Advanced Auditing

DCOM509

Edited by:
Pooja

LOVELY PROFESSIONAL UNIVERSITY

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ADVANCED AUDITING

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SYLLABUS

Advanced Auditing

Objectives:

- Student would get familiar with various techniques of auditing used in different kinds of audit.
- It will give a description for the ways of examination of books of accounts and the auditing standards to be followed while authenticating the books of accounts.
- It will also develop an understanding about auditing of books of accounts which are helpful in prevention and detection of frauds and errors in the business.

Sr. No.	Description
1.	Auditing: introduction, auditing standards and IFRS, their relevance, Introduction to US- GAAP
2.	Internal Control, Evaluation of internal control procedures and establishing coordination between internal audit and external audit.
3.	Audit Sampling, Analytical procedures
4.	Auditing in computerized environment, improving audit effectiveness
5.	Audit of limited companies
6.	Government audit, government and independent financial audit: comparison, Introduction to Special Audit and Efficiency Audit
7.	Special features of audit of public sector undertakings , audit of banks, audit of non banking financial companies, insurance companies, co-operative societies ,Tax audit
8.	Special Audit, Efficiency Audit, Cost audit and its relevance
9.	Professional Ethics and Regulations
10.	Current issues in auditing

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Unit 1: Introduction to Auditing

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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

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 Companies Act

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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 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. Companies 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.

Caselet

Let us Root the GAO on

I like the heat CMS and its contractors are getting for their audit activities as of late. The lead for this story in Bloomberg Business week, based on a recent report from the Government Accountability Office (GAO), pretty much says it all:

"A program to fight fraud in the Medicaid health system for the poor has cost the U.S. at least $102 million in auditing fees since 2008 while identifying less than $20 million in overpayments, investigators found."

In other words, the government spends about five times more money chasing fraud than it gets back. The story continues:

Contd....

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"The majority of the audits conducted by 10 companies were discontinued, produced 'low or no findings' or were 'put on hold,' the GAO, the non-partisan investigative arm of Congress, said in a report."

Anecdotally, I've heard providers come to these same conclusions not only about CMS's audit activities, but also about its competitive bidding program. CMS estimates that competitive bidding has saved $202.1 million in its first year. But at what cost? I've never been able to put a finger on exactly how much the agency has spent to not only launch the program but also keep it going. The only thing I've seen: a contract for almost $10 million related to creating the DBidS system that providers use to submit their bids.

With this GAO report, the industry has more solid proof that a program meant to save money is actually costing money. The beauty of all of this is that, at least in the case of this investigation of audit activities for Medicaid, CMS doesn't disagree that its efforts are penny-wise, pound-foolish. Peter Budetti, director of program integrity at CMS, told Bloomberg that three of the companies conducting the audits won't have their contracts renewed and two others will be reassigned.

"The results were extremely disappointing, way below what the expectations had been," he said.

The ugly of all of this is that, while CMS throws money at finding and collecting overpayments, legitimate providers are too often the ones paying the price. A story in Forbes on the faulty data that CMS is using to set expectations and launch audit activities says:

"Upon reading (the recent testimony of HHS Regional Inspector General Ann Maxwell to Congress), another vastly different but no less important point emerges: inaccurate Medicaid claims data can wreak havoc on innocent medical providers. Indeed, for those who counsel health care providers, Ms. Maxwell's testimony is noteworthy not just for what it says about the (in) accuracy of Medicaid data, but also for what it reveals about the extent to which providers have been and will continue to be subjected to unjustified, burdensome and meritless government scrutiny."

The GAO has never been shy about looking into DME-related issues. In this case, let us root the agency on and hope it now turns its focus on audit activities for Medicare and competitive bidding.

Source: http://www.hmenews.com/article/case-let-us-root-gao

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*."

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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

There are few points which make differentiation between auditing and accounting. These are as follows:

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.

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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. 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.

1.4.1 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.

1.4.2 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.

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

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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.

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 Companies 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.

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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 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 book keeping 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.

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

1.7.1 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.

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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 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 totalling, wrong calculations, wrong balancing and wrong casting of subsidiary books.

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.

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(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 nullifying the net effect of the error.

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.

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

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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 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?

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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.
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.
15. Qualifications of the statutory auditor are prescribed in the .....

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 Non-performance. 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 ancillary or multidisciplinary consulting practice.

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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).

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.

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- 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.
- 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

Audit: Audit may be defined as 'an official inspection of an individual's or organization's accounts, typically by an independent body'.

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.

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 Companies Act.

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

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.

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

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(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?

7. Define the main objective of audit.

8. What instructions should be followed while doing audit?

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
15. Companies Act, 1956

1.12 Further Readings

Books

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

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

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

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

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

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

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

Unit 2: Auditing Standards and IFRS

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Objectives

After studying this unit, you will be able to:

- Explain the concept of Indian Auditing Standards
- Understand the relevance or importance of Auditing Standards
- Analyze the setting of auditing standards in India
- Describe the concept of International Financial Reporting Standards

Introduction

As the trade and commerce grew extensively globally, the involvement of public money therein also increased manifolds. This in turn created a demand from the investors to have the accounts of the business ventures examined by a person independent of the owners and management of

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the business to ensure that they were correct and reliable. Such a demand laid down the foundation for the profession of auditing. The extent of reliance placed by the public on the auditors has increased so much with time that it is, unreasonably of course, felt by the public that nothing can go wrong with an organization which has been audited. Though the fact that an audit has been carried out is not a guarantee as to the future viability of an enterprise, it is extremely important that the auditors carry out their assignments with utmost professional care and sincerity, to uphold the faith posed by the public in them.

2.1 Indian Auditing Standards

Undoubtedly growth of trade and commerce has witnessed utilization of public money, employment of management skills from other than the owners of resources and government involvement. The trend seen since last century is more of deregulation with government assuming the role of policy maker. This in turn has created a demand from investors, managements, regulators and general public to have the accounts of the business ventures examined by a person independent of the owners and managements to ensure that such financial statements are proper and reliable. The need and role of auditors in this perspective was felt by the society and the reliance placed by public on the auditors has increased so much with the passage of time that it is perceived, unreasonably of course, by the public that nothing is wrong in the financial statements of an enterprise which were audited.

2.1.1 International Response to Auditing Needs

As a response to the above needs, the International Federation of Accountants (IFAC) was established in 1973 with the objective of "worldwide development and enhancement of the accountancy profession of high quality in the public interest". The International Auditing and Assurance Standards Board (IAASB), earlier known as the International Auditing Practices Committee, of the IFAC was established to "improve the quality and uniformity of practice throughout the world", by, inter alia, issuing International Standards on Auditing (ISAs) and guidance on the application of the ISAs.

2.1.2 India's Response to Auditing Needs

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.

Notes 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.

2.1.3 Rationale of Auditing Standards

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

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2.1.4 Evolution of Auditing Standards

Institute of Chartered Accountants of India has from time to time issued 'Guidance Notes' and 'Statements' on a number of matters with the formation of 'Auditing Practices Committee'. Various statements on 'Standard Auditing Practices' (SAPs) were issued applicable w.e.f. 1st April 1985.

In the year 2002, the above committee was renamed as 'Auditing and Assurance Standards Board' (AASB) and in July 2002, the SAPs were renamed as; Auditing and Assurance Standards' (AASs).In all, 35 standards were issued till the year 2008. The council of the Institute of Chartered Accountants of India at its 267th meeting, held on March 12-14, 2007 approved the revised classification and numbering pattern of AASs. The revised Preface replacing the Preface to Standards on Auditing Practices issued in 1983 paved way for total revamp of the existing structure of the Auditing and Assurance Standards (AAS) on the lines of the International Auditing and Assurance Standards Board (IAASB).

The new standards to be issued by the AASB henceforth, are to be collectively known as 'Engagement Standards' and comprise of –

(a) Standards on Auditing (SA)

(b) Standards on Review Engagement (SRE)

(c) Standards on Assurance Engagement (SAE)

(d) Standards on Related Service (SRS)

Brief particulars of changes in Audit: The concept of audit has undergone a change with the thrust on providing an assurance to the reader of financial statements by expressing an opinion. In audit, the Chartered Accountant's objective is to provide a high (but not absolute) level of assurance on the reliability of financial statements. The auditor provides a positive opinion, which essentially states that based on the work performed; the financial statements comply with relevant accounting standards and principles. The level of testing procedures to obtain the evidence necessary to support such an opinion is high.

Caution An audit engagement involves a study and evaluation of internal accounting controls, detailed tests of accounting records, or corroborative evidence through inspection, observation and confirmation, which is not usually required in a review engagement.

Review: In contrast, a review provides a negative assurance report giving only a moderate level of assurance on the reliability of the financial information. The report essentially states that nothing has come to the reviewer's attention to indicate that the financial information is not presented fairly in accordance relevant accounting standards and principles. Review engagements are designed as a limited review of financial statements; therefore the risk of mistakes, omissions or incorrect disclosures is considerably greater than with an audit.

Related Services: These are the services provided by a Chartered Accountant, which do not provide any assurance at all. In fact, these are the services, which are carried out at the behest of an enterprise to fulfil the objectives of an enterprise as per the procedure laid down by the enterprise.

2.2 Importance or Relevance of Auditing Standards

Apart from the mandatory compliance of these standards, a professional also should endeavour to ensure compliance so as to ensure the quality control in the output services rendered by him.

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Quality is the prime-driving factor of this whole concept. Its aim is to ensure that the members comply with the technical standards for maintaining the quality of the attestation works they perform.

Attestation services includes auditing, verification of financial transactions, books, accounts or records or preparation, verification or certification of financial accounting and related statements as defined under Sec 2(2)(ii) of the CA Act,1949 but does not include:

(i) Management consulting

(ii) Representing clients before authorities

(iii) Engagements for the compilation of financial statements

(iv) Engagements to prepare tax returns or advising clients in taxation matters

(v) Engagements solely to assist the client in preparing, compiling or collating information other than financial statements

(vi) Testifying as expert witness and providing expert opinion on AS or applicability of certain laws.

It is said that a professional should not only be a professional but also should be seen as professional and to that end, it is necessary that the work carried out by him speaks for itself. This can be achieved only by proper and satisfactory documentation.

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.

2.2.1 Relevance for Indian Accounting Standards

The need for accounting standards was felt when the enterprises and organization started altering the accounting policies and concepts in order to achieve their profit maximization objective. In such a case, an authorized body was set up to form accounting standards applicable for all and keeping in mind the objective and the working criteria of the enterprises. The ICAI (Institute of Charted Accountancy in India) formed the accounting standards for our country. At present, in total 30 Accounting Standards are in effect in the country.

2.2.2 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

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departures there from, failing which he would be held guilty of professional misconduct under clause 9 of Part 1 of the Second Schedule to the Chartered Accountants Act, 1949.

Table 2.1: Comparative Position of International Engagement Standards

Comparative Position of International Engagement Standards, issued by the International Auditing and Assurance Standard Board of the International Federation of Accountants vis-à-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
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

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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.*
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

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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

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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

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	04

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	4. ISAE 3000, Assurance Engagements other than Audits or Reviews of Historical Financial Information	
	(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

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.

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17. Tax Audit under the Income tax Act.
18. Unqualified Auditor's Report.

Self Assessment

State whether the following statements are 'True' or 'False':

1. The Institute of Chartered Accountants of India was set up in 1962 to regulate the profession of chartered accountancy in India.
2. A review provides a negative assurance report giving only a moderate level of assurance on the reliability of the financial information.
3. The concept of audit has undergone a change with the thrust on providing an assurance to the reader of financial statements by expressing an opinion.
4. In audit, the Chartered Accountant's objective is to provide a high (but not absolute) level of assurance on the reliability of financial statements.
5. The aim of Auditing standards is to ensure that the members comply with the technical standards for maintaining the quality of the attestation works they perform.

Caselet

Audit the Pentagon

The Chief Financial Officers Act of 1990 and other laws require almost every major and minor federal agency to produce financial statements that can pass an independent external audit each year. The US Department of Defense (DOD) is the only agency that cannot be audited or predict realistically when it will pass an audit. Meanwhile, nearly sixty cents of every federal discretionary dollar now goes toward defense spending, and by the Pentagon's own admission, it cannot properly account for how the money is spent. There is no doubt that these circumstances have contributed to instances of waste, fraud, and abuse at the Pentagon.

Budget penalties for lack of transparency

Reduce by 5 percent the discretionary budget authority of any Federal agency for a fiscal year if the financial statement of the agency for the previous fiscal year cannot be audited by an external independent auditor. The bill would exempt military personnel accounts and the Defense Health Program. It also contains a waiver for any potential harm to national security or combat forces. The savings generated from H.R. 6528 would be retained in the general fund for deficit reduction.

This bill embodies a simple principle: If an agency is chronically unable to properly account for taxpayer dollars, there should be consequences for that agency's budget. In the last dozen years, DOD has broken every promise about when it would pass an audit. This problem is not newly discovered, and further delay is unacceptable, especially given our fiscal constraints, and the enormous and increasing proportion of federal dollars going toward the defense budget.

The financial reforms necessary to abide by basic accounting standards, laws, and regulations at DOD cannot wait. It is time for DOD to comply with current law and to finally do away with a culture of unlimited spending and no accountability at the Pentagon.

Source: http://www.dailykos.com/story/2012/10/25/1150275/-Audit-the-Pentagon

Notes

2.3 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.

2.3.1 International Harmonization of Auditing Standards

The Institute of Chartered Accountants of India is a member of the International Federation of Accountants. Therefore, as a matter of policy, the auditing standards issued by the ICAI are in harmony with the International Standards on Auditing. Till date, the IAASB of the IFAC has issued thirty nine Engagement Standards, comprising one Standard on Quality control (ISQC), thirty two ISAs, two International Standards on Review Engagements (ISREs), two International Standards on Assurance Engagements (ISAEs) and two International Standards on Related Services (ISRSs). The ICAI has issued thirty five auditing standards corresponding to the Engagement Standards issued by the IAASB of the IFAC and three auditing standards are in the pipeline.

Notes The Generally Accepted Accounting Principles in the United States (US GAAP), essentially working to make the two sets of accounting standards increasingly similar to each other.

Further, the Council of the Institute of Chartered Accountants of India has also approved the following technical drafts:

- Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services
- Due Process of the Auditing and Assurance Standards Board
- Revised Classification and Numbering Pattern of the Auditing and Assurance Standards
- Framework for Assurance Engagements

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2.3.2 Compliance with Auditing Standards

The members of the Institute shall follow high standards of fairness, integrity and ethical conduct, achieve their work with honesty, diligence, and responsibility and observe the standards and make disclosures expected by the law and the profession. They should be not knowingly be a party to any illegal activity, or engage in acts that are discreditable to the institute. Respect the integrity of other members, recognizing their different experiences and areas of expertise, and contribute to the legitimate and ethical objectives of the institute.

Self Assessment

Fill in the blanks:

6. After taking into the comments received, the draft of the proposed auditing standard is finalised by the Board and submitted to the ..... of the Institute.
7. While formulating the ..... the Board also takes into consideration the applicable laws, customs, usages and business environment in the country.
8. The members of the Institute shall follow high standards of ....., ... and .....
9. The Institute of ..... of India is a member of the International Federation of Accountants.
10. The ICAI has issued thirty five auditing standards corresponding to the ..... Standards issued by the IAASB of the IFAC and three auditing standards are in the pipeline.

2.4 International Financial Reporting Standards (IFRS)

In an increasingly interconnected global economy, many market participants are considering the question of whether it is possible or desirable to move toward a more uniform global "language" for financial reporting. The proponents of this idea argue that a uniform set of global accounting standards, supported by strong governance, independent standard-setting and a sound regulatory framework, could benefit investors and businesses alike. Others suggest that trying to establish a uniform set of global standards would run the risk of overlooking the unique economic, political, cultural, legal and regulatory realities that exist in different nations and regions.

In the coming years, critical decisions will need to be made regarding the use of global accounting standards in the United States. Market participants will be called upon to determine whether achieving a uniform set of high quality global accounting standards is feasible, what sort of investments would be required to achieve that outcome, and whether it is a desirable goal in the first place. This dialogue will be critical to the future of financial reporting and of fundamental importance to the long-term strength and stability of the global capital markets.

Did u know? In 2001, the International Accounting Standards Board (IASB) adopted the first iteration of International Financial Reporting Standards (IFRS) to serve as a possible pathway for establishing uniform global accounting standards.

2.4.1 The Evolution of Accounting Standards

Accounting standards around the world have evolved over centuries of business and capital market development. In this process, accounting standards historically were designed to meet

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the needs of each nation's capital markets. Those standards that were found to work well in the legal, cultural, political and economic context of each nation became the "generally accepted accounting principles," or GAAP, for that particular jurisdiction. Naturally, different norms in each nation led to different GAAPs in each nation.

The growing dynamic of globalization presented a challenge to these "legacy systems." Global protocols for the internet, electronic payments, software systems and cargo shipping demonstrated the potential value of uniform global systems. A discussion began among market participants over whether the global capital markets would similarly benefit by having a single set of high-quality accounting standards that could be applied around the world.

