In fact, in some countries, law has recognized that there cannot be a statutory limit on the useful life of a capital asset. Expenditure incurred/to be incurred to maintain the operating capabilities of such eligible assets could be charged off towards permissible depreciation. The Company Law should provide a framework that recognizes rates of depreciation for infrastructure projects where such rates are prescribed by statutory regulator for concerned sector. In all other cases, rates of depreciation may be provided taking into account the special requirements of infrastructure sector, as applicable to a class of projects, under the Company Law.

14.2.4 Appointment of Auditors

The issue of appointment of First Auditor of the company and his subsequent appointments were discussed at length. The Committee acknowledged the role of the Audit Committee

Notes

wherever such Committees were mandated, in recommending the appointment of the Auditors to the Board in general. The Committee recommended that the existing provisions relating to appointment of first Auditor to be made by the Board, failing which by the shareholders and the power of the Central Government to appoint the Auditors whenever the Board/shareholders fail to appoint them were necessary and should continue. The company should also be required to send intimation to the Registrar of Companies regarding appointment of First Auditors, within 7 days of such appointment.

Subsequent to the appointment of First Auditors, the appointment of Auditors should be done on AGM to AGM basis with a power to the Board to fill any casual vacancy. There should not be any situation where the company is without duly appointed Auditors. Such appointment of Auditors should be made by the shareholders taking into account the recommendations of the Board, which, in turn should be arrived at after obtaining the recommendations of the Audit Committee, where such a Committee is mandated or is in existence. In case any of the shareholders wish to propose any other Auditor in place of retiring Auditors, this process should also necessarily seek the views of the Audit Committee. There should be an obligation to intimate appointment of Auditor to Registrar of Companies by the Company within 7 days.

14.2.5 Remuneration of Auditors

The Committee discussed the provisions relating to the payment of remuneration to the Auditors and felt that this should be subject to decision by shareholders and that the provisions in the existing law provided a suitable framework for the purpose. However, the Committee felt that the basic remuneration to be termed as 'Audit Fee' should be distinguished from reimbursement of expenses. Reimbursement of expenses to Auditors should not form part of remuneration but should be disclosed separately in the Financial Statements along with the Auditor's fees.

Rotation of Auditors

The view that rotation of Audit partner should take place every five years in the case of all listed Companies was also considered by the Committee. However, the Committee thought it fit that the matter of change of Auditors be left to the shareholders of the Company and the Auditors themselves rather than be provided under law.

Provision of Non-audit Services

The Committee took note of the fact that rendering of non-audit services by Auditors of the Company was is a matter of general concern. The Committee was of the view that rendering of all services by the Auditors which were not related to audit, accounting records or financial statements, should not be prohibited from being rendered by the Auditors subject to a prescribed threshold of materiality. All non audit services may however be pre-approved by Audit Committee where such a committee is mandated or in existence. An Audit firm should however be prohibited from rendering the following non audit services to its audit client and its subsidiaries. Accounting and book keeping services relating to accounting records.

1. ***Internal Audit:*** Design and implementation of financial information systems including services related IT systems for preparing financial or management accounts and information flows of a company.
2. ***Actuarial services:*** Investment Advisory or Investment banking services
3. ***Rendering of outsourced financial services:*** Management functions including provision of temporary staff to audit clients.

Notes

14.2.6 Disqualifications of Auditors

The Committee deliberated on issues relating to disqualification of Auditors. The relevant provisions of the Companies Act in different countries including those existing in India as well as the views of the ICAI on the matter were discussed. The Committee was of the view that the Auditors' position and responsibilities involved access to sensitive market information particularly relating to the profits of the company. There was a possibility of misuse of such information. A view was expressed that the existing ban on an Auditor owning securities of the auditee company should be reviewed and that a concept of materiality be introduced. Considering the wide variation in the sizes of companies, a common prescription to be legislated under law would be difficult. The Committee, therefore, feels that at present there may not be any change in the existing framework. However, the matter may be examined further by the Government in context of the framework of ethical conduct and statutory requirements under the Chartered Accountants Act, 1949 in consultation with ICAI. The conclusions that emerged out of the discussions and deliberations are summed up as follows:

The amount of indebtedness/guarantee be increased beyond the present limit of ₹1,000/- and such a limits could be prescribed under Rules. The indebtedness/guarantee of the Auditors should also be extended to cover indebtedness/guarantee to the Directors and all entities whose financial statements are required to be consolidated under the Act. The disqualification envisaged under the Act/Rules should be applicable not only to the Auditors but also to his relatives, (the term relatives being defined under the Companies Act) any of the associates of the auditor and any entity in which the Auditor has a substantial interest. ·The Auditor should disclose holdings in the securities of the company, if any, at the time of appointment. However, the Committee feels that the Auditor would be privy to insight financial information of the company and there could be possibility of making wrongful gain by the Auditors by mis-utilizing such information. The work of the Auditor should be credible and free from conflict of interests. Therefore, the Committee are not in favour of relaxing the prohibition on holding of shares or securities of the subject company by the Auditor. The matter should be examined by the Government in consultation with the ICAI.

Appointment of Auditors other than Retiring Auditors

The Committee discussed and agreed that the existing provisions of the Companies Act relating to appointment of Auditors were well established and should continue. However, the retiring auditor should be appointed if in the Annual General Meeting, the accounts of the company for the immediately preceding financial year are not approved.

Duties and Liabilities of Auditors

Auditors have the general duty of discharging their statutory functions with care and diligence. Many stakeholders would rely on the auditor's reports for accessing the financial picture of the company. However, there cannot be any specific prescription of negligence keeping in view the expectations of all the stakeholders. However, auditors are required to carry out their work within the discipline of the legal provisions and the standards of accounting/Accounting Standards (where notified). There is a necessity that the work of the auditors should uphold the highest standards of excellence and independence. Non-compliance with such standards should invite stringent penalties. The Committee was of the view that the basic duties of the Auditors and their liability need to be laid down in the law itself instead of in the Rules. Quantification of penalty for Auditors may be prescribed in the Rules.

Notes

Powers of Auditor of a Holding Company

A view was expressed that the Auditor signing the consolidated financial statement should be empowered to access the books, records and documents of the entities whose accounts are consolidated. It was also felt that such right of the Auditor would be subject to the rules to be framed under the Act. In view of the legal position that a statutory auditor will not be able to access to all books and records of all entities whose accounts are consolidated, by virtue of the limitations of his appointment in the holding company, adequate records stating the basis for consolidation of accounts should be made available to him.

Certification of Internal Control by CEO/CFO

The Committee dwelt at length matters connected with Audit and the basic principles governing Audit. The Committee felt the need for a high quality of financial reporting, a strengthened corporate governance mechanism, an independent audit and fearless expression of opinion by the Auditors. The Committee feels that the internal controls in any organization constitute the pillar on which the entire edifice of Audit stands. For this purpose, it was felt that public listed companies be required to have a regime of internal financial controls for their own observance. Active interest of the shareholders' association in improving the quality of financial reporting, investor education for better understanding of the financial statements combined with presence of internal controls would provide for effective financial reporting. In sum :- Internal controls as mandated by the company with the approval of the Audit Committee, if any, should be certified by the CEO and CFO of the Company and in the Directors report through a separate statement on the assessment. The investors be educated and imparted with better understanding and appreciation of the financial statements. The law should also provide for an active role for the shareholders' associations in ensuring high quality of financial reporting.

The Audit Committee

While considering issues relating to management and governance structures in a company (Chapter IV, para 17.1), this Committee has recommended a committee of the Board on accounting and financial matters to be termed as the Audit Committee.

All matters relating to appointment of auditors, examination of the auditor's report along with financial statements prior to consideration and approval by the Board, related party transactions, valuations and other matters involving conflicts of interest should also be referred to the Board only through the Audit Committee.