In order to create a uniform global system for financial reporting, the IASB was formed to serve as the global accounting standard-setting body. In 2001, the IASB promulgated the first iteration of IFRS, offering the possibility of a single set of high-quality accounting standards that could be used by all nations.

2.4.2 The Challenges and Opportunities of IFRS

Since 2001, IFRS has become accepted or been adopted for public reporting purposes in over 100 countries, including the 27 member-states of the European Union. Others scheduled to follow in the next few years include Argentina, Brazil, Canada, Chile, India, Korea, Singapore and Mexico. In addition, in June 2009, Japan approved a roadmap for the adoption of IFRS which includes an election for Japanese companies to begin voluntarily using IFRS immediately. As more and more countries adopt IFRS, a robust conversation has begun about whether the United States should take this step or otherwise participate in a process that leads to the acceptance of more uniform global accounting standards for use in the U.S.

As part of that effort, since 2002, the IASB and the FASB, which sets accounting standards in the United States, have been engaged in a process aimed at "converging" IFRS and US GAAP. The goal is that over time the differences between IFRS and US GAAP could steadily be diminished and eventually the two sets of standards would be essentially, if not completely, identical. While progress has been made to reduce the differences between IFRS and US GAAP, the speed at which that progress has been made has been substantially slower than originally anticipated. In addition, there are some who believe that convergence is unlikely to get to the point where the two sets of standards are truly identical. This view has led some to call for the United States to adopt IFRS outright to replace US GAAP.

Example: In that vein, the U.S. Securities and Exchange Commission (SEC) in November 2008 proposed a "Roadmap for the Potential Use of Financial Statements Prepared in Accordance with IFRS by U.S. Issuers" (the Proposed Roadmap) and solicited public reaction.

The Proposed Roadmap laid out a process and a set of milestones which, if met, could lead to certain larger public companies in the United States being required to begin issuing their financial reports in accordance with IFRS by the year 2014, with smaller public companies adopting IFRS in 2015 and 2016.

Notes More recently, some market participants have raised the possibility of transitioning entirely from US GAAP to IFRS for public company financial reporting in the United States.

Notes

2.4.3 Standards of IFRS

International Financial Reporting Standards (IFRS) are principles-based Standards, Interpretations and the Framework adopted by the International Accounting Standards Board (IASB). IFRS represent a set of internationally accepted accounting principles used by companies to prepare financial statements.

The goal with IFRS is to make international comparisons as easy as possible. More than 100 countries around the world currently require or permit IFRS reporting. Approximately 85 of those countries require IFRS reporting for all domestic, listed companies. All member states of the EU are required to use IFRS as adopted by the EU for listed companies since 2005. The US is also gearing towards IFRS. While some countries require all companies to adhere to IFRS, others merely allow it or try to coordinate their own country's standards to be similar.

IFRS include the following Standards:

- IFRS 1 First-time Adoption of International Financial Reporting Standards
- IFRS 2 Share-based Payment
- IFRS 3 Business Combinations
- IFRS 4 Insurance Contracts
- IFRS 5 Non-current Assets Held for Sale and Discontinued Operations
- IFRS 6 Exploration for and Evaluation of Mineral Resources
- IFRS 7 Financial Instruments: Disclosures
- IFRS 8 Operating Segments
- IFRS 9 Financial Instruments
- IAS 1 Presentation of Financial Statements
- IAS 2 Inventories
- IAS 7 Statement of Cash Flows
- IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors
- IAS 10 Events after the Reporting Period
- IAS 11 Construction Contracts
- IAS 12 Income Taxes
- IAS 16 Property, Plant and Equipment
- IAS 17 Leases
- IAS 18 Revenue
- IAS 19 Employee Benefits
- IAS 20 Accounting for Government Grants and Disclosure of Government Assistance
- IAS 21 The Effects of Changes in Foreign Exchange Rates
- IAS 23 Borrowing Costs
- IAS 24 Related Party Disclosures
- IAS 26 Accounting and Reporting by Retirement Benefit Plans

Notes

- IAS 27 Consolidated and Separate Financial Statements
- IAS 28 Investments in Associates
- IAS 29 Financial Reporting in Hyperinflationary Economies
- IAS 31 Interests in Joint Ventures
- IAS 32 Financial Instruments: Presentation
- IAS 33 Earnings Per Share
- IAS 34 Interim Financial Reporting
- IAS 36 Impairment of Assets
- IAS 37 Provisions, Contingent Liabilities and Contingent Assets
- IAS 38 Intangible Assets
- IAS 39 Financial Instruments: Recognition and Measurement
- IAS 40 Investment Property
- IAS 41 Agriculture

International Accounting Standards (IAS) are the older standards that IFRS are gradually replacing (IAS were issued from 1973 to 2000).

A complete set of IFRS financial statements includes a statement of financial position, a statement of comprehensive income, a statement of changes in equity, a statement of cash flows, and accounting policies and explanatory notes.

Current use of IFRSs in the countries of the G20*

Country	Status for listed companies
Argentina	Required for financial years beginning on or after 1 January 2012
Australia	Required for all private sector reporting entities and as the basis for public sector reporting since 2005
Brazil	Required for consolidated financial statements of banks and listed companies from 31 December 2010 and for individual company accounts progressively since January 2008
Canada	Required from 1 January 2011 for most listed entities and permitted for private entities including not-for-profit organisations
China	Substantially converged standards, active convergence initiatives; Hong Kong SAR adopted IFRSs for listed companies in 2005
European Union	All member states of the EU are required to use IFRSs as adopted by the EU for consolidated financial statements of listed companies since 2005
France	Required via EU adoption and implementation process since 2005
Germany	Required via EU adoption and implementation process since 2005
India	Converging with IFRSs; implementation date of new converged standards to be confirmed
Indonesia	Convergence process ongoing; a decision about a target date for full compliance with IFRSs is expected to be made in 2012

Contd....

Notes

Italy	Required via EU adoption and implementation process since 2005
Japan	Permitted from 2010 for a number of international companies; decision about mandatory adoption expected around 2012
Mexico	Required from 2012
Republic of Korea	Required from 2011
Russia	Required for consolidated financial statements of banks since 2004, for insurance and listed companies from 2012
Saudi Arabia	Not permitted for listed companies
South Africa	Required for listed entities since 2005
Turkey	Required for listed entities since 2005
United Kingdom	Required via EU adoption and implementation process since 2005
United States	Allowed for foreign issuers in the US since 2007, not publicly traded US companies are permitted to use IFRSs; target date for substantial convergence between IFRSs and US GAAP is 2011; decision about possible adoption for US publicly traded companies expected in 2011

* Data actuality - July, 2011

Source: http://www.readyratios.com/reference/accounting/international_financial_reporting_standards_ifrs.html

Self Assessment

Fill in the blanks:

11. ..... represent a set of internationally accepted accounting principles used by companies to prepare financial statements.
12. In the coming years, critical ..... will need to be made regarding the use of global accounting standards in the United States.
13. Accounting standards around the world have evolved over centuries of business and ..... development.
14. The growing dynamic of ..... presented a challenge to these "legacy systems."
15. Since ....., IFRS has become accepted or been adopted for public reporting purposes in over 100 countries, including the 27 member-states of the European Union.

Task Give light on International Financial Reporting Standards.

Case Study

PetroChina Company Limited

PetroChina Company Limited (PetroChina) was established as a joint stock company under the company law of the People's Republic of China in 1999 as part of the restructuring of China National Petroleum Corporation. PetroChina is an integrated

Contd....

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oil and gas company with operations in virtually every aspect of China's oil and gas industry, including exploration and production, refining and marketing, natural gas transmission, and petrochemicals. PetroChina manages some 70 percent of China's oil and gas reserves and 45 percent of its oil-refining capacity. Its shares were listed on the Hong Kong and New York Stock Exchanges in 2000.

You are an equity research analyst and have been asked to prepare a research report on PetroChina. Your business strategy analysis indicates that PetroChina's sales growth and financial performance can probably be sustained.

However, although your qualitative analysis has yielded promising results, you are concerned that your financial analysis will be difficult due to accounting and audit-quality issues.

You start your analysis by becoming familiar with the accounting principles used to prepare PetroChina's financial statements filed with the U.S. Securities and Exchange Commission. You are encouraged that the company states that its financial statements conform to IASB standards, but realize that how accounting standards are applied is as important as the standards themselves.

Required

PetroChina's financial statements filed with the U.S. Securities and Exchange Commission may be found at www. petrochina.com.cn/resource/EngPdf/ annual/20-f_2008.pdf. Examine Petro China's Note 3, "Summary of Principal Accounting Policies," and read about the IASB Standards on the IASB Web site (www.iasb.org) and the IAS Plus Web site (www.iasplus.com).

Questions:

1. As much as possible, assess the extent to which PetroChina's accounting principles conform to IASB standards.
2. How reliable is your assessment?
3. What further information would help your assessment?
4. Does the auditor's report provide information useful in your assessment? Explain.

Source: http://ebooks.narotama.ac.id/files/International%20Accounting%20(7th%20Edition)/Chapter%208%20%20%20Global%20Accounting%20And%20Auditing%20Standards.pdf

2.5 Summary

- Generally Accepted Accounting Principles (GAAP) is defined as the standard guidelines of accounting rules for financial accounting and to prepare financial statements for private companies and the companies trading publicly in United States.
- It chalks down the standards, conventions, and rules for accountants to pursue in recording and summarizing transactions, and in the preparation of financial statements.
- In United States these rules are decided by the Governmental Accounting Standards Board (GASB) which applies to local and state governments.
- The looming decisions about the future of accounting standards in the United States involve complex and challenging questions.
- While there are significant benefits for investors, businesses, and the entire economies of having all nations move to a single, uniform set of high-quality accounting standards, there are a number of considerations that need to be evaluated in making such a transition.

Notes

- IFRS is a dynamic — and fast evolving — issue. To keep current with developments regarding global accounting standards, the following websites include information about the development of IFRS, the convergence efforts between the FASB and the IASB, and the acceptance of IFRS around the world.
- Again, it has to be remembered that GAAP are not a rigid set of rules. These are flexible guidelines only.
- Over the years, these groups of conventions and standards have evolved in the specific need of standard common platform for the preparation and presentation of financial statements.
- In United States, the American Institute of Certified Public Accountants (AICPA), The Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC) offer guidance and assistance about standard acceptable practices of accounting.

2.6 Keywords

Audit: An official inspection of an individual's or organization's accounts, typically by an independent body.

Auditing Standards: The mandatory examination procedures to be executed during an audit to ensure consistency of findings..

GAAP: Generally Accepted Accounting Principles (GAAP) is defined as the standard guidelines of accounting rules for financial accounting and to prepare financial statements for private companies and the companies trading publicly in United States.

ISAE: International Standards on Assurance Engagements..

ISQC: Standards on Quality Control.

ISRE: International Standards on Review Engagements.

ISRS: International Standards on Related Services.

Quality: The standard of something as measured against other things of a similar kind.

2.7 Review Questions

1. What do you mean by Indian Auditing Standards?
2. Discuss the importance or relevance of Auditing standards.
3. Explain the concept of IFRS. What are the basic principles or standards of IFRS?
4. How auditing standards set in India?
5. The new standards to be issued by the AASB henceforth, are to be collectively known as 'Engagement Standards' and comprise of few things. What are they?
6. Discuss the procedure for formulating Auditing Standards.
7. Give a briefing of particulars of changes Audit.
8. Explain the evolution of Auditing Standards.

Notes

Answers: Self Assessment

1.	False	2.	True
3.	True	4.	True
5.	True	6.	Council
7.	Auditing Standards	8.	Fairness, integrity & ethical conduct
9.	Chartered Accountants	10.	Engagement
11.	IFRS	12.	Decisions
13.	Capital market	14.	Globalization
15.	2001		

2.8 Further Readings

Books

Canadian Institute of Chartered Accountants *AcSB Confirms Changeover Date to IFRSs*. 13 February 2008. Retrieved 8 August 2009.

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Epstein, Barry J., Ralph Nach, and Steven M. Bragg. Hoboken, NJ: *Wiley GAAP 2007: Interpretation and Application of Generally Accepted Accounting Principles.*, Wiley (2006)

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Online links

http://ebooks.narotama.ac.id/files/International%20Accounting%20(7th%20Edition)/Chapter%208%20%20%20Global%20Accounting%20And%20Auditing%20Standards.pdf

http://usgaap.tripod.com/id6.html

http://www.icisa.cag.gov.in/Background%20Material/Auditing%20Standards%20in%20India.pdf

http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/IFRS-GAAP-comparisons/Documents/IFRS-compared-to-US-GAAP-2012.pdf

http://www.thecaq.org/publications/GuidetoIFRS.pdf

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Unit 3: Introduction to US-GAAP

CONTENTS

Objectives

After studying this unit, you will be able to:

- Explain the meaning and definition of US GAAP
- Understand the difference between IFRS and US GAAP
- Analyze the role of US GAAP in India

Introduction

Generally Accepted Accounting Principles refer to the standard framework of guidelines for financial accounting used in any given jurisdiction; generally known as accounting standards or Standard accounting practice. These include the standards, conventions, and rules that accountants follow in recording and summarizing, and in the preparation of financial statements.

In the US, from 1938 to 1959 the Committee on Accounting Procedure (CAP), a committee of the American Institute of Accountants (AIA) later known as (i.e., after it was renamed) the American Institute of Certified Public Accountants (AICPA) assumed the task of setting standards. CAP issued 51 Accounting Research Bulletins (ARBs) which dealt with specific accounting and reporting problems. In 1959, the Accounting Principles Board (APB) replaced the CAP. The APB operated from 1959 through 1973 and issued 31 Accounting Principles Board Opinions (APBOs), various Interpretations, and four Statements. The Opinions also dealt with specific accounting and reporting problems. Many ARBs and APBOs have not been superseded and still represent authoritative GAAP. Criticism of the APB led to the creation of the Financial Accounting Standards

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Board (FASB) and its supporting structure in 1973. The board has also issued over 120 specific accounting standards, called Statements of Financial Accounting Standards (SFASs), as well as numerous FASB Interpretations and Technical Bulletins.

All the above standards employed for the purpose of financial accounting and reporting are known as Generally Accepted Accounting Principles (GAAP) also referred to as US GAAP.

3.1 Meaning and Definition of US GAAP

The Generally Accepted Accounting Principles in the US (US GAAP) refer to the accounting rules used in United States to organize, present, and report financial statements for an assortment of entities which include privately held and publicly traded companies, non-profit organizations, and governments. The term is confined to the US and is, therefore, generally abbreviated as US GAAP. But theoretically, the term "GAAP" covers the entire accounting industry, rather than only the US.

3.1.1 GAAP

Generally Accepted Accounting Principles (GAAP) is defined as the standard guidelines of accounting rules for financial accounting and to prepare financial statements for private companies and the companies trading publicly in United States. It chalks down the standards, conventions, and rules for accountants to pursue in recording and summarizing transactions, and in the preparation of financial statements.

Example: In United States these rules are decided by the Governmental Accounting Standards Board (GASB) which applies to local and state governments.

3.1.2 U.S. GAAP

Again, it has to be remembered that GAAP are not a rigid set of rules. These are flexible guidelines only. Over the years, these groups of conventions and standards have evolved in the specific need of standard common platform for the preparation and presentation of financial statements In United States, the American Institute of Certified Public Accountants (AICPA), The Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC) offer guidance and assistance about standard acceptable practices of accounting.

Did u know? In the United States, the Financial Accounting Standards Board (FASB) established in 1973 has been acting as the authoritative organization entrusted with the task of establishing Accounting Standards under the aegis of the Securities and Exchange Commission (SEC).

3.1.3 Necessity of GAAP

1. Acquiescence with GAAP promotes creditability with stockholders and creditors reassuring them and outsiders that financial report of a company precisely reflect its financial position.
2. Routine auditing is done by Certified public accountants to determine the compliance of financial statements with GAAP. Financial statements display these audit findings.
3. Even finance companies, banks and investors look for these audited financial statements of their clients.

Notes

The evolvement of GAAP is based on four fundamental qualities the financial statements must possess. The financial statements must be Relevant, Reliable, Consistent and Comparable. Economic Entity Assumption, Going Concern Assumption, Monetary Unit Assumption, and Periodic Reporting Assumption are the four basic assumptions for these financial statements.

3.1.4 Basic Objectives of US GAAP

As a part of US GAAP, the financial reporting should provide information as following:

1. The provided info should be apt to be presented to creditors and potential investors in addition to other users for making cogent decisions concerning investment, credit and similar financial activities.
2. The provided info should be helpful to the creditors and potential investors in evaluating the amounts, timing, and uncertainty of expected cash receipts.
3. The info should be related to economic resources, the claims to those resources, as well as the changes occurring in them.
4. The provided info should be helpful in making financial and long-term decisions.
5. The information should be helpful in perking up the business performance.
6. The information should be helpful in maintaining records.

3.1.5 Basic Assumptions of US GAAP

The US GAAP features four basic assumptions to meet its objectives. These are:

1. ***Accounting Entity:*** This assumes the business to be a separate entity from its owners as well as other businesses. Moreover, it also stresses on keeping revenue and expense separate from personal expenses.
2. ***Going Concern:*** This assumption presumes that the business will be indefinitely in operation. This assumption authenticates the methods of amortization, depreciation, and asset capitalization. However, this assumption is not applicable in the event of liquidation.
3. ***Monetary Unit Principle:*** This assumption presumes an unwavering currency to continue to be the unit of record.
4. ***Time-period Principle:*** This assumption states that a business enterprise's economic activities can be divided into simulated time periods.

While preparing financial statements through the use of GAAP, a large number of American corporations and other business enterprises follow the rules of how to report different business transactions based on the assorted GAAP rules.

Notes The FASB has issued six Statements of Financial Accounting Concepts (SFACs) to describe its conceptual framework.

3.1.6 Organizations behind GAAP

1. ***United States Securities and Exchange Commission (SEC) –*** During the Great Depression, the SEC was created as need of structure setting accounting standards. The SEC works

Notes

closely with various private organizations setting GAAP, believing that the private sector had the proper knowledge, resources, and talents, but does not set GAAP itself.

2. ***American Institute of Certified Public Accountants (AICPA) -*** SEC urged the AICPA and in 1939, Committee on Accounting Procedure (CAP) has come into existence. However, it could not address the growing need for structured body of accounting principles. So, 1959, the AICPA created the Accounting Principles Board (APB), which also got dissolved in 1973 for lack of productivity and failure to act promptly. So, again the AICPA created FASB.

3. ***Financial Accounting Standards Board (FASB) -*** Realizing the need to reform the APB, a new structure is composed of three organizations: the Financial Accounting Foundation (FAF), the Financial Accounting Standards Advisory Council (FASAC), and the major operating organization in this structure the Financial Accounting Standards Board (FASB).

4. ***Governmental Accounting Standards Board (GASB) –*** With structure similar to that of the FASB, GASB was created in 1984 to the addresses state and local government reporting issues.

Caselet

Statutory Reporting Simplified with IFRS

Abstract

A large global company with more than 100 subsidiaries in 70 countries sought to consolidate and enhance its statutory reporting processes to reduce complexity, decrease potential reputational risk, and increase transparency and efficiency of its global finance organization.

The Challenge

With limited visibility into the statutory reporting processes and requirements, the client was not fully aware of its existing risk exposure at the subsidiary level, or opportunities to simplify its reporting.

How We Helped

Deloitte worked with the client in conducting an assessment to determine an appropriate approach for adapting to (and eventually) adopting IFRS as a basis for financial reporting. The project included the following components:

- A comprehensive evaluation of the "IFRS landscape" facing the company and its subsidiaries
- An assessment of readiness for an IFRS conversion

Solution

As a result, the client is recognizing improvements in its financial and tax reporting processes, its treasury processes, and internal controls. In streamlining the global finance organization, other benefits (including cost savings and opportunities for simplification) were identified.

Source: http://www.deloitte.com/view/en_US/us/Services/consulting/Strategy-Operations/7804f75d99efd110VgnVCM100000ba42f00aRCRD.htm

Notes

Self Assessment

State whether the following statements are True or False:

1. Theoretically, the term "GAAP" does not cover the entire accounting industry, rather than only the US.
2. The APB operated from 1970 through 1973 and issued 31 Accounting Principles Board Opinions (APBOs), various Interpretations, and four Statements.
3. Again, it has to be remembered that GAAP are not a rigid set of rules.
4. The evolvement of GAAP is based on four fundamental qualities the financial statements must possess.
5. The US GAAP features four basic assumptions to meet its objectives.

3.2 Difference between IFRS and US GAAP

There are significant differences between Indian GAAP and US GAAP. US GAAP stipulate stringent accounting treatment as well as disclosure norms, whereas their Indian GAAP in many cases has relaxed requirements (AS 18, 17, AS 3). Similarly, there are several areas where no Accounting Standard has been issued by ICAI. These differences lead to wide variations when Financial Results of Indian Companies are computed under US GAAP and it is found that Profits computed under US GAAP are generally lower.

Notes The Standards are recognized by Securities and Exchange Commission (SEC) and the American Institute of Certified Public Accountants (AICPA).

Some of these major differences between US GAAP and Indian GAAP which give rise to differences in profit are highlighted hereunder:

1. ***Underlying assumptions:*** Under Indian GAAP, Financial statements are prepared in accordance with the principle of conservatism which basically means "Anticipate no profits and provide for all possible losses". Under US GAAP conservatism is not considered, if it leads to deliberate and consistent understatements.
2. ***Prudence vs. rules:*** The Institute of Chartered Accountants of India (ICAI) has been structuring Accounting Standards based on the International Accounting Standards (IAS), which employ concepts and 'prudence' as the principle in contrast to the US GAAP, which are "rule oriented", detailed and complex. It is quite easy for the US accountants to handle issues that fall within the rules, while the International Accounting Standards provide a general framework of accounting standards, which emphasise "substance over form" for accounting. These rules are less descriptive and their application is based on prudence. US GAAP has thus issued several Industry specific GAAP, like SFAS 51 (Cable TV), SFAS 50 (Record and Music Industry), SFAS 53 (Motion Picture Industry) etc.
3. ***Format/Presentation of financial statements:*** Under Indian GAAP, financial statements are prepared in accordance with the presentation requirements of Schedule VI to the Companies Act, 1956. On the other hand, financial statements prepared as per US GAAP are not required to be prepared under any specific format as long as they comply with the disclosure requirements of US GAAP.

Notes

4. ***Consolidation of subsidiary companies:*** Under Indian GAAP (AS 21), Consolidation of Accounts of subsidiary companies is not mandatory. AS 21 is mandatory if an enterprise presents consolidated financial statements. In other words, the accounting standard does not mandate an enterprise to present consolidated financial statements but, if the enterprise presents consolidated financial statements for complying with the requirements of any statute or otherwise, it should prepare and present consolidated financial statements in accordance with AS 21.Thus, the financial income of any company taken in isolation neither reveals the quantum of business between the group companies nor does it reveal the true picture of the Group. Savvy promoters hive off their loss making divisions into separate subsidiaries, so that financial statement of their Flagship Company looks attractive .Under US GAAP (SFAS 94), Consolidation of results of Subsidiary Companies is mandatory, hence eliminating material, inter company transaction and giving a true picture of the operations and profitability of the various majority owned Business of the Group.

5. ***Cash flow statement:*** Under Indian GAAP (AS 3) , inclusion of Cash Flow statement in financial statements is mandatory only for companies whose share are listed on recognized stock exchanges and Certain enterprises whose turnover for the accounting period exceeds ₹ 50 crores. Thus, unlisted companies escape the burden of providing cash flow statements as part of their financial statements. On the other hand, US GAAP (SFAS 95) mandates furnishing of cash flow statements for 3 years – current year and 2 immediate preceding years irrespective of whether the company is listed or not.

6. ***Investments:*** Under Indian GAAP (AS 13), Investments are classified as current and long term. These are to be further classified Government or Trust securities, Shares, debentures or bonds Investment properties others-specifying nature. Investments classified as current investments are to be carried in the financial statements at the lower of cost and fair value determined either on an individual investment basis or by category of investment, but not on an overall (or global) basis. Investments classified as long term investments are carried in the financial statements at cost. However, provision for diminution is to be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually. Under US GAAP (SFAS 115), Investments are required to be segregated in 3 categories i.e. held to Maturity Security (Primarily Debt Security), Trading Security and Available for sales Security and should be further segregated as Current or Non-current on Individual basis. Debt securities that the enterprise has the positive intent and ability to hold to maturity are classified as held-to-maturity securities and reported at amortized cost. Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and reported at fair value, with unrealised gains and losses included in earnings. All Other securities are classified as available-for-sale securities and reported at fair value, with unrealised gains and losses excluded from earnings and reported in a separate component of shareholders' equity.

Caution There are three major parties that are involved in the standard setting where U.S companies must abide by.

7. ***Depreciation:*** Under the Indian GAAP, depreciation is provided based on rates prescribed by the Companies Act, 1956. Higher depreciation provision based on estimated useful life of the assets is permitted, but must be disclosed in Notes to Accounts. (Guidance note no 49). Depreciation cannot be provided at a rate lower than prescribed in any circumstance. Similarly, there is no compulsion to provide depreciation at a higher rate, even if the actual wear and tear of the equipments is higher than the rates provided in Companies Act. Thus, an Indian Company can get away with providing with lesser depreciation, if the

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same is in compliance to Companies Act 1956. Contrary to this, under the US GAAP , depreciation has to be provided over the estimated useful life of the asset, thus making the Accounting more realistic and providing sufficient funds for replacement when the asset becomes obsolete and fully worn out.

8. ***Foreign currency transactions:*** Under Indian GAAP (AS11) Forex transactions (Monetary items) are recorded at the rate prevalent on the transaction date .Year end foreign currency assets and liabilities (Non-Monetary Items) are re-stated at the closing exchange rates. Exchange rate differences arising on payments or realizations and restatements at closing exchange rates are treated as Profit/loss in the income statement. Exchange fluctuations on liabilities incurred for fixed assets can be capitalized. Under US GAAP (SFAS 52), Gains and losses on foreign currency transactions are generally included in determining net income for the period in which exchange rates change unless the transaction hedges a foreign currency commitment or a net investment in a foreign entity. Capitalization of exchange fluctuation arising from foreign liabilities incurred for acquiring fixed assets does not exist. Translation adjustments are not included in determining net income for the period but are disclosed and accumulated in a separate component of consolidated equity until sale or until complete or substantially complete liquidation of the net investment in the foreign entity takes place. US GAAP also permits use of Average monthly Exchange rate for Translation of Revenue, expenses and Cash flow items, whereas under Indian GAAP, the closing exchange rate for the Transaction date is to be taken for translation purposes.

9. ***Expenditure during Construction Period:*** As per the Indian GAAP (Guidance note on 'Treatment of expenditure during construction period'), all incidental expenditure on Construction of Assets during Project stage are accumulated and allocated to the cost of asset on completion of the project. Contrary to this, under the US GAAP (SFAS 7), such expenditure are divided into two heads – direct and indirect. While, direct expenditure is accumulated and allocated to the cost of asset, indirect expenditure is charged to revenue.

10. ***Research and Development expenditure:*** Indian GAAP (AS 8) requires research and development expenditure to be charged to profit and loss account, except equipment and machinery which are capitalized and depreciated. Under US GAAP (SFAS 2), all R&D costs are expenses except intangible assets purchased from others and Tangible assets that have alternative future uses which are capitalised and depreciated or amortised as R&D Expense. Under US GAAP, R&D expenditure incurred on software development is expensed until technical feasibility is established (SOP 81.1). R&D Cost and software development cost incurred under contractual arrangement are treated as cost of revenue.

11. ***Revaluation reserve:*** Under Indian GAAP, if an enterprise needs to revalue its asset due to increase in cost of replacement and provide higher charge to provide for such increased cost of replacement, then the Asset can be revalued upward and the unrealised gain on such revaluation can be credited to Revaluation Reserve (Guidance note no. 57). The incremental depreciation arising out of higher book value may be adjusted against the Revaluation Reserve by transfer to P&L Account. However for window dressing some promoters misutilise this facility to hoodwink the shareholders on many occasions. US GAAP does not allow revaluing upward property, plant and equipment or investment.

12. ***Long term Debts:*** Under US GAAP, the current portion of long term debt is classified as current liability, whereas under the Indian GAAP, there is no such requirement and hence the interest accrued on such long term debt in not taken as current liability.

13. ***Extraordinary items, prior period items and changes in accounting policies:*** Under Indian GAAP (AS 5), extraordinary items, prior period items and changes in accounting policies are disclosed without netting off for tax effects. Under US GAAP (SFAS 16) adjustments for tax effects are required to be made while reporting the Prior period Items.

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14. ***Goodwill:*** Under the Indian GAAP goodwill is capitalized and charged to earnings over 5 to 10 years period. Under US GAAP (SFAS 142), Goodwill and intangible assets that have indefinite useful lives are not amortized, but they are tested at least annually for impairment using a two-step process that begins with an estimation of the fair value of a reporting unit. The first step is a screen for potential impairment, and the second step measures the amount of impairment, if any. However, if certain criteria are met, the requirement to test goodwill for impairment annually can be satisfied without a remeasurement of the fair value of a reporting unit.

15. ***Capital issue expenses:*** Under the US GAAP, capital issue expenses are required to be written off when incurred against proceeds of capitals, whereas under Indian GAAP, capital issue expense can be amortized or written off against reserves.

16. ***Proposed dividend:*** Under Indian GAAP, dividends declared are accounted for in the year to which they relate.

Example: If dividend for the FY 1999-2000 is declared in Sep 2000, then the corresponding charge is made in 2000-2001 as below the line item. Contrary to this, under US GAAP dividends are reduced from the reserves in the year they are declared by the Board. Hence in this case under US GAAP, it will be charged Profit and loss account of 2000-2001 above the line.

17. ***Investments in Associated companies:*** Under the Indian GAAP (AS 23), investment in associate companies is initially recorded at Cost using the Equity method whereby the investment is initially recorded at cost, identifying any goodwill/capital reserve arising at the time of acquisition. The carrying amount of the investment is adjusted thereafter for the post acquisition change in the investor's share of net assets of the investee. The consolidated statement of profit and loss reflects the investor's share of the results of operations of the investee is carried at cost. Under US GAAP (SFAS 115) Investments in Associates are accounted under equity method in Group accounts but would be held at cost in the Investor's own account.

18. ***Preoperative expenses:*** Under Indian GAAP, (Guidance Note 34 - Treatment of Expenditure during Construction Period), direct Revenue expenditure during construction period like Preliminary Expenses, Project related expenditure are allowed to be Capitalised. Further, Indirect revenue expenditure incidental and related to Construction is also permitted to be capitalised. Other Indirect revenue expenditure not related to construction, but since they are incurred during Construction period are treated as deferred revenue expenditure and classified as Miscellaneous Expenditure in Balance Sheet and written off over a period of 3 to 5 years. Under US GAAP (SFAS 7), the concept of preoperative expenses itself doesn't exist. SOP 98.5 also mandates that all Start up Costs should be expensed. The enterprise has to prepare its balance sheet and Profit and Loss Account as if it were a normal running organization. Expenses have to be charged to revenue and Assets are capitalised as a normal organization. The additional disclosures include reporting of cash flow, cumulative revenues and Expenses since inception. Upon commencement of normal operations, notes to Statement should disclose that the Company was but is no longer is a Development stage enterprise. Thus, due to above accounting anomaly, Accounts prepared under Indian GAAP, contain higher charges to depreciation which are to be adjusted suitably under US GAAP adjustments for indirect preoperative expenses and foreign currencies.

19. ***Employee benefits:*** Under Indian GAAP, provision for leave encashment is accounted based n actuarial valuation. Compensation to employees who opt for voluntary retirement scheme can be amortized over 60 months. Under US GAAP, provision for leave encashment is accounted on actual basis. Compensation towards voluntary retirement scheme is to be charged in the year in which the employees accept the offer.

Notes

20. ***Loss on extinguishment of debt:*** Under Indian GAAP, debt extinguishment premiums are adjusted against Securities Premium Account. Under US GAAP, premiums for early extinguishment of debt are expensed as incurred.

Self Assessment

Fill in the blanks:

6. ..... stipulate stringent accounting treatment as well as disclosure norms, whereas their Indian GAAP in many cases have relaxed requirements.
7. Under ..... Financial statements are prepared in accordance with the principle of conservatism which basically means "Anticipate no profits and provide for all possible losses".
8. Under US GAAP ..... is not considered, if it leads to deliberate and consistent understatements.
9. Under Indian GAAP, financial statements are prepared in accordance with the presentation requirements of Schedule VI to the Companies Act, ...
10. Under Indian GAAP (AS 13), ... are classified as current and long term.

3.3 Role of US GAAP in India

In India, the Institute of Chartered Accountants of India (ICAI), being the premier accounting body in the country, has been formulating Accounting Standards since 1977. The standard setting followed by Indian GAAP:

1. The ICAI follows a consultative process in the formulation of accounting standards which ensures participation of all interest groups through Accounting Standards Board (ASB).
2. Following the above process, the ICAI has issued 29 Accounting Standards till date. Out of these Standards, one Standard, viz., AS 8, has been withdrawn pursuant to AS 26 becoming mandatory.

Notes The members of the FASB are appointed by a privately-funded foundation, the Financial Accounting Foundation (FAF).

In US, the legalistic and litigious nature of the business environment has led to a style of accounting standards and supporting guidance that is rule-driven. The standard setting followed by US GAAP:

1. A rule for almost every circumstance. Even then the standards written in terms of broad principles, interpretations are written that have the effect of fencing the principles with rule.
2. Because of federal character of US Govt. there are multiples accounting and other bodies making accounting statements and pronouncements.
3. Under such circumstances it becomes difficult to find the accounting pronouncement, can be called US GAAP.
4. Financial Accounting Standard Board (FASB) is the main body which formulates the US GAAP.