Cost Audit

At present, the Companies Act contains provisions relating to maintenance of Cost Records under section 209 (1) (d) and Cost Audit under section 233B of the Companies Act in respect of specified industries. The Committee felt that Cost Records and Cost Audit were important instruments that would enable companies make their operations efficient and exist in a competitive environment.

The Committee noted that the present corporate scenario also included a sizeable component of Government owned enterprises or companies operating under administered price mechanism or a regime of subsidies. It would be relevant for the Government or the regulators concerned with non-competitive situations to seek costing data. The Committee, therefore, took the view that while the enabling provision may be retained in the law providing powers to the Government to cause Cost Audit, legislative guidance has to take into account the role of management in

addressing cost management issues in context of the liberalized business and economic environment. Further, Government approval for appointment of Cost Auditor for carrying out such Cost Audit was also not considered necessary.

Special Audit

The Committee felt that the provisions in the present Act requiring Special Audit under certain circumstances were not relevant in view of the detailed investigation provisions recommended by the Committee. During the course of investigation, it is expected that the inspector would have access to the specialized expertise of various professionals as may be required. Further, such investigation may be carried out by private professionals operating individually or in teams. In this background, Special Audit taken in isolation would serve no useful purpose and may be dispensed with.

The Committee discussed the application of the corporate law framework to Government companies on many occasions and took the view that in general, there should not be any special dispensation for such companies. In respect of audit of Government companies however, Companies Act provide a special regime. Pursuant to Section 19(1) of Comptroller and Auditor-General's Duties, Powers and Conditions of Service Act, 1971, audit of the accounts of Government companies is conducted by the Comptroller and Auditor General (C&AG) in accordance with the provisions of the Companies Act, 1956, the Auditor (Chartered Accountant) of a Government Company is appointed or reappointed by the C&AG. It is further stipulated that C&AG shall have the power to (a) direct the auditor to conduct the audit in a specified manner, (b) give instructions on any matter relating to the performance of his functions, (c) conduct himself a supplementary or test audit of the company's accounts and (d) comment upon or supplement the audit report in such manner as he (C&AG) thinks fit. The comments of C&AG are to be placed before AGM along with Auditor's Report.

The Committee noted with concern the delays in finalization of the accounts of Government companies. In many cases, Government companies and their directors become liable for penal action but are provided selective exclusions from their liabilities only because they are Government companies. This is leading to an unhealthy situation which must be addressed.

While considering classifications of companies in Chapter III of this Report, the Committee discussed the manner in which company law should apply to Government companies (Chapter III, para 7.1-7.4). The law should clearly provide the definition of a Government company in context of ownership of the Central and/or State Government. Therefore, the extension of special exemptions and protections to various commercial ventures taken up by Government companies in the course of their commercial operations along with strategic partners or general public should be done away with so that such entities can operate in the market place on the same terms and conditions as other entities. In particular, reflection of financial information of such ventures by Government companies and their audit should be subject to the common legal regime applicable. The existing delays are enabling a large number of corporate entities to evade their responsibilities and liability for correct disclosure of true and fair financial information in a timely manner. In this context, the relevance of the present section 619B of the Act was considered appropriate for a review.

The Committee felt that since statutory audit is conducted by the statutory auditor appointed by the C&AG in the manner directed by him, the test/supplementary audit is superfluous since it would duplicate audit work already done by statutory auditor. Further, where any directions are given by the C&AG to the Statutory Auditor not in accordance with the Accounting Standards, the Statutory Auditor may be required to mention the same in the notes on accounts.