Notes

Accounting practice: The financial statements prepared by the business organization reflect the results of their operations during a specified period and also the state of financial affairs as at the end of the financial year. These statements are used by the investors, lenders and others for their decisions making. Generally Accepted Accounting Principles (GAAP) is an accounting term that represents the conventions, rules and procedures and accepted accounting practices and includes broad guidelines of general application and detailed practices and procedures. GAAP are the ground rules for financial reporting. These principles provide the general framework in determining what information is presented in the financial statements and how the information is to be presented.

US Accounting practice: US GAAP refers to accounting principles, which are generally accepted accounting practices in USA and were set in the year 1973. US Securities Exchange Commission (SEC) is the authority to promulgate US GAAP. The principles have evolved from experience, reason, custom, usage and practical necessity and are contained in different pronouncements such as issued by the board of the Financial Accounting Standards Board (FASB) and American Institute of Certified Public Accountants (AICPA). Over the years, the SEC has, for the most part, relied on FASB for carrying out the standard setting process.

Need for adoption of US GAAP: With increasing cross-border dealings, more and more Indian corporates and financial institutions are realizing the need of adopting internationally accepted accounting standards with the objective of improving the quality of corporate governance. Several well-known Indian Corporates such as Infosys Technologies and financial institutions like ICICI Bank have adopted US GAAP in the recent years.

Advantages: The adoption of these norms gives to an Indian Corporate, a number of benefits including enabling the corporate to raise funds at competitive rates from the US Capital market and other international markets. Transparency in transactions and disclosure standards are integral part of corporate governance in almost all organizations.

Self Assessment

Fill in the blanks:

11. Because of federal character of ..... there are multiples accounting and other bodies making accounting statements and pronouncements.

12. The ..... follows a consultative process in the formulation of accounting standards which ensures participation of all interest groups through Accounting Standards Board (ASB).

13. The ICAI has issued ..... Accounting Standards till date.

14. Financial Accounting Standard Board (FASB) is the main body which formulates the .....

15. US GAAP refers to accounting principles, which are generally accepted accounting practices in USA and were set in the year .....

Task Discuss the role of US GAAP in India.

Notes

Case Study

Security Audit and Control Solutions

Abstract

In its quest to provide a better approach to workflow management and ensure that its clients have adequate tools, Security Audit and Control Solutions uses COBIT 2nd Edition as the basis for control and risk assessment activities. Security Audit and Control Solutions has developed a well-accepted audit program based on COBIT and has used it to audit NetWare, NT, network infrastructure, firewalls, UNIX and many other areas. COBIT is instrumental to on-time and on-budget value-added audits.

Background

Security Audit and Control Solutions is a consulting firm that focuses on developing specialised tools for risk management and auditing for clients including international financial organisations based in South Africa, UK, Taiwan, Russia and the USA. In addition to offering advanced audit software and tools, Security Audit and Control Solutions performs IT audits, security reviews, penetration studies, firewall testing, forensic investigation, password recovery and encryption services.

Security Audit and Control Solutions uses COBIT 2nd Edition as the foundation for performing its audits and have developed Audit and Risk Manager, a COBIT-based software application to support audit activities. Senior managers at client offices understand and welcome the benefits of COBIT's control objectives approach.

Audit and Risk Manager is deployed as a master and an agent. Using COBIT as a starting point, Security Audit and Control Solutions auditors use the master to develop a client's audit program. The client (auditee) portion of the application can be anywhere on the network and the auditee is assigned access to his/her relevant audit.

A Security Audit and Control Solutions consultant then performs the audit using the customised audit program based on COBIT principles. High-risk items that are uncovered are entered in Audit and Risk Manager as an audit finding worksheet (AFW) related to an audit code. After AFWs are raised, the auditee has access to the finding and can update his/her comments and commit to a timeframe for when compensating controls will be put into place.

Auditors can close AFWs when all correspondence has been completed. Regular reports can be issued to management with details on the current status of the audit and the controls implemented.

Other Security Audit and Control Solutions products that feed information into Audit and Risk Manager enable COBIT to become part of the living environment.

Process

Security Audit and Control Solutions uses COBIT during all audits and has met with great success communicating its benefits to senior management at client offices. Because several of its clients are large financial organisations, Security Audit and Control Solutions takes care to show them how they will be empowered by implementing COBIT as a baseline. This process leads to knowledgeable risk-taking considerations at every stage of the systems development life cycle.

Contd....

Notes

An additional COBIT-based application allows the audit to be managed in real-time with the auditee's version of the application. As a result of the continuous near real-time interaction, the auditor, auditee and other management share a better understanding of the risk in their environment.

The COBIT-based audit management application runs in a Windows environment. Client interaction requires a network connection.

Conclusion

Based on its successful implementation of COBIT at different client sites, Security Audit and Control Solutions is finalising a customised version of Audit and Risk Manager that will be used in 12 countries in Africa. This version will help operational managers use the COBIT methodology to manage their risks.

Question:

Analyse the case and write down the case facts.

Source: http://www.isaca.org/Knowledge-Center/cobit/Pages/Security-Audit-and-Control-Solutions.aspx

3.4 Summary

- Within the accounting profession, there have been challenges to develop a set of standards that are generally accepted and universally practiced.
- Thus far, the main debate in setting accounting standards is "Whose rules should we play by, and what should they be?" While the answer is unclear, users of financial statements and reporting must find methods that has an universal objective, that allows "Grapes for Grapes" comparisons that clearly, fairly, and completely prepares a company financial statements.
- For years GAAP has been the common set of standards and procedures for the U.S., the core for establishing a principle of reporting but now IFRS an international friendly financial reporting system has become popular for its use globally.
- Securities and Exchange (SEC), established by the federal government to help create and regulate financial information presented to stockholders.
- American Institute of Certified Public Accountants (AICPA), an organization of practicing Certified Public Accountants (CPA's) established to contribute to the effort.
- And the major operator Financial Accounting Standards Board (FASB), objective is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, which includes issuers, auditors, and use of financial information.
- Transpired by the London-based International Accounting Standards Boards (ISAB); for international purposes U.S GAAP or (IFRS) International Reporting Standards, also known as IGAAP are two rules accepted for financial reporting. Requirements for IFRS.
- U.S. GAAP accounting for EPS is with more details on the computational guidance on calculations similar to IFRS accounting for EPS which is calculations of year to date that varies.

Notes

3.5 Keywords

Accounting Entity: This assumes the business to be a separate entity from its owners as well as other businesses. Moreover, it also stresses on keeping revenue and expense separate from personal expenses.

AICPA: American Institute of Certified Public Accountants.

FASB: Financial Accounting Standards Board.

GAAP: General Accepted Accounting Principles.

GASB: Governmental Accounting Standards Board.

Going Concern: This assumption presumes that the business will be indefinitely in operation. This assumption authenticates the methods of amortization, depreciation, and asset capitalization. However, this assumption is not applicable in the event of liquidation.

Monetary Unit Principle: This assumption presumes an unwavering currency to continue to be the unit of record.

Time-period Principle: This assumption states that a business enterprise's economic activities can be divided into simulated time periods.

US GAAP: The Generally Accepted Accounting Principles in the US (US GAAP) refer to the accounting rules used in United States to organize, present, and report financial statements for an assortment of entities which include privately held and publicly traded companies, non-profit organizations, and governments.

US SEC: United States Securities and Exchange Commission.

3.6 Review Questions

1. Explain the meaning and definition of US GAAP.
2. Discuss the difference between IFRS and US GAAP.
3. What is the role of US GAAP in India?
4. Give a short note on Consolidation of subsidiary companies and preoperative expenses.
5. As a part of US GAAP, the financial reporting should provide little information. Explain that information.
6. In US, the legalistic and litigious nature of the business environment has led to a style of accounting standards and supporting guidance that is rule-driven. What are those standards setting followed by US GAAP.
7. What is the necessity and assumptions of US GAAP?
8. Explain the organization behind GAAP.
9. Define the following terms:
   (a) Cash flow Statements
   (b) Depreciation
   (c) Foreign currency transactions
   (d) Goodwill

Notes

(e) Proposed dividend

(f) Principle of Monetary Unit

Answers: Self Assessment

1.	False	2.	False
3.	True	4.	True
5.	True	6.	US GAAP
7.	Indian GAAP	8.	Conservatism
9.	1956	10.	Investments
11.	US Govt.	12.	ICAI
13.	29	14.	US GAAP
15.	1973		

3.7 Further Readings

Books

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

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

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

Jeanette Franzel (2009). *Single Audit: Opportunities Exist to Improve the Single Audit Process and Oversight*, DIANE Publishing.

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

Online links

http://usgaap.tripod.com/id6.html

http://www.luxottica.com/en/governance/us_gaap_accounting_policies/

http://www.pwc.in/assets/pdfs/india-publications-similarities-differences.pdf

http://www.termpaperwarehouse.com/essay-on/Ifrs-Vs-Gaap/62520

http://www.tnkpsc.com/Image/Convergence1.pdf

Notes

Unit 4: 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
- Describe internal checking

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.

Notes

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.

4.1 Process of 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.

Example: Within the University, administrative employees at the department-level are primarily responsible for internal control in their departments.

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. A short description of 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.

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.

Notes

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.

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.

According to SA 400: "Risk assessment and internal control" issued by the Institute of Chartered Accountants of India, internal control relating to accounting system are meant to accomplish the following objectives:

- To ensure that transactions are executed in accordance with management's general or specific authorization.
- To ensure that all transactions are promptly recorded in the correct amount in the appropriate accounts and in the accounting period in which these are executed so as to permit preparation of financial information within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets.
- To ensure that assets are safeguarded from unauthorized access, use or disposition.
- To ensure that the recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

Self Assessment

State whether the following statements are True or False:

1. Effective internal control is not a built-in part of the management process.
2. Internal control is the process designed to ensure reliable financial reporting, effective and efficient operations, and compliance with applicable laws and regulations.
3. Safeguarding assets against theft and unauthorized use, acquisition, or disposal is not the part of internal control.
4. In order to identify and establish effective controls, management must continually assess the risk, monitor control implementation, and modify controls as needed.
5. 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

4.2 Types of Internal Control

The Committee of Sponsoring Organizations (COSO) of the National Commission on Fraudulent Financial Reporting (also known as Tread way Commission) defines internal control as:

"Internal Control is a process, effected by an Entity's Board of Directors, Management and other personnel, 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.

From the study of above two definitions, following key concepts of internal control emerge:

1. Internal control is a process. It is a means to an end, not an end in itself.
2. It is designed, implemented and maintained by personnel at every level of organization.
3. Internal control provides reasonable assurance not absolute assurance about the achievements of stated objectives of an entity.
4. The stated objectives can be regarding reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets and compliance with applicable laws and regulations.

Based on objectives internal controls can be classified into two ways:

1. ***Preventive Controls:*** Designed to discourage errors or prevent irregularities from occurring. They are proactive controls that help to prevent a loss.

Example: Separation of duties, proper authorization, adequate documentation and physical control over the assets.

2. ***Detective Controls:*** Designed to find errors or irregularities after they have occurred.

Example: Reviews, analysis, variable analysis, reconciliations, physical inventories and audits.

Based on functions, internal control can again be classified in two ways:

1. ***Accounting Controls:*** It comprises "the plan of organization and all methods and procedures that are concerned mainly with, and relate directly to, safeguarding of assets and the reliability of financial records."

Example: Authorization and approval of transactions, separation of duties with regard to record keeping and accounting reports from those concerned with actual business operations, custody of assets, physical control over assets and internal audit.

2. ***Administrative Controls:*** It comprises "the plan of organization and all methods and procedures that are concerned mainly with operational efficiency and adherence to managerial policies, and usually relate only indirectly to the financial records."

Example: Statistical analysis, time and motion studies, performance reports, employee training programme, and quality controls.

Notes

From the above classifications, it is clear that internal control goes beyond the accounting functions of the organization and incorporates both accounting and administrative controls.

For your better understanding of the concept, as example, we are giving below some of the important matters to be decided in connection with controls relating to fixed assets:

1. Who authorizes capital expenditure and how such authorization is recorded and authenticated?
2. Who authorizes the sale, or transfer of fixed assets (including scrap/defective/obsolete etc.) and how such authorization is recorded and authenticated?
3. Who maintains accounting records in respect of fixed assets and how it is being ensured that capital and revenue expenditure are separately recorded?
4. Who maintain fixed assets registers and how frequently they are agreed with relevant accounts and physically verified?
5. What arrangements are being made to ensure that fixed assets are properly maintained and used for the service of the company (i.e. by periodic physical checks as to their location, operation and condition)?
6. Where the fixed assets are transferred between branches or companies of the same group, what arrangements in respect of pricing, depreciation and accounting are to be made?
7. How depreciation rates are to be authorized and evidenced and which persons are to be responsible for carrying out and checking necessary calculations?

4.3 Characteristics of an Effective Control System

Internal control is the whole system of controls, financial or otherwise, established by the management in order to carry on the business of the enterprise in an orderly manner, safeguard its assets and secure as far as possible the accuracy and reliability of its records.

Now question arises, whether internal control system is effective or ineffective, how you will determine it. Obviously, there are certain special characteristics of an effective internal control system which are discussed below:

1. ***Plan of organization:*** A proper plan and an appropriate structure of the organization is a must for implementation of an effective internal control system. It is true that the appropriate structure will be different for different organizations but few features are common for all. Some of them are as follows:
   - Organization structure should facilitate independence of different functions performed at different level.
   - There should be a clear demarcation between the department which conducts the activities and the department which records the activities.
   - Similarly, there should be a clear demarcation between the department which is custodians of the assets and the department which maintains account relating to those assets.
   - Authorities and responsibilities of each department should be clearly defined based on the policies of the management.
   - There should not be any scope of duplication of jobs, duties and assignments in the organization structure.

Notes

2. ***Authorization, Record and Control Procedures:*** The basic objective of authorization, record and control procedure should be to ensure that:

   - Every item of expenditure has been properly authorized and accounted for.
   - Every item of receipt has in fact been received and duly accounted for.
   - There is proper custody of the funds and other assets of the enterprise, and there is no misapplication or misuse of the same.

   This will necessitates for having an appropriate procedures for proper review and authorization of all transactions before they are entered in the books of account. Documents pertaining to each transaction should bear signatures or initials of the persons concerned to ensure effective accountability. Fixing of responsibility for the transaction will become easier if there is an accounting manual laying down the authorities and responsibilities of all persons connected with the accounting work.

3. ***Sound practices:*** An effective internal control system must have inherent safeguard in procedures and processes. A strong system of internal check should be in practice. Under internal check system, it should be ensured that no person alone handles a transaction completely from beginning to end. Moreover, there should be inbuilt system, which ensures that work of every individual gets checked automatically by another person.

4. ***Quality of Personnel:*** The availability of competent and efficient personnel is a basic prerequisite of an effective internal control system. It is the competent executives who carry out and enforce effectiveness in the internal control system. Competency of personnel does not mean competency of departmental heads and key personnel alone, but all the persons, who perform routine tasks at different levels. This will require proper selection and training of the personnel, backed by effective direction, supervision and control and an ample provision for quick corrective action to prevent lax performance, or violation of prescribed procedures.

Caselet

Internal Control Self-assessment Procedures

Abstract

An organisation recognised that the policies and procedures they had in place could not ensure the continued effectiveness of their operations.

Challenge

We were engaged by an organisation to develop procedures that would allow them to assess the internal financial controls that were in place. The scope of this engagement also included the review of these procedures as they were implemented to ensure their effectiveness.

Approach

The approach taken in this engagement involved examination of a number of areas:

- Policies and procedures are clearly stated
- Adequate review processes are exercised
- Systems in operation are effective and efficient

Contd....

Notes

As part of our work we developed a tailored self-assessment internal financial controls questionnaire. We created a variety of review and evaluation procedures and we also conducted numerous walk-through tests on the main financial transaction cycles to confirm the understanding of the financial controls.

Our review also consisted of consultation with appropriate personnel and testing to gain understanding of financial internal controls in place.

The focus of our review was to obtain assurance as to whether:

- Policies and procedures are clearly stated
- Adequate review processes are exercised
- Systems in operation are effective and efficient

Solution

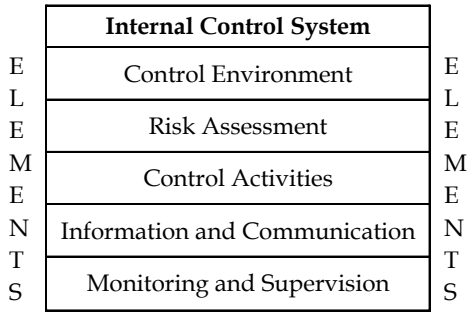
- Documented policies or procedures covering all areas are not yet available in a relevant procedures manual.
- No formal procedures, such as the creation of a risk register, exist with respect to the identification and evaluation of the financial implications of business risks.
- Significant financial and non-financial risks may not be identified or assessed and related effective controls established.
- With the aid of new procedures for self-assessment, formal documentation of controls can be made and included in a Policies and Procedures manual.
- It is apparent from our high level review and walk-through testing, with the exception of a number of matters identified in our report, that the organisation has put in place a framework of processes and control procedures which will contribute to the reliability of financial information and the safeguarding of assets.

Source: http://www.deloitte.com/view/en_IE/ie/services/enterprise-risk-services/ers-cases-studies/74b195df7e1fb110VgnVCM100000ba42f00aRCRD.htm

4.4 Internal Control Process

Internal control consists of five inter-related components. An entity's internal control system is much more then entity's record keeping procedure. It includes the elements as reflexes in Figure 4.1 below:

Figure 4.1: Internal Control System



All five internal control components must be present to conclude that internal control is effective.

Notes

4.4.1 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 behavioural 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. "Risk assessment and internal control" issued by the Institute of Chartered Accountant of India (ICAI) mentioned some of the factors which influence the control environment. These are listed below:

	Factors		Examples
a.	Organization Structure	a.	Segregation of incompatible functions helps in fixing accountability.
b.	Board of Directors and their committees	b.	A board which is independent of management or an effective audit committee points out to strong internal control environment.
c.	Management's philosophy and operating style	c.	Management should not adopt policies that encourage company personnel to manipulate data.
d.	Management control system	d.	A competent internal audit department and clear cut hiring, training, promoting and compensating policies for employees are indicators of strong control environment.

Notes People at every level of an organization affect internal control.

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.

4.4.2 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.

Notes

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.

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 behaviour. 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

Notes

- 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.

Caution Internal control can provide only reasonable assurance – not absolute assurance – regarding the achievement of an organization's objectives.

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.

Self Assessment

State whether the following statements are True or False:

6. General control and application controls in a computerised environment.
7. 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.
8. In particular, auditors may need to express opinions in the areas of corporate governance, risk management, and internal controls.
9. Internal controls help safeguard funds, provide efficient and effective management of assets, and permit accurate financial accounting.
10. Internal controls cannot eliminate all errors and irregularities, but they can alert management to potential problems.
11. 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.

4.5 Basic principles governing Internal Control

Following are given, in a summarized form, some of the important basic principles governing internal control:

1. A proper system, preferably in writing, must be implemented in the entity, in such a way that origination, recording and accounting of business transactions take place in a standardized way.
2. The authorities and responsibilities of every official should prefix and must be in writing.
3. Accounting entries should not be allowed without a supporting document.
4. A standard system of internal check should be established in such a way that no person alone handles a transaction completely from beginning to end and the work of every person is in the ordinary course checked by another person in the same or another department.
5. Responsibility for the custody and control of assets should be segregated from the responsibility of accounting for the assets. In other words, persons having the custody or

Notes

control of assets and those responsible for the accounting in respect of them should not be same.

6. The internal control system should be in consonance with the organizations structure. As far as possible, controls should be in built in the operating functions.

Example: The establishment of a separate credit control department would not be justified if the objective of reducing credit risk and minimizing debt recovery period could be met through controls in built in the accounting and sales system especially in smaller and medium sized concerns.

7. Every internal controls should be established after a cost and benefit analysis.
8. Books of accounts should be maintained up to date.
9. The entity must have a system of rotation of duties among employee. Employees should be encouraged to take permissible leave. This is more applicable to those employees who are custodian of assets like cashier who deals in receipts and payment of cash.
10. The system should have inbuilt verification system from independent records.

Example: Verification of Bank balances from bank statement, comparison of purchase ledger account with supplier statement etc.

11. The system should facilitate the surprise physical verification of assets with the records.

Example: Surprise cash verification can be conducted by the officials, other than accounts department. Surprise inventory can be verified by officials from accounts department etc.

12. A reliable and accurate Management Information System (MIS) should be in place to support the internal control system, so that immediate corrective actions can be taken if needed.

In conclusion, it may be said that the attitude of top management plays a very important role in establishment of an effective internal control. Internal auditor, external auditor and other auditors (if any) are in fact deficiency finders. It is the management who take corrective actions until and unless, they are keen to establish the required internal control, it will not function properly. So, the attitude of management regarding internal control will decide the effectiveness of internal control system in any organization.

Self Assessment

Fill in the blanks:

12. Accounting entries should not be allowed without a …….. document.
13. Persons having the custody or control of assets and those responsible for the …….. in respect of them should not be same.

4.6 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.

Notes

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.

Task Identify various factors contribute to internal control for a manufacturing company.

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.

4.7 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?

Notes

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.

4.8 Inherent Limitations of Internal Control

SA 400: "Risks Assessment and Internal Control" issued by the Institute of Chartered Accountants of India says that, Internal Control can provide only reasonable, but not absolute assurance that the objectives stated will be achieved. This is because there are some inherent limitations of internal control, such as:

(a) Management's consideration that a control be cost effective.

(b) The fact that most controls do not tend to be directed at transactions of unusual nature.

(c) The potential for human error.

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

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

(f) The possibility that procedures may become inadequate due to changes in conditions and compliance with procedures may deteriorate.

(g) Manipulations by management with respect to transactions or estimates and judgments required in the preparation of financial statements.

Let us try to understand, the inherent limitations of internal control with the help of some examples:

Example: **(for human error):** The Finance Manager did not check the 'Goods Received Note' before authorizing the payment to supplier's bill. The result was excess payments made to supplier without receiving the materials.

Example: **(for possibility of collusion):** Mr. X who had custody over incoming cash receipts colluded with B, who was responsible for processing and recording those receipts, to misappropriate cash by non recording of cash receipts.

Example: **(manipulation by Management):** A company has a reliable system of materials purchase and recording in the books of accounts. The company's top management wanted to show increased profit with the help of inflated closing stock in the profit and loss account. They instruct both the clerks to record fictitious purchase near the end of the accounting period, thus, undermining the utility of internal control system.

Self Assessment

Notes

Fill in the blanks:

14. The internal audit activity is led by the .....
15. The purpose of internal audit is to evaluate the .....
16. Internal checking is an accounting procedure or physical control to safeguard ..... due to fraud or other irregularities.
17. An effective internal ..... can provide assurance to other stakeholders such as regulators, employees, providers of finance, and shareholders.

Case Study

Cosma International

Business Needs

The foremost need of Cosma International in wanting an audit product was to aid prepare SOX Audit Reports of their 280+ users and 250+ computers; this said the elementary block was breaking down the humongous assorted data into comprehendible SOX Audit compliance reports.

Solution

ADAudit Plus scores not only on the functionality of gathering assorted Active Directory data, but also in interpreting them as simple reports. It likewise excels in monitoring the Active Directory data and furthermore pinpointing security breaches.

A brief input on SOX Audit Compliance for Public Limited Companies:

The Sarbanes-Oxley Act (SOX) of 2002 set new requirements for the integrity of the source data related to financial transactions and reporting, stored within corporate databases including: user management, authentication, separation of duties, access control, and audit trail.

The iterative compliance process includes the following four steps:

1. ***Assess*** - Gather risk and data usage information.
2. ***Set Controls and Policies*** - Define acceptable usage pattern.
3. ***Monitor and Enforce*** - Capture activity and prevent unauthorized actions.
4. ***Measure*** - Report on activity, recommend refinements as needed.

Benefits

Manage Engine ADAudit Plus with its complete audit reporting features helped Cosma International primordially in preparing the SOX Audit compliance reports and to manage data. ADAudit Plus is simple to deploy, easy to manage and reasonably priced making it a valuable asset for any company.

About Customer

Cosma International's strong foundation in the automotive industry lies in their belief to boldly pursue opportunities while allowing the ability to respond to customers' needs

Contd....

Notes

with precision and speed. Their imagination and passion is proven by the numerous awards garnered. Collaborating with best-in-class customers pushes the company to excel at what they do. In turn, Cosma International consistently strives to meet and exceed the needs of customers.

About ADAP

ADAudit Plus is an enterprise-wide Active Directory change auditing software with reports and alerts that:

- Address the most-needed audit and compliance demands set forth by regulatory and government bodies.
- Assist an IT administrator in Active Directory change management.

The comprehensive reports and alerts provided by ADAudit Plus are easily comprehendible even to technically naive users. The reports answer the four vital Ws of Active Directory auditing: "Who" did "what" action, "when" and from "where"!

Questions:

1. Discuss the problem of the case study.
2. Give light on the consequences of the case.

Source: http://www.manageengine.com/products/active-directory-audit/case-study-cosma-international.html

4.9 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.

Notes

4.10 Keywords

Accounting Controls: The plan of organization and all methods and procedures that are concerned mainly with, and relate directly to, safeguarding of assets and the reliability of financial records.

Administrative Controls: The plan of organization and all methods and procedures that are concerned mainly with operational efficiency and adherence to managerial policies, and usually relate only indirectly to the financial records.

Control Activities: Control activities are the specific policies and procedures management uses to achieve its objectives.

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.

Detective Controls: Designed to find errors or irregularities after they have occurred.

Internal Auditing: Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations.

Internal control: Internal control is the process designed to ensure reliable financial reporting, effective and efficient operations, and compliance with applicable laws and regulations.

Preventive Controls: Designed to discourage errors or prevent irregularities from occurring. They are proactive controls that help to prevent a loss.

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).

4.11 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 auditing?
6. Narrate the characteristics of effective internal control system.
7. Describe the elements of internal control.
8. Explain the basic principles governing internal control.
9. Describe the inherent limitations of internal control.
10. Identify the scope and objectives of the Statutory Auditor and its role in internal control.
11. What are the two dimensions of internal control?

Notes

12. Write short notes on:
    (a) Internal Control Questionnaire
    (b) Systems Based Audit (SBA)

Answers: Self Assessment

1.	False	2.	True
3.	False	4.	True
5.	True	6.	Application
7.	Proxy	8.	Auditors
9.	Internal	10.	Errors
11.	Effective	12.	Supporting
13.	Accounting	14.	Chief Audit Executive (CAE)
15.	Internal check system	16.	Assets against loss
17.	Audit Activity		

4.12 Further Readings

Books

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

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

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

Jeanette Franzel (2009). *Single Audit: Opportunities Exist to Improve the Single Audit Process and Oversight*, DIANE Publishing.

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

Online links

http://www.asosai.org/asosai_old/journal1999/evaluation_of_internal_controls.htm

www.asiatradehub.com/india/tr9.asp

www.auditservices.com/aevidence.html

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

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

Unit 5: Evaluation of Internal Control System

Notes

CONTENTS

Objectives

After studying this unit, you will be able to:

- Explain the objectives and steps of evaluation
- Discuss the techniques of evaluation

Notes

- Analyze the formulation of internal control schemes
- Discuss the evaluation of Internal Control with special reference to Audit of Public Sector Enterprises

Introduction

In the previous units, you have noted that in the present scenario of complex business environment, organizations are recognizing the importance of an effective internal control system. In fact, due to enormous growth in the volume and size of the business, it is almost impossible to manage it smoothly without having an effective internal control. Miracle inventions in data computing and communicating systems have altogether changed the principles and practices of management. New management techniques and controls are being introduced in organizations regularly.

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 organisation. The general methods for evaluation are flow charts and internal control questionnaire.

5.1 Objectives of Evaluation

The basic objectives of evaluating internal control system arise from the fact that internal control system has certain purposes to fulfil. The auditor, in forming his opinion on financial statements, looks for a fair confidence that transactions are properly recorded authorized and in the accounting records and that certain transactions are not being omitted. Internal controls, even if fairly simple, helps in enhancing the confidence level of the auditor. The important objectives of evaluation of internal control system can be summarized as follows:

- The most important objective in studying and evaluating internal control system is to establish the reliance an auditor can place on the system in determining the nature, timing and extent of his substantive auditing procedures.
- The next important objective is to identify the areas of weakness in the system so that an auditor can draw his audit programme and procedures for conducting audit.

Example: Normally, investments and cash are physically verified at the end of the year and this routine is known to the client and his employees. In case auditor comes across a weakness in the system he may provide in the programme for surprise cash or investments verification as per his convenience.

- The other important objective in studying and evaluating internal control system is to gain evidence that those internal controls on which the auditor intends to rely operate generally as identified by him and that they function effectively throughout the period of intended reliance.
- The last but not the least, objective of evaluating internal control system is to reduce the auditor's work and save his time and also resources of the organization.

Self Assessment

Fill in the blanks:

1. The basic objectives of evaluating internal control system arise from the fact that internal control system has certain ……. to fulfil.

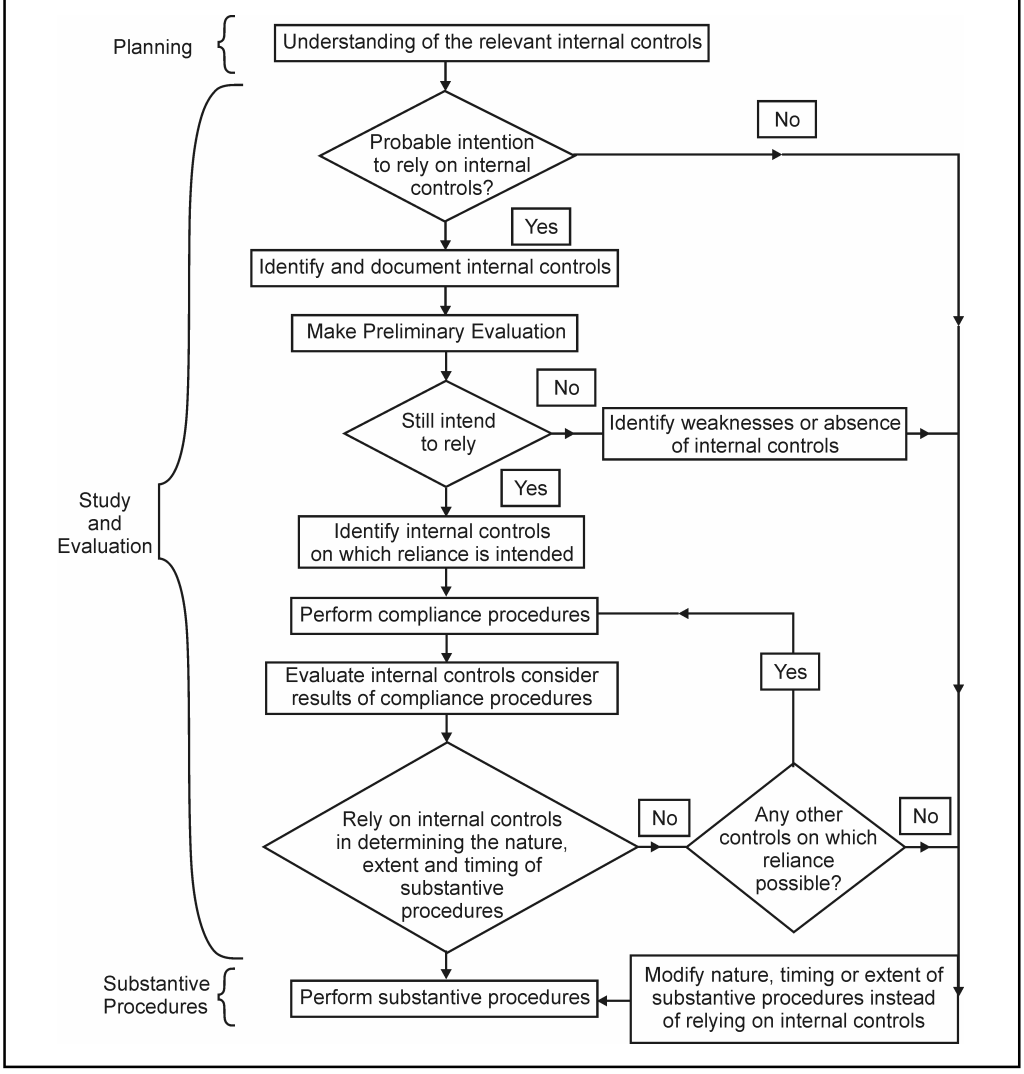
Notes

2. The objective of evaluating internal control system is to reduce the auditor's work and save his time and also …….. of the organization.

5.2 Steps in Evaluation

The different steps undertaken by the auditor for evaluating the system of internal control has been illustrated through Figure: 5.1 (adapted from 'Contemporary Audit' by Kamal Gupta) below:

Figure 5.1: Study and Evaluation of Internal Controls an Illustration



Now, let us discuss the steps of evaluating internal control system which are as follows:

(i) ***Understanding the system:*** At first the auditor should understand the internal control system with the purpose to have an idea of the flow of transactions and the various controls procedures. This will help him to pinpoint those internal controls on which he might base in doing his audit. To understand the internal control system, it may be useful to choose a few transactions through the system. The auditor should also ascertain whether the internal controls were effective and efficient throughout the period under audit.

Notes

Organization charts, procedure manuals, job description, and flow charts etc. are some of the tools to have an idea about internal controls system. The auditor can also discuss with different officials of organization. Sometimes, he may have to rely on direct observations and inquiry only. The auditor should, especially in the case of first audit, maintain a detailed written record of his observations on the internal controls system.