Notes

A Government Company is defined in Section 617 as "*any company in which not less than 51 per cent of paid-up share capital is held by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments and includes a company which is a subsidiary of a Governments Company as thus defined.*"

Special Provisions

The special provisions of the Companies Act relating to Government Companies are as follows:

1. ***As regards audit***

   (a) The 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, provided that the auditor so appointed or reappointed does not hold appointment as auditor in more than twenty companies, of which not more than ten could be companies, with paid-up share capital of ₹ 25 lakhs or more. In the case of an audit firm so appointed the ceiling of twenty companies shall be per partner of the firm. The Auditor General will have the power to direct the company's auditor relating to the manner of audit and the performance of his duties. He shall also have the power to conduct a supplementary test audit of the company's account by persons appointed by him; and

   (b) The auditor is required to submit a copy of his audit report to the Comptroller and Auditor General, who shall have the right to comment upon the report. Any such comments shall be placed before the annual general meeting of the company along with the audit report (Sec. 619 as amended by the Amendment Act, 1974). Thus, it may be seen that the general provisions contained in Sees. 224 to 233 of the Act relating to audit and appointment of auditors do not apply to a Government Company.

2. ***As regards annual report***

   (a) Where the Central Government is a member of a Government Company, the Central Government shall prepare an annual report on the working and affairs of the company within three months of its annual general meeting before which the audit report is placed. The annual report is to be laid before both houses of Parliament together with a copy of the audit report and any comments thereupon, made by the Comptroller and Auditor General of India [Sec. 619A(1)].

   (b) Where in addition to the Central Government, any State Government is also a member of a Government Company, that State Government shall place a copy of the annual report (prepared by Central Government) together with a copy of the audit report and the comments (referred to earlier) before the Houses or both Houses of the State Legislature [Sec. 619A (2)3].

   (c) Where the Central Government is not a member of a Government Company, every State Government which is a member shall cause an annual report on the working and affairs of the company to be prepared within the same time (as referred to above), and then soon after lay it before the House or both Houses of the State Legislature with a copy of the audit report and comments thereupon [Sec. 61 9 A (3)].

3. ***As regards the application of the Companies Act.***

   (a) A Government Company is to be registered under the Companies Act. It may be incorporated as a 'public' or 'private' company. The Central Government may, however, by notification in the Official Gazette, direct that any of the provisions of this Act shall not apply to any Government Company or shall apply only with such exceptions, modifications and adaptations, as may be specified in the notification.

Notes

(b) The notification shall be effective to the extent to which it is approved by Parliament (Sec. 620). Subject to such notification, such companies are governed by the Companies Act like any other limited company without any discrimination. The Central Government has issued notifications (published in the Gazette of India, dated 11 February and 4 March, 1978) granting exemptions to Government Companies from the application of certain Sections of the Companies Act.

For example, they have been exempted from complying with the provisions of Sections 198,259,268, 269, 309, 310, 311, 387 and 388 relating to the appointment of Managing or Whole time directors and payment of remuneration to them. Similarly, Sections 255, 256 and 257 pertaining to appointment and retirement of directors, and Section 370 relating to making of loans, etc., to companies under the same management shall not apply to such Government Companies which are wholly owned by the Central or State Government. Examples of popular Government Companies are: Heavy Engineering Corporation Ltd., Hindustan Machine Tools Ltd., State Trading Corporation of India Ltd., and Indian Drugs and Pharmaceuticals Ltd.

(c) A Government Company, no doubt, has certain special feature" but it should not be placed on the same footing as a State or Government. It basically remains a company in the ordinary sense, having a legal entity of its own, separate from that of its shareholders whoever they may be. It makes no difference whether the entirety of the capital is subscribed by the Government or Government holds only 51 per cent of the share capital. In no case a Government Company is identified with the State and its employees do not become Government servants, holders of civil posts under the Union or State Governments (S. K. Debnath vs. Mining and Allied Machinery Corporation.

14.2.7 Audit Fees

Minimum Audit Fee in respect of Audit

A member of the Institute in practice shall not, on behalf of the firm of chartered accountants in which he is a partner, accept or carry out any audit work involving receipt of audit fees (excluding reimbursement of expenses, if any) for such work of an amount less than what is specified hereunder:

1. Consisting of 5 or more partners but less than 10 partners with at least one partner holding a certificate of practice for five years or more; or
2. Consisting of 10 or more partners with at least one partner holding a certificate of practice for five years or more.