(ii) ***Test through compliance procedures:*** Having reviewed the system, the auditor may select the specific controls on which he intends to rely and which, therefore, need to be tested through compliance procedures. He may decide not to rely on certain internal controls which are defective in design, or reliance on which may not be cost effective. It is important to test the application of internal controls in practice.

Example: An auditor may take up a few sales bills at random and examine all the related documents right from the order of the customer to the payment received from the customer. At each stage, the auditor would see whether the transaction has taken place as stipulated in the flow chart or in the procedure manual. Thus, if the flow chart prescribes that the detail terms and condition of each order of customer has to be verified by a particular manager, the auditor should examine whether or not this has been done in practice.

The objective of compliance tests is to provide a fair confidence to the auditor that the internal controls procedures are being effective as prescribed. The auditor should carry out such tests in case of all procedures on which audit reliance is intended to be placed. Tests of compliance are concerned primarily with the following questions:

- Were the necessary procedures complied with?
- How were they complied with?
- By whom were they complied with?

(iii) ***Evaluating the system:*** Based on his observation during the tests made by him, the auditor has to make an estimate of how far he can depend on various internal controls. Normally, he should have a reasonable confidence that the system is such that the errors and fraud can be discovered automatically. He has to ascertain whether the control procedures as designed to implement are in practice and competent in preventing or detecting material errors and fraud in the accounting system. This is essentially a question of individual judgment in a particular situation. If he finds certain errors or weaknesses in the system, he should try to evaluate the impact of the same on various transactions. Let us suppose he finds weaknesses in the system of maintaining debtors' ledger. Since this is a material item, he should ask for independent confirmations from the debtors. Thus, the auditor's evaluation of internal control system will determine the nature, timing and extent of his substantive procedures.

Self Assessment

Fill in the blanks:

3. The auditor should understand the internal control system with the purpose to have an idea of the flow of …… and the various control procedures.
4. The objective of compliance tests is to provide a fair …….. to the auditor that the internal control procedures are being effective as prescribed.

Notes

5.3 Techniques of Evaluation

Different techniques may be used by an auditor to have an idea and assessing the effectiveness of an internal control system. The selection of a particular technique is a matter of the auditor's judgment.

Two most common techniques of internal control evaluation are:

1. the flow charts and
2. the internal control questionnaires.

The auditor may prepare flow charts of the various categories of transactions in order to have a quick grasp of the system. An internal control questionnaire lists a series of questions which an auditor may wish to ask in order to understand and evaluate an internal control system.

1. ***Flow Charts:*** The flow charting technique is an important technique for evaluation of the internal control system. It is a graphic presentation of internal controls in the organization and is normally drawn up to show the controls in each section or sub section. As distinct from a narrative form, it provides the most concise and comprehensive way for reviewing the internal controls and the evaluator's findings.
2. ***Internal Control Questionnaires:*** Because of the wide experience that auditors possess about the business operations in general and the knowledge about the appropriate control, most of the auditing firms have developed their own standardized internal control questionnaire on a generally applicable basis. In developing the standard questionnaire, endeavour is made to make it as wide as possible so that all situations, generally found, are included therein but all of these may not be applicable in a particular case. A questionnaire is a set of questions framed in an organized manner, about each functional area, which has as objective, the evaluation of the effectiveness of control and detection of its weakness if any.

Self Assessment

Fill in the blanks:

5. The selection of a particular ……is a matter of the auditor's judgment.
6. Two most common techniques of internal control evaluation are the …….. and the internal control questionnaires.

5.4 Flow Charts

In a flow chart, narratives, though cannot perhaps be totally banished but are reduced to the minimum and by that process, it can successfully bring the whole control structure, especially the essential parts thereof, in a condensed but meaningful manner. It gives a bird's eye view of the system and is drawn up as a result of the auditor's review thereof. It should, however, not be understood that details are not reflected in a flow chart. Every detail relevant from the control point of view and the details about how an operation is performed can be included in the flow chart. Essentially a flow chart is a diagram full with lines and symbols and, if judicious use of them can be made, it is probably the most effective way of presenting the state of internal controls in the client's organization. A properly drawn up flow chart can provide a neat visual picture of the whole activities of the section or department involving flow of documents and activities. More specifically it can show:

(a) At what point a document is raised internally or received from external sources.

Notes

(b) The number of copies in which a document is raised or received.

(c) The intermediate stages set sequentially through which the document and the activity passes.

(d) Distribution of the document to various section department or operations.

(e) Checking authorization and matching at relevant stages.

(f) Filing of the documents.

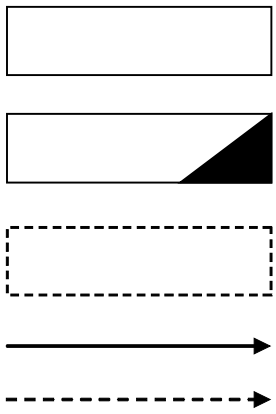
(g) Final disposal by sending out or destruction.

As a matter of fact a very sound knowledge of internal control requirements is imperative for adopting flow charting technique for evaluation of internal controls, also it demands a highly analytical mind to be able to see clearly the inter division of a job and the appropriate control at relevant points.

Did u know? Various professional accounting bodies now recognize the fact that the evaluation of internal control system helps in formulating an audit programme.

A flow chart is normally a horizontal one in which documents and activities are shown to flow horizontally from section to section and the concerned sections are shown as the vertical column head; in appropriate cases an individual also may be shown as the vertical column head. Care should be taken to see that the first column head is devoted to the section or the individual wherefrom a transaction originates and the placements of other column heads should be in the order of the actual flow of the transaction. It has been stated earlier that a flow chart is a symbolic representation the flow of activity and related documents through the section from origin to conclusion. These can be sales, purchases, wages, production etc. Each one of the main functions is to be linked with related functions for making a complete course. Purchase is to be linked with sundry creditors and payments; sales with sundry debtors and collection. For actual drawing of the flow chart, the auditor has to formulate his symbols to reflect the flow and the connected details. There should be a direction of movement for the activity and documents, at several stages new documents may be added, documents may be matched, annexed or destroyed; there may be points for checking the documents. This will depend upon the details that the auditor can get from the section head or by a process of verification on the basis of the rough flow chart. Skinner an Anderson in their book "Analytical Auditing" has suggested the following symbols for the use of auditors:

Symbols



Documents

Documents prepared

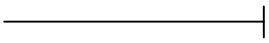
If copy made

Flow of documents

Used for next step

Notes

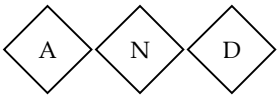
Fork (Alternative Possibilities)



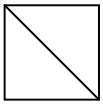
Dead End (Leaves Charted System)

Permanent file of documents (alphabetically, numerically, or by date)

Serial continuity checked, unimportant, or unchecked respectively

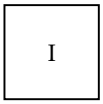


Temporary file of documents (alphabetically, numerically, or by date)

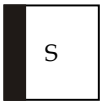


Attached

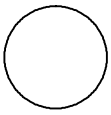
Destroyed



Initials

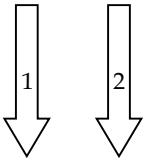


Signs



Posting Source

Keypad to explanatory note



Keypad to explanatory note

Notes

Sometimes, it is necessary to briefly narrate some aspects of flow or control on the flow chart. Those which could be entered on the chart itself, without making it cumbersome, should be recorded in the chart.

Example: If the billing section makes the calculation of the sales tax payable by customer, this is a relevant fact and it can be expressed by entering "S.T. Calculation" alongside the document. It will not make the chart less intelligible.

But if the requirement for narration is slightly bigger, to effectively supplement the information on the flow chart, the narration should be given at the bottom of the chart by making the exact position of the chart needing the narration by an asterisk or some other suitable symbol, which in turn should be corresponded at the bottom.

Example: On a flow chart on production you may have to narrate how production orders are initiated. This will be slightly bigger narration and it should be provided at the bottom. The keying symbol should be placed by the side of the document and the narration at the bottom. It should, however, be remembered that wherever it is possible to obviate the use of narration, it should be so done and, when it is unavoidable, necessary use of keyed narration should be made.

Generally, a questionnaire is also is also enclosed with a flow chart, incorporating questions, the answers to which are to be looked into from the flow chart. In fact, the questionnaire is a guide for the study of a control system through flow charts.

Self Assessment

Fill in the blanks:

7. A properly drawn up flow chart can provide a neat visual picture of the whole activities of the section or department involving flow of …….. and activities.
8. For actual drawing of the flow chart, the auditor has to formulate his …… to reflect the flow and the connected details.

5.5 Internal Control Questionnaires

A questionnaire usually consists of several separate sections devoted to areas such as purchases, sales, debtors, creditors, wages etc. However, this poses some practical difficulties. The questionnaire is to travel from executives and, therefore, it may take a pretty long time to be filled, also the questions may not be readily intelligible to busy executives and there is a possibility of the questionnaire being misplaced while travelling from one table to another. Having regard to these difficulties, it is now almost an accepted practice that the auditor (or his representative) arranges meetings with the executives concerned and gets the answers filled by each executive. Sometimes, the auditor himself may be required to fill answers. In such a case, he should ensure that the concerned executive has initiated the answers as a token of his agreement therewith.

Notes 'Basic principles governing an Audit' issued by the Institute of Chartered Accountants of India states that the auditor should gain an understanding of the accounting system and related internal controls and should study and evaluate the operation of those internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures.

Notes

Questionnaires can be prepared for various aspects of the internal control system. An illustrative questionnaire regarding fixed assets is given below:

(a) Who authorizes capital expenditure and how is such authorization recorded and authenticated?

(b) Who authorizes the sale, or transfer of fixed assets (including scrap/ defective/obsolete etc.) and how is such authorization recorded and authenticated?

(c) Who maintains accounting records in respect of fixed assets and how is it ensured that capital and revenue expenditure are separately recorded?

(d) Who maintains fixed assets registers and how frequently they are agreed with relevant accounts and physically verified?

(e) What arrangements are being made to ensure that fixed assets are properly maintained and used for the service of the company (i.e. by periodic physical checks as to their location, operation and condition)?

(f) Where fixed assets are transferred between branches or companies of the same group, what arrangements in respect of pricing, depreciation and accounting are made?

(g) How are depreciation rates authorized and evidenced and which persons are to be responsible for carrying out and checking necessary calculations?

Task List six important questions that can be included in the internal control questionnaire regarding purchase of machinery.

Self Assessment

Fill in the blanks:

9. A questionnaire usually consists of several separate ……. devoted to areas such as purchases, sales, debtors, creditors, wages etc.

10. The questionnaire is intended to be filled by the company ……. who are in charge of various areas.

5.6 Formulating Internal Control Schemes

A professional accountant often asks to formulate schemes of internal control in various functional areas of an organization. Drafting a scheme of internal control is similar to drafting an internal control questionnaire. Knowledge of detail business process is vital in both cases. However, when a scheme of internal control is drafted the various statements are given in the form of instructions whereas in an internal control questionnaire, the auditor asks specific questions from the client.

Example: A scheme of internal control over fixed asset may state the following: "A written approval from the General Manager of the plant must be taken before selling or transfer of any fixed assets." A specific question in the internal control questionnaire in this regard may be: "Has a written approval from the General Manager of the plant taken before selling or transfer of any fixed assets."

Notes

Notes The questionnaire is intended to be filled by the company executives who are in charge of the various areas.

In formulating schemes of internal control or drafting an internal control questionnaire the following important points should be kept in mind:

1. ***Understanding various stages of a transaction:*** Understanding of various stages of a transaction is very important to formulate a scheme of internal control or drafting an internal control questionnaire. Each job or transactions passes through various tasks. Detail knowledge of these tasks and their links with other tasks are very crucial for formulating a scheme of internal control or drafting an internal control questionnaire.
2. ***Distribution of duties:*** This is vital for formulating a scheme of internal control or drafting an internal control questionnaire. The duties should be divided in such a way that no person alone handles a transaction completely from beginning to end and the work of every person is in the ordinary course checked by another person in the same or another department.
3. ***Rotation of duties:*** There are various advantages of rotating employees on different job periodically. Firstly, it ensures that no employee can have a vested interest in his job. If the clerk processing purchase orders is changed every six months, the suppliers will find it difficult to develop permanent contacts. Secondly, each employee will keep his work up to date because he knows that somebody else will check his work. Thirdly, work does not suffer due to absence of any employee because another person with required experience is always available.
4. ***Review:*** An internal control scheme should provide for a periodic review of the system to ensure that the prescribed scheme is being followed as far as practicable. Many organizations entrust internal audit departments the responsibility for periodic review of the system including the controls.

Task Draft a suitable internal control system by which control may be exercised over the purchase of raw materials.

Self Assessment

Fill in the blanks:

11. Drafting a scheme of internal control is similar to drafting an internal control …….
12. There are various advantages of …….. employees on different job periodically.

5.7 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,

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3. Promoting operational efficiency, and
4. Fostering and encouraging adherence to the prescribed managerial policies.

5.7.1 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.

5.7.2 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.

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.

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.

Source: http://article.yeeyan.org/bilingual/339990

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5.7.3 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 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.

5.7.4 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:
   - Selective Verification in areas where he finds that internal control is effective.
   - Detailed or comprehensive verification of transactions in areas where the internal control is weak.
   - Internal control investigation and evaluation is most relevant in the context of–
     (a) Independent financial audits,
     (b) Special systems study engagements.

Notes

5.7.5 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.
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.

5.7.6 Inter-relationship between Audit and Internal Controls

Caution 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.

5.7.7 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.

Notes

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'.

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.

5.8 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 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.

5.8.1 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.

5.8.2 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,

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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.

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?

5.8.3 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.

Notes

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.

5.8.4 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 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.

5.8.5 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.

Self Assessment

Fill in the blanks:

13. Methodology for internal evaluation include:.....;..... and.....
14. Answers of internal control questionnaire are compiled by the auditor on the basis of his ..... with the auditee.
15. The corrective action taken for rectification by the management and its periodic assessment through..... method enables the fulfilment of the principal objectives of internal control procedures.

Notes

Case Study

Internal Control Breakdown

Readers of a certain age may associate Haight Ashbury with the peace movement of the '60s, youthful exuberance and caring nonprofits such as the Free Clinic - not fraud perpetrated by one of its executives. What makes this story even more disheartening is the fact that the embezzlement occurred at the Haight Ashbury Free Clinic and could have been avoided if even the simplest of accounts payable best practices had been observed.

Cause and Effect

According to published reports, what happened at the clinic is typical of the types of employee fraud that happens day in and day out at many organizations. It was nothing overly sophisticated and demonstrated how insiders who know the peculiarities of differing requirements use their knowledge for their own enrichment.

A former CFO of the clinic took advantage his knowledge that requires nonprofits receiving federal grants to return any unspent money. This money is supposed to go directly to a federal office. However at the free clinic, authorities claim the CFO created an account at a Sacramento bank under a name similar to the federal office. For over two years he had clinic workers return these checks, which he deposited into this account that he actually owned.

He allegedly set up several accounts with names similar to legitimate vendors. The CFO had payments intended for these legitimate vendors be sent to his dummy corporations and later cashed the same checks.

These schemes began in June 2001 and went on for over two years. After the irregularities were uncovered and investigated, the CFO was fired and the case was turned over to prosecutors, who miraculously prosecuted and got a conviction. We say miraculously because white-collar crime is rarely prosecuted. Even more amazing is the fact that he was convicted. He was sentenced on April 30, 2008 to serve four years in prison, make restitution and pay back taxes and fines.

Returning checks to anyone besides the intended payee is a break in best-practice procedures. What happened here demonstrates clearly why returning checks to anyone but the payee is such a bad practice.

Clearly the process for setting up new vendors was lax at the clinic.

Solution

If one of your employees is determined to steal from you, you probably can't stop them from trying. But, you can stop them from succeeding. And even if they get away with it once, you should be able to catch it early on - not two years and $700,000 later. By following these best practices, financial executives can avoid and prevent most internal fraud:

- Never, ever, return checks to requisitioners.
- Use appropriate segregation of duties including master vendor file responsibilities.
- Limit access to the master vendor file.
- Get W-9s from every new vendor before making the first payment.

Contd....

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- Run W-9s against the IRS TIN (Taxpayer Identification Number) Matching Program before making the first payment.
- Check to see if duplicate vendors have the same TIN.
- Do some sort of verification of new vendors, checking TIN and phone numbers to ensure you are not dealing with a phony vendor.
- Use coding standards for master vendor file data entry and be suspicious of vendors with similar names.
- Have a corporate policy restricting transactions with company employees unless there is a specific written contract approved by senior management not involved with the case.
- Require dual approvals before a new vendor is added to the master vendor file.

Be wary of executives who request or require access to everything. This makes fraud all the easier to commit. No employee should have such access, regardless of their level within the organization. Remember, trusted employees are the ones who are most likely to steal from you successfully - so put safeguards in place to ensure it doesn't happen on your watch.

Conclusion

While very few organizations will employ all the practices described above, the more you can incorporate into your policy and procedures, the more difficult it is for a fraudster (either an employee, former employee or someone else) to steal from you.

Question:

How many of these practices are in place in your organization?