		Practising firm having 5 or more partners but less than 10 partners	Practising firm having 10 or more partners
(i)	In cities with population of 3 million and above. (as per the last census)	Rs. 6000/- p.a.	Rs. 12,000/- p.a
(ii)	In cities/towns having population of less than 3 million. (as per the last census)	Rs. 3500/- p.a	Rs 8000/- p.a

Provided that such restriction shall not apply in respect of the following:

1. Audit of accounts of charitable institutions clubs, provident funds, etc. where the appointment is honorary i.e. without any fees;.
2. Statutory audit of branches of banks including regional rural banks;

Notes

3. Audit of newly formed concerns relating to two accounting years from the date of commencement of their operations;
4. Certification or audit under Income-tax Act or other attestation work carried out by the Statutory Auditor; and
5. Sales Tax Audit and VAT Audit.

14.3 Comptroller and Auditor-General of India

14.3.1 Audit Jurisdiction

The organisations subject to the audit of the Comptroller and Auditor-General of India are:-

1. All the Union and State Government departments and offices including the Indian Railways and Posts and Telecommunications.
2. About 1500 public commercial enterprises controlled by the Union and State governments, i.e. government companies and corporations.
3. Around 400 non-commercial autonomous bodies and authorities owned or controlled by the Union or the States.
4. Over 4400 authorities and bodies substantially financed from Union or State revenues.

14.3.2 Audit of Government Companies (Commercial Audit)

There is a special arrangement for the audit of companies where the equity participation by Government is 51 percent or more. The primary auditors of these companies are Chartered Accountants, appointed by the Comptroller and Auditor-General of India, who gives the directions to the auditors on the manner in which the audit should be conducted by them. The Comptroller and Auditor-General of India is also empowered to comment upon the audit reports of the primary auditors. In addition, the Comptroller and Auditor-General of India conducts a test audit of the accounts of such companies and reports the results of his audit to Parliament and State Legislatures.

14.3.3 Audit Board Setup in Commercial Audit

A unique feature of the audit conducted by the Indian Audit and Accounts Department is the constitution of Audit Boards for conducting comprehensive audit appraisals of the working of Public Sector Enterprises engaged in diverse sectors of the economy.

These Audit Boards associate with them experts in disciplines relevant to the appraisals. They discuss their findings and conclusions with the managements of the enterprises and their controlling ministries and departments of government to ascertain their view points before finalisation.

The results of such comprehensive appraisals are incorporated by the Comptroller and Auditor-General in his reports.

14.3.4 Nature of Audit

While fulfilling his Constitutional obligations, the Comptroller & Auditor-General examines various aspects of Government expenditure. The audit done by C&A G is broadly classified into Regularity Audit and Performance Audit.

Notes

14.3.5 Performance Audit

Performance audit to see that Government programmes have achieved the desired objectives at lowest cost and given the intended benefits. For a complete list of Performance Appraisals since 1983.

14.3.6 Regularity Audit (Financial)

In regularity (financial) audit and in other types of audit when applicable, auditors should analyze the financial statements to establish whether acceptable accounting standards for financial reporting and disclosure are complied with. Analysis of financial statements should be performed to such a degree that a rational basis is obtained to express an opinion on financial statements.

14.3.7 Action on Audit Reports

The scrutiny of the Annual Accounts and the Audit Reports thereon by the Parliament as a whole would be an arduous task, considering their diverse and specialised nature, besides imposing excessive demands on the limited time available to the Parliament for discussion of issues of national importance. Therefore the Parliament and the State Legislatures have, for this purpose, constituted specialized Committees like the Public Accounts Committee (PAC) and the Committee on Public Undertakings (COPU), to which these audit Reports and Annual Accounts automatically stand referred.

14.3.8 Public Accounts Committee

The Public Accounts Committee satisfies itself:-

1. that the moneys (shown in the accounts) were disbursed legally on the service or purpose to which they were applied;
2. that the expenditure was authorized;
3. that reappropriation (i.e. distribution of funds).