Source: http://www.cpa2biz.com/Content/media/PRODUCER_CONTENT/Newsletters/Articles_2009/CorpFin/IntControls_Breakdown.jsp

5.9 Summary

- Internal controls, even if fairly simple, helps in enhancing the confidence level of the auditor.
- The most important objective in studying and evaluating internal control system is to establish the reliance an auditor can place on the system in determining the nature, timing and extent of his substantive auditing procedures.
- Two most common techniques of internal control evaluation are the flow charts and the internal control questionnaires.
- The flow charting technique is an important technique for evaluation of the internal control system. It is a graphic presentation of internal controls in the organization and is normally drawn up to show the controls in each section or sub section.
- A sound knowledge of internal control requirements is essential for adopting flow charting technique for evaluation of internal controls, also it demands a highly analytical mind to be able to see clearly the inter division of a job and the appropriate control at relevant points.
- A questionnaire is a set of questions framed in an organized manner, about each functional area, which has as objective, the evaluation of the effectiveness of control and detection of its weaknesses, if any.

Notes

- A professional accountant often asks to formulate schemes of internal control in various functional areas of an organization.
- When a scheme of internal control is drafted, the various statements are given in the form of instructions, whereas in an internal control questionnaire, the auditor asks specific questions from the client.
- Understanding of various stages of a transaction is very important to formulate a scheme of internal control or drafting an internal control questionnaire.
- An internal control scheme should provide for a periodic review of the system to ensure that the prescribed scheme is being followed as far as practicable.

5.10 Keywords

Evaluation: Evaluation is a systematic determination of a subject's merit, worth and significance, using criteria governed by a set of standards.

Flow Charts: A graphic representation of a system which depicts the various operations, controls, and stages involved in a system.

GAAP: Generally Accepted Accounting Practices.

Internal Control Questionnaire: A list of various questions which an auditor may ask in order to verify the existence and effectiveness of an internal control system.

Questionnaire: A questionnaire is a research instrument consisting of a series of questions and other prompts for the purpose of gathering information from respondents.

SEC: Securities Exchange Commission (of America).

Substantive Procedures: Tests designed to obtain evidence to verify balance of an account or a specific financial statement assertion.

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).

5.11 Review Questions

1. Describe the objectives of evaluation of internal control system.
2. Explain the steps in evaluation of internal control system.
3. Discuss flow charts and internal control questionnaire.
4. What are the points to be consider in formulating internal control scheme?
5. Distinguish between control environment and control procedures.
6. Write short notes on:
   (a) Internal Control Questionnaire
   (b) Systems Control Evaluation
7. What are the advantages of internal control evaluation?
8. Explain the concept of EDP Environment the New Dimension.

Notes

Answers: Self Assessment

1. Purposes
2. Resources
3. Transactions
4. Confidence
5. Technique
6. Flow Charts
7. Documents
8. Symbols
9. Sections
10. Executives
11. Questionnaire
12. Rotating
13. Appraisal by workflow; appraisal by duties; appraisal by questionnaire
14. Observations and personal interaction
15. the Systems Control Evaluation

5.12 Further Readings

Books

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

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

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

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

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

Online links

http://www.asosai.org/asosai_old/journal1999/evaluation_of_internal_controls.htm

http://www.asosai.org/journal1999/evaluation_of_internal_controls.htm

www.asiatradehub.com/india/tr9.asp

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Notes

Unit 6: Internal and External Audit

CONTENTS

Objectives

After studying this unit, you will be able to:

- Narrate the concept of internal audit
- Explain the various objectives of internal audit
- Co-relate the management functions and scope of internal audit
- Differentiate between internal audit and external audit
- Describe internal check and internal audit

Introduction

Internal audit is established by management to assist in corporate governance by assessing internal controls and helping in risk management. The ethical requirements differ from those of

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external auditors due to the nature of the function. Techniques used by internal auditors are similar to those used by external auditors. There are usually no statutory requirements in relation to internal audit. Internal audit is a relatively new profession and there is an expectation gap i.e. the difference between what the public perceives and what the profession perceives to be the role of the internal auditor.

The main objective of Internal audit is to detect the mistake and errors committed during the assessment work, TROs and Administrative Officers/Superintendents, so that a suitable/ appropriate remedial action is taken to retrieve the loss caused to the revenue not to allow relief to the assessee in case of overcharge/over assessment. The other objective of internal audit is to find out whether the procedure and laws laid down are properly followed or not and whether there is any violation of CBDT Guidelines, Instructions and Circulars. Ultimate aim is to improve quality of assessments by reducing the errors and omissions which are subsequently detected by receipt audit.

6.1 Meaning of Internal Audit

Internal audit is defined as an appraisal or monitoring activity established within an entity as a service to the entity. It functions by, amongst other things, examining, evaluating and reporting to the management and the directors on the adequacy and effectiveness of the components of the Accounting and Internal Control Systems.

The Institute of Internal Auditors, USA, defines Internal Audit as an independent appraisal activity within an organization for the review of accounting, financial and other operations as a service to management. Internal audit is generally a feature of large companies. It is a function which is provided either by employees of the entity or sourced from outside the entity.

The Institute of Internal Auditors (IIA) defines internal audit as follows:

"Internal Audit 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."

The above definition leads us towards the following elements:

1. Internal audit is an independent activity.
2. It provides assurance and consulting services.
3. It helps the organization to achieve its objectives.
4. It enhances the effectiveness of processes related to internal control and risk management.
5. It is a systematic and disciplined approach.

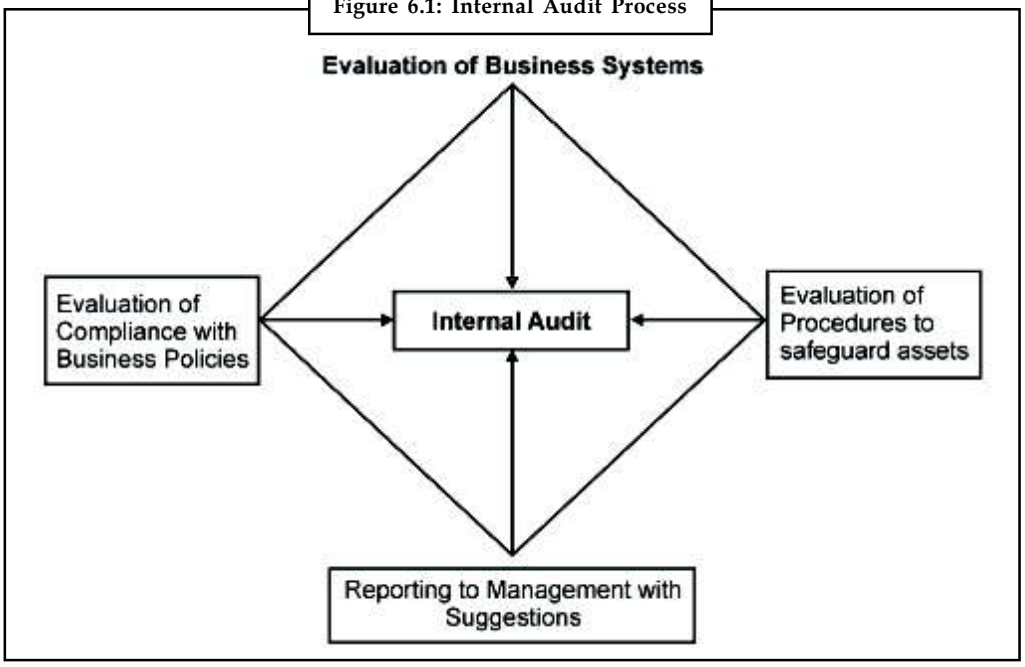
From the figure 6.1, it is clear that internal audit is basically an evaluation and reporting function of financial and operational areas. Now-a-day, management puts a lot of reliance on the report and suggestions made by the internal auditors. It is relevant to mention here that internal audit works as a part of the management. It provides assurance to the Board of Directors and Audit Committee that:

- The existing system of controls is commensurate with the size and nature of the company.
- The existing system of controls is cost effective.
- Financial and operating information systems are reliable and accurate.
- Company is complying with all applicable policies, procedures, laws and regulations.

Notes

- The assets of the company are properly recorded and sufficient measures have been taken to safeguard it.
- Operational results of the company are as per the fixed target and objectives.

Figure 6.1: Internal Audit Process



The complexity and increasing size of entities has drastically increased the importance of the role of internal auditor. The significance of internal audit is growing day by day. Historically, internal audit was mostly confine to ensure that the accounting and allied records have been properly maintained, the assets management system is in place in order to safeguard the assets and also to see whether standing policies and procedures are duly complied with. But with the passage of time, the objectives of internal audit have been significantly changed. Now cost benefit analysis, resources utilization and their proper deployment, effectiveness of management decisions etc. are also being reviewed by the internal auditor.

Did u know? Internal Audit was introduced in 1954 and after the audit of receipt was entrusted with Comptroller & Auditor General of India in the year 1960, the scope of duties of Internal Audit were made co-extensive with that of statutory Audit.

Briefly, the objects of internal audit may be described as follows:

1. ***Evaluation of business control system:*** Internal audit is concerned with ensuring effective and efficient system of accounting control, standard cost control, budgetary control and other functional control.
2. ***Compliance with standard policies and procedures:*** Reporting to management about the compliance of standard policies and procedures is an important objective of internal audit. For example, suppose company's standing policy is that any purchase order worth more than TZS 4,000,000 cannot be awarded without asking quotation from at least three parties. If internal auditor found that this has not been strictly followed then he must report those cases to the management.

Notes

3. ***Safeguarding and adequate utilization of business assets:*** Internal audit has to ensure that all assets of the company are properly recorded. It has to verify assets utilization report and determine whether fixed targets have been achieved or not. For example, suppose internal auditor found that valuable scrap is not being properly recorded in the books, he should include this observation in his audit report.

4. ***Reliability of Management Information System (MIS):*** Internal Audit ascertains the reliability of financial and operating reports prepared throughout the organization. The management relies on the reports of internal auditors as they provide an assurance as to validity of records and transactions of the enterprise.

5. ***Suggesting improvements:*** The ultimate objective of internal audit is to assist management in the effective discharge of their responsibilities by furnishing them with proper suggestions for improvements.

Self Assessment

State whether the following statements are True or False:

1. Internal audit is an independent activity.
2. Internal audit is basically an evaluation and reporting function of financial areas only.

Caselet

The Effectiveness of Internal Audit in Central Government

The National Audit Office has today published a report examining the effectiveness of internal audit in central government, covering both main departments and their associated arm's length bodies. Government is not getting the most out of the £70 million it spends on internal audit because the service does not always focus on the right issues and it is often not of sufficient quality to be useful in decision-making.

According to today's report, Chairs of Audit Committees and other senior stakeholders expect more from their internal audit service. Although 84 per cent of respondents to an NAO consultation considered internal audit added some or substantial value to their organization, they had concerns over the current depth of insight, relevance and underlying execution of internal audit work. Many key stakeholders believe that internal audit work is not sufficiently tailored to be relevant to the different issues facing individual organizations.

Treasury guidance on what internal audit should deliver is not sufficiently specific, leading to expectations of internal audit being unclear. There is little consistency in the application of standards. Variations in quality and coverage mean that the NAO often cannot take assurance from internal audit work, and it is often of insufficient scope or quality for the spending watchdog's external audit work.

There are specific areas where internal audit could be more effective. Users of internal audit identified particular gaps in such areas as the usefulness and relevance of reports; the expertise of staff, including expertise on IT-based information systems; the identification of efficiencies in the organization; and the ability to offer advice to senior management.

Contd....

Notes

Some 40 per cent of stakeholders thought some or substantial improvement was needed in the expertise or professionalism of internal audit.

HM Treasury's Internal Audit Transformation Programme is a partial solution to the issues identified by the NAO, but the project does not consider, in sufficient detail, what should be expected of an effective internal audit service. Nor does the Treasury have an accurate view on the costs of internal audit in government.

Source: http://www.nao.org.uk/publications/1213/internal_audit.aspx

6.2 Objectives of Internal Auditing

The significance of internal audit is growing day by day. Historically, internal audit was mostly confine to ensure that the accounting and allied records have been properly maintained, the assets management system is in place in order to safeguard the assets and also to see whether standing policies and procedures are duly complied with. But with the passage of time, the objectives of internal audit have been significantly changed. Now cost benefit analysis, resources utilization and their proper deployment, effectiveness of management decisions etc. are also being reviewed by the internal auditor.

Briefly, the objects of internal audit may be described as follows:

1. ***Evaluation of business control system:*** Internal audit is concerned with ensuring effective and efficient system of accounting control, standard cost control, budgetary control and other functional control.

2. ***Compliance with standard policies and procedures:*** Reporting to management about the compliance of standard policies and procedures is an important objective of internal audit.

Example: Suppose company's standing policy is that any purchase order worth more than ₹ 4,00,000 cannot be awarded without asking quotation from at least three parties. If internal auditor found that this has not been strictly followed then he must report those cases to the management.

3. ***Safeguarding and adequate utilization of business assets:*** Internal audit has to ensure that all assets of the company are properly recorded. It has to verify assets utilization report and determine whether fixed targets have been achieved or not.

Example: Suppose internal auditor found that valuable scrap are not being properly recorded in the books, he should include this observation in his audit report.

4. ***Reliability of Management Information System (MIS):*** Internal Audit ascertains the reliability of financial and operating reports prepared throughout the organization. The management relies on the reports of internal auditors as they provide an assurance as to validity of records and transactions of the enterprise.

5. ***Suggesting improvements:*** The ultimate objective of internal audit is to assist management in the effective discharge of their responsibilities by furnishing them with proper suggestions for improvements.

To achieve full objectives of internal audit, the internal audit should have sufficient authority to access all necessary records of the organization.

Notes

Notes The Central Board of Direct Taxes, New Delhi has now introduced the new internal audit set up, procedure for working and dealing with the internal audit objections, responsibilities of the officers and staff and procedure for settlement of internal audit objections with special reference to different views expressed by the courts.

The following excerpts from the internal audit manual of a public undertaking may help you to understand how a typical organization perceives the role of its internal audit department:

- The management of every corporate body has the direct responsibility for the maintenance of an adequate and effective system of accounts for the proper recording of all transactions in the books of accounts and for safeguarding the assets of the concern. In addition to this responsibility, the management of a public undertaking has a moral responsibility to the community at large which demands that the assets of the concern be properly maintained, augmented and utilized in a manner that contributes to the general welfare of the country.
- Internal audit helps the management in the discharge of this responsibility. It is said that the internal audit functions as an eye of the management.
- Internal audit has to ensure that the accounts are maintained correctly by the accounts department. Also that the rules, regulations and orders having financial bearing and issued by the competent authorities are observed by all departments. For this purpose, internal audit scrutinizes all transactions accounted for in the books with reference to the initial documents like purchase orders, receipts, vouchers, issue vouchers, cash vouchers, pay rolls, muster rolls, adjustment memos, sale invoices, journal entries etc and checks the books of accounts like journals, ledgers and final accounts including the schedules.
- Another important function is to review all transactions from the angle of financial proprietary and to suggest correct methods of executive action and ways and means for effecting economy and for safeguarding against fraud, misappropriation or other losses with the emphasis upon prevention. Where irregularities are deducted, internal audit should see that they are promptly reported to the higher authorities for necessary action.
- In striving to make the accounting department more efficient in attaining its basic management objectives, internal audit has the responsibility of appraising the efficiency of both the accounting procedures and the actual performance of the staff. Internal audit has also to ensure that the subsidiary accounts and other relevant records maintained in other departments like hostel, canteen, hospital, schools, outstation offices, etc. are scrutinized at suitable intervals.
- Internal audit will undertake special investigations and reviews as may be required from time to time and on the instructions of the Chief Finance Officer.
- Internal audit is entrusted with the responsibilities of conducting physical verification of stores, raw materials, finished products and movable assets as lying under the control of the stores/executive officers, as the case may be.
- Internal audit should also check the accuracy of the monthly journal entries prepared by the various sections before these are passed on the central accounts section for incorporation in the main and sub-ledgers.
- Internal audit has also the duty of constantly examining and improving upon the system of internal check currently followed.

Notes

Self Assessment

State whether the following statements are True or False:

3. It is said that the internal audit functions as an eye of the management.
4. Internal audit is not concerned with the correctness of accounts.

6.3 Essentials for Effective Internal Auditing

Following are the essentials for effective Internal Auditing:

- ***High organizational status:*** Whether internal audit is undertaken by an outside audit firm or by an internal audit department of the company itself, the organizational status of the internal auditor must be high. In an ideal situation, he should report to the highest authority of the company. He should have the liberty to directly communicate with the external auditor.
- ***Independence:*** Internal auditor must have the full independence of work. There should not be any constraints or restrictions placed upon his work. Independence facilitates internal auditors to render the impartial and unbiased opinion essential to the proper conduct of audits.
- ***Technical competence:*** The internal audit team should be professionally qualified and adequately trained. The number of staffs should appropriate.
- ***Due professional care:*** The internal auditor should exercise due professional care in fulfilling his responsibilities. Examples of the exercise of due professional care by the internal auditor are the existence of adequate audit manuals, audit programmes and working papers.
- ***Reporting and follow-up:*** The internal auditor should ensure that his findings with recommendations should reach to the appropriate authority of the management. He should also ensure that proper follow up actions have been taken by the management based on his reports.