It is also the duty of the PAC to examine the statement of accounts of autonomous and semi-autonomous bodies, the audit of which is conducted by the Comptroller & Auditor-General either under the directions of the President or by a Statute of Parliament.

14.3.9 Committee on Public Undertakings

The Committee on Public Undertakings exercises the same financial control on the public sector undertakings as the Public Accounts Committee exercises over the functioning of the Government Departments. The functions of the Committee are:-

1. To examine the reports and accounts of public undertakings.
2. To examine the reports of the Comptroller & Auditor General on public undertakings.
3. To examine the efficiency of public undertakings and to see whether they are being managed in accordance with sound business principles and prudent commercial practices.

The examination of public enterprises by the Committee takes the form of comprehensive appraisal or evaluation of performance of the undertaking. It involves a thorough examination, including evaluation of the policies, programmes and financial working of the undertaking.

Notes

The objective of the Financial Committees, in doing so, is not to focus only on the individual irregularity, but on the defects in the system which led to such irregularity, and the need for correction of such systems and procedures.

14.3.10 CAG's Role

The Comptroller & Auditor General of India plays a key role in the functioning of the financial committees of Parliament and the State Legislatures. He has come to be recognised as a 'friend, philosopher and guide' of the Committee. His Reports generally form the basis of the Committees' working, although they are not precluded from examining issues not brought out in his Reports. He scrutinises the notes which the Ministries submit to the Committees and helps the Committees to check the correctness submit to the Committees and helps the Committees to check the correctness of facts and figures in their draft reports.

The Financial Committees present their Report to the Parliament/State Legislature with their observations and recommendations. The various Ministries/Department of the Government are required to inform the Committees of the action taken by them on the recommendations of the Committees (which are generally accepted) and the Committees present Action Taken Reports to Parliament/Legislature.

In respect of those cases in Audit Reports, which could not be discussed in detail by the Committees, written answers are obtained from the Department/Ministry concerned and are sometimes incorporated in the Reports presented to the Parliament/State Legislature. This ensures that the audit Reports are not taken lightly by the Government, even if the entire report is not deliberated upon by the Committee.

Did u know? **Union Audit Reports**

The Union Audit Reports of the Comptroller and Auditor-General of India, contain the findings of transaction audit and performance audit in the areas of:

1. Civil Audit
2. Audit of Autonomous Bodies
3. Defense Services
4. Railways
5. Receipts of the Government
6. Central Commercial

The Audit of the CAG is bifurcated into two streams namely Performance Audit and Regularity (Compliance) Audit.

While audit of the Civil Departments, Railways and Defense are conducted as per the direct mandate in the constitution and relevant provisions of the DPC Act, the Commercial Audit is conducted under the provisions of Company Act. Autonomous Bodies are audited as per the mandate in the act establishing the body.

The reports of the CAG are deliberated upon by the Public Accounts Committee (PAC) of the parliament, save the commercial reports which are examined by the Committee on Public Undertakings (COPU).

Self Assessment

Notes

Fill in the blanks:

10. At present, Section 209 (4A) of the Act requires companies to preserve the....., together with the vouchers relevant to any entry in such books of account, in good order, relating to a period of not less than .....immediately preceding the current year.

11. The auditor appointed or reappointed for Government company audit does not hold appointment as auditor in more than .....companies, of which not more than ten could be companies, with paid-up share capital of ₹ ..... or more.

12. At present, the Companies Act contains provisions relating to maintenance of ..... under section 209 (1) (d) and Cost Audit under section 233B of the Companies Act in respect of specified industries.

14.4 Summary

- Key audit partner focuses on whether a partner is responsible for key decisions or judgments on significant matters with respect to the audit of the financial statements on which the firm will express an opinion.
- Audit procedure for a partnership account include: Partnership deed or the clauses containing the working of the firm should be carefully studied; Seek explanations if the partnership deed is silent about any important matter; Powers and duties of partners; Division of work; Study the financial clauses; Checking of the books of account and making report of the audit.
- A Government Company is defined in Section 617 as "any company in which not less than 51 per cent of paid-up share capital is held by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments and includes a company which is a subsidiary of a Governments Company as thus defined."
- The 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.
- The auditor will submit a copy of the audit report to the Comptroller and Auditor-General of India who may comment upon or supplement the audit report in such manner as he may think fit.
- The preparation of financial information and its audit, therefore, needs to be regulated through law with stringent penalties for non-observance Accounting Standards serve a vital function in this respect.
- The Audit Committee discussed at length the existing provisions of the Act regarding approval and authentication of accounts, circulation of accounts and filing of accounts with the Regulatory body.
- The Committee discussed other miscellaneous matters in relation to definition of certain terms such as "derivative", "employees stock option", "net worth" etc. the need for rules relating to "Transfer of Profit to Reserves" and "Declaration of Dividend out of Reserves" and related matters.
- The measure of depreciation is based on three important parameters viz. depreciable amount, estimated useful life and estimated scrap value.

Notes

- At present, the Companies Act contains provisions relating to maintenance of Cost Records under section 209 (1) (d) and Cost Audit under section 233B of the Companies Act in respect of specified industries.
- The Committee felt that the provisions in the present Act requiring Special Audit under certain circumstances were not relevant in view of the detailed investigation provisions recommended by the Committee.

14.5 Keywords

A Government Company is defined in Section 617 as "any company in which not less than 51 per cent of paid-up share capital is held by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments and includes a company which is a subsidiary of a Governments Company as thus defined."

Audit Committee: The Companies (Amendment) Act (2000), among other things, provides for the formation and functioning of audit committees (section 292A). Similar requirements for audit committees are prescribed under clause 49 of the Listing Agreement issued by SEBI.

Partnership Deed: A document setting out the agreement of the partners on how the partnership is to be conducted (including the arrangements for sharing profits and losses.

Partnership, partner, firm and firm name - "Partnership" is the relation between persons who have agreed to share the profits of business carried on by all or any to them acting for all.

14.6 Review Questions

1. What do you understand by audit of partnership accounts? Describe various features of a partnership account.
2. Describe procedure for appointment of auditor by individual partners.
3. What the key features of a government company.
4. Describe in detail the audit procedure of a government company.
5. What the roles and responsibilities of an Audit Committee?
6. What are the various special provisions of the Companies Act relating to Government Companies as regard to audit?
7. What are the powers of auditor of a holding company?
8. What do you understand by authentication, circulation and revision of financial statements?

Answers: Self Assessment

1. True
2. False
3. True
4. True
5. a key audit partner
6. drawings
7. comptroller and auditor general of India

Notes

8. 1974
9. 30 days
10. books of accounts; 8 years
11. twenty; 25 lakhs
12. Cost Records

14.7 Further Readings

Books

David Coderre, *Internal Audit: Efficiency through Automation*, John Wiley & Sons, 2009.

Emile Woolf, Moira Hindson, *Audit and Accountancy Pitfalls: A Casebook for Practising Accountants, Lawyers and Insurers*, John Wiley & Sons, 2011.

Iain Gray, Stuart Manson, *The Audit Process: Principles, Practice and Cases,* Cengage Learning EMEA, 2007.

Jeanette Franzel, *Single Audit: Opportunities exist to improve the Single Audit Process and Oversight*, DIANE Publishing, 2009.

Susan Switzer, *Internal Audit Reports Post Sarbanes-Oxley: A Guide to Process-Driven Reporting*, John Wiley & Sons, 2007.

Online links

www.asiatradehub.com/india/tr9.asp

www.auditservices.com/aevidence.html

www.investopedia.com/terms/a/auditing-evidence.asp#ixzz1x6PIvbTg

www.informationbible.com/article-auditing-in-depth-111904.html

LOVELY PROFESSIONAL UNIVERSITY
Jalandhar-Delhi G.T. Road (NH-1)
Phagwara, Punjab (India)-144411
For Enquiry: +91-1824-521360
Fax.: +91-1824-506111
Email: odl@lpu.co.in

978-93-90164-16-5
9 789390 164165