Self Assessment

Fill in the blanks:

5. Internal auditor should have the liberty to directly communicate with the …….. auditor.
6. The internal auditor should exercise due …… care in fulfilling his responsibilities.

6.4 Management Functions and Scope of Internal Audit

From past few decades, the size of business organizations has grown tremendously. Accordingly, the management functions have become more complex. As we have already discussed above, the main purpose of internal audit is to help management to achieve its objectives. With the increase of size of business and operations the scope of internal audit has also widen. Now, internal audit is no more concerned with only verification of financial records, calculations and clerical operations but also with appraisal of various operational functions on behalf of top management. In other words, of late, there has been a shift in the orientation of internal auditing to include what is sometimes referred to as 'operational auditing'. The scope of audit is very clearly narrated by Shekhar in his books of "auditing" (p. 105), which is as follows:

Notes

"……. that under contemporary practices, a wide range of activities is being done by the internal audit department. These activities may broadly be classified as financial and operational audits. Under the former may be included:

1. A continuous review of internal accounting control;
2. The scrutiny of reports and statements, financial or operating, as prepared for management purposes;
3. The ascertainment of the extent to which the assets of the organization are accounted for and safeguarded from losses or damages;
4. The examination of balance sheet items, tests of balances and transactions as to their authenticity through appropriate tests, etc.

Notes Internal audit shall also exercise vigilance for prevention of mistake having both deterrent as well as reformative effect.

Under operational audit may include:

1. The study and assessment of operating practices to promote increased efficiency and economy;
2. The carrying out of audits to determine whether operating objectives, targets and associated control procedures are properly instituted and the degree to which the desired results are achieved;
3. The examination and the ascertainment of the extent to which established policies, plans and procedures are complied with;
4. The assessment of budgetary standard setting;
5. The assessment of the level of performance in successfully discharging duties and responsibilities assigned."

From the above discussion it is clear that internal audit is basically a review function. On the basis of such review, the internal auditor should in his report, highlight the weaknesses observed and give suggestions for improvement.

Task Visit Head office of any known company to you and meet the head of internal audit department. Discuss with him about the scope and objectives of internal audit in his company. Make a project report and try to find the weaknesses if any.

Self Assessment

State whether the following statements are True or False:

7. The main purpose of internal audit is to help the management to achieve its objectives.
8. Operational audit includes assessment of budgetary standard setting.

Notes

6.5 External Audit

An external audit is a review of the financial statements or reports of an entity, usually a government or business, by someone not affiliated with the company or agency. External audits play a major role in the financial oversight of businesses and governments because they are conducted by outside individuals and therefore provide an unbiased opinion. External audits are commonly performed at regular intervals by businesses, and are typically required yearly by law for governments.

6.5.1 Function

External audits are performed to verify that the financial statements of an entity are correctly presented. They do not involve an actual accounting of a business' or company's financial accounts, but rather external audits are an independent review of financial documents provided to the auditor.

For a private-sector business, an external audit will typically include a review of the company's quarterly or monthly financial reports as well as statements on revenues and expenditures to ensure they are correctly tabulated and reported.

For governments, an external audit will include a review of the budget, the allocation of funds and the actual expenses to ensure the budgeted revenues and expenses were correctly compiled and used.

6.5.2 Time Frame

External audits are typically conducted once a year at the end of the company's or government's fiscal year. They are performed after the entity's in-house bookkeepers prepare a year-end financial report, which is one of the documents verified in an external audit.

Companies and governments will typically issue quarterly financial reports throughout; however, these are usually by internal accountants and bookkeepers, and have not been externally reviewed for accuracy.

6.5.3 Significance

Because external audits are performed by third-party accountants, they represent an unbiased view of an entity's financial standing. For governments, this independent review will ensure taxpayers that budgeted funds are being appropriately spent and the revenues are not being under- or over-projected.

In the private sector, external audits are valuable to stockholders as they provide an independent assessment of the company's financial holdings and can be used to determine investment levels in the business.

6.5.4 Features

An external audit will feature a report outlining the auditor's findings. This will generally be a summary of the overall validity of the financial statements and documents as presented by the company or government.

Should the external auditor uncover discrepancies between the statements presented by the company and his findings, these will be noted in the report as well. The audit will often include financial suggestions for the entity as ways to improve its overall financial standing and accounting practices.

Notes

The more important feature of an external audit is the conclusion of the auditor. A favourable conclusion is unbiased evidence that the entity is reporting financial data correctly while a negative conclusion is a red flag for poor accounting practices.

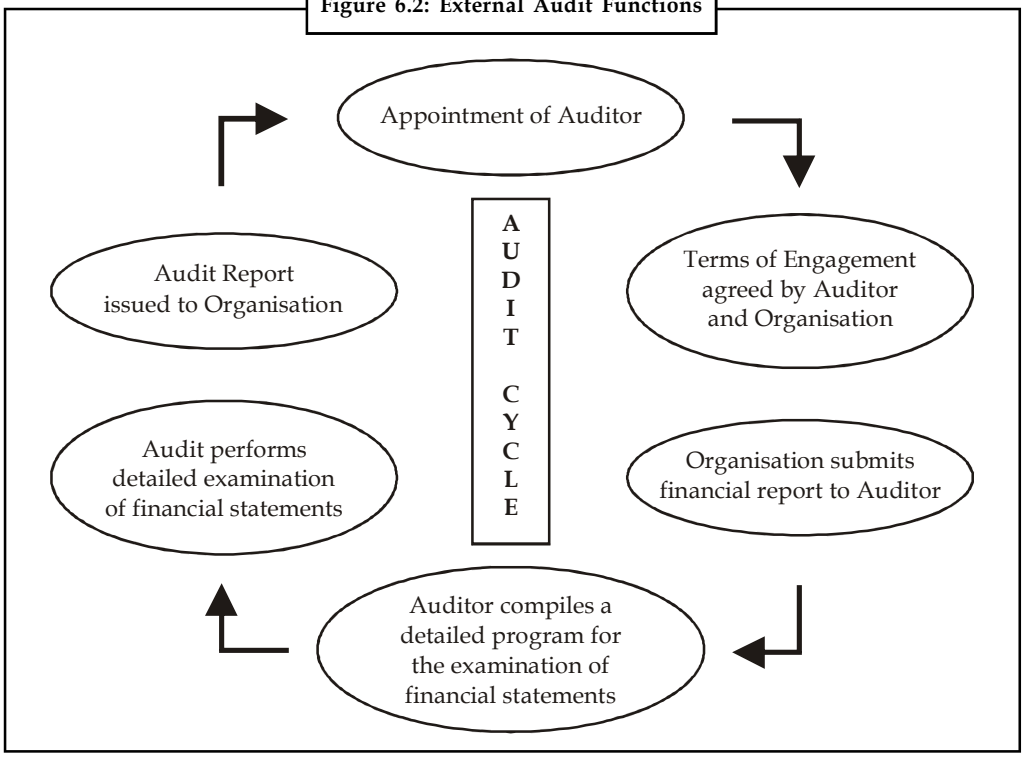
6.5.5 Misconceptions

An external audit is not related to an inquiry conducted by the Internal Revenue Service. The role of an external auditor is not to investigate fraud or tax evasion, but rather to ensure the financial documents presented by a business are an accurate reflection of its financial standing.

External auditors are not employed by the IRS or any government agency. They are generally certified public accountants hired by the entity.

6.5.6 External Audit Activities

Figure 6.2: External Audit Functions



Source: http://www.audit.gov.sh/publications/briefguide_extaud.pdf

Appointment of Auditor: Auditors are usually appointed by shareholders at the Annual General Meeting. Governing legislation may also state who the auditor shall be.

Terms of Engagement: An engagement letter provides written confirmation of the auditor's acceptance of appointment, sets out the scope of the audit plus auditors and management responsibilities.

Audit Program: Sets out the extent and type of audit procedures.

Auditors work to internationally agreed auditing standards: Auditors start by gaining an understanding of the organisation's activities. For each major activity listed in the financial statements, auditors identify and assess risks that could have a significant impact on the financial position or performance.

Notes

Detailed Examination: Auditors perform testing and obtain evidence to satisfy the requirements of the audit program. Testing may include e.g. confirming compliance with the organisation's accounting policies, examining accounting records and verifying the existence of tangible items such as plant and equipment.

Audit Report: Contains the audit opinion on the financial report and basis of that opinion. The scope of the audit plus auditors and management responsibilities are also restated.

Self Assessment

Fill in the blanks:

9. An ..... audit will feature a report outlining the auditor's findings.
10. Auditors start by gaining an understanding of the organisation's .....
11. Auditors perform ..... and obtain evidence to satisfy the requirements of the audit program.
12. The more important feature of an ..... audit is the conclusion of the auditor.
13. External audits are typically conducted once a ..... at the end of the company's or government's fiscal year.

6.6 Similarities and Dissimilarities between Internal and External Audit

So far, you have already acquired a good understanding about the concept of internal audit and external audit. Now, we are going to discuss about the similarities and dissimilarities between the two. We will also discuss how internal auditor and external auditor can cooperate among themselves in achieving their objectives.

Points of similarities: Internal audit and external audits are similar in following ways:

1. Both are concerned with evaluation of internal control system.
2. Both are concerned with adequacy and correctness of accounting entries.
3. Both are concerned with verification of assets and liabilities.
4. Both are similar in their approaches of auditing like test checking application of statistical tools, observations, enquiries etc.

Points of dissimilarities: External and internal audits differ in the following respects:

1. ***Mandatory:*** In most of cases, enterprises are under compulsion of law to appoint an external auditor. However, internal audit is not mandatory expect for those companies where Companies (Auditor's Report) Order, 2003 is applicable.
2. ***Independent:*** The external auditor is independent of the organization which appoints him. On the other hand, internal auditor is generally an employee of the organization or an outside audit firm appointed especially for the purpose. So, independence of internal auditor is assured in most cases.
3. ***Scope:*** The scope of an external audit is determined by Law as applicable to organization and cannot be modified or restricted. Whereas the scope of internal audit is determined by the management and may be expanded or restricted depending on the needs and objectives of the organization.

Notes

4. ***Responsibility:*** The responsibility of external auditor is very wide and covers almost all stakeholders of the company. However, the internal auditor, who is an employee of the company, is only responsible to the management.

5. ***Power:*** The external auditor being appointed by law has statutory powers to conduct audit. He has very wide powers compare to internal auditor. The power of internal auditor comes from the views of management. In many companies, internal auditor also has very wide power and he reports directly to audit committee of the company.

6. ***Submission of Reports:*** External auditor submits his report to the owners or shareholders. But an internal auditor submits his report to management.

7. ***Periodicity:*** External audit may be conducted on an annual or on a periodical basis. But internal auditor reviews the operations of a company continuously i.e. throughout the year.

Caution The scope of scrutiny by Internal Audit has been continuously enlarged and in 1969 it was made coterminous with that the Receipt Audit.

6.7 Co-operation between External Auditor and Internal Auditor

In spite of the various dissimilarities mentioned above, there is ample scope of a gainful cooperation and coordination between external auditor and internal auditor. Due to his professional standing, the external auditor acquires a wide area of experiences, whereas internal auditor has an in-depth experience of the organization. If they work in tandem, the quality of audit will improve tremendously.

Unnecessary duplications of work can also be avoided by proper audit plan. The work load of external auditor can be reduced significantly as we know that inherent objectives and approaches of both the audit are same.

In order to determine, whether and to what extent the external auditor will depend and rely on the work of an internal auditor is given by SA 610, relying upon the work of an internal auditor, issued by the Institute of Chartered Accountants of India (ICAI). The important points of the standards are summarized below:

1. ***Assessing the work of internal auditor:*** The external auditor should assess the quality of work done by internal auditor before relying upon the work of the latter. He should essentially consider factors such as:

   (a) Competence

   (b) Independence and

   (c) Objectivity of the internal auditor while evaluating his work.

2. ***Co-ordination:*** It can be achieved by:

   (a) Meetings with internal auditor

   (b) Access to relevant audit reports and

   (c) Communication by the internal auditor of any significant information, which may affect his work.

Notes

3. ***Relying upon specific internal audit work:*** If as a result of his evaluation and appropriate interaction with internal auditor, the external auditor intends to rely upon specific internal audit work, he should take into account the factors such as:

   (a) Scope of internal auditor's work and adequacy of related audit programmes used by him;

   (b) Examine whether the work of assistants was properly supervised, reviewed and documented;

   (c) Examine whether sufficient and appropriate evidence was obtained.

Thus, the degree of reliance that is placed by the external auditor on such work is a matter of professional judgment.

Notes It may be noted that the report of the external auditor is his sole responsibility and he cannot shove off this responsibility on internal auditor by relying upon his work.

Kamal Gupta, in his famous book "Contemporary Auditing" has elaborated about the coordination among external auditor and internal auditor as follows:

"Having decided in principle that external auditor intends to rely upon the work of the internal auditor, it is desirable that he ascertains the internal auditor's tentative plan for the year and discusses with him at as early stage as possible to determine areas where he considers that he could rely upon the internal's auditor work. Where internal audit work is to be a factor in determining the nature, timing and extent of the external auditor's procedures, it is desirable to plan in advance the timing of such work, the extent of audit coverage, tests levels and proposed methods of sample selection, documentation of the work performed and review and reporting procedures.

Coordination with the internal auditor is usually more effective when meetings are held at appropriate intervals during the year. It is desirable that the external auditor is advised of, and has access to, relevant internal audit reports and in addition is kept informed, along with management, of any significant matter that comes to the internal auditor's attention and which he believes may affect the work of the external auditor. Similarly, the external auditor should ordinarily inform the internal auditor of any significant matters which may affect his work."

Self Assessment

Fill in the blanks:

14. Internal audit and external audits are concerned with evaluation of ……. control system.

15. The external auditor should assess the quality of work done by ……. before relying upon the work of the latter.

6.8 Internal Check and Internal Audit

Internal check is an important process of internal control system. Under the system of internal check, it is ensure that the job performed by one employee gets checked, automatically by another employee. No employee, alone, allowed handling transactions from beginning to end.

Notes

Example: Please recall what happens when you visited a bank branch to encash a cheque. First, you produce the cheque to a counter, where the official concerned issued you a token and enters the token numbers on the back of the cheque and in the token book. The cheque is then sent to the ledger clerk, who verify the balance in your account and makes debit entry therein. The cheque then sent to an officer, who verify your signature on the cheque with bank records, and if it tallies then he sends the cheque to the cashier to make payment. The cashier makes the payment against the token handed over to you and records it in his cash register.

This is an excellent example of internal check. Here arrangement is such that the job of one employee is automatically checked by other.

From the above discussion, we can summarize some characteristics of internal check:

1. Proper segregation of duties;
2. Automatic checking of job;
3. Multiple recording of same transactions;
4. Rotation of jobs;
5. Prevention of errors and frauds;
6. Separation of custodial and recording functions.

Notes External Audit is an audit conducted by an individual or firm that is independent of the company being audited. These independent auditors audit the books of a company generally once per year after the completion of the company's fiscal year.

Let us understand the concept of internal check with a practical example of a medium sized manufacturing company regarding its purchases.

- Purchases should be supervised by and organized by a separate department called purchase department or procurement department. The department should be headed by a qualified and trained senior officer.
- The department should maintain a list of approved suppliers with whom orders for making purchases are regularly placed.
- The purchase process should invariably be start with the placing of a requisition duly authorized by a senior official to the purchase department.
- Each department of the company should have a book of requisition slips bearing serial numbers. The purchase department should maintain a register of books of requisition slips issued to different departments.
- The purchase department should keep a separate record of requisition forms received from different departments.
- Upon receipt of a requisition, the purchase department should send inquiry letter to the listed suppliers for quotation of the price, fright and delivery terms.
- After examination of the terms quoted by suppliers, the purchase department should place an order with the supplier selected by it. It should also send copies of the order to the Accounts Department, stores department and the department which has made the requisition. In case an order has been placed with a supplier other than the one who had quoted the lowest price, the reason for the same should be recorded.

Notes

- The procedure relating to receipt, inspection, acceptance and transfer of the goods to concerned departments, should be clearly laid down.
- Receipt of goods should be recorded in the Goods Received (or Inward) Register. The person in charge of receiving the goods should prepare a Goods Received Note (or Materials Received Report) and send a copy thereof to the Accounts department and to the department upon whose requisition the good have been ordered.
- Goods received should be inspected to see that they are exactly as ordered. This should be dome with the assistance of the inspection department and the department which has requisitions the goods. The final inspection report should send to Accounts department. Wherever possible, goods received note and goods inspection note may be combined.
- Upon receipt of the supplier's invoice, the purchase (or the Accounts) department should check it with the order and the goods received/inspection note to ensure that the rate, discount, quality and quantity of the goods are exactly as earlier agreed.
- After due checking, necessary particulars of the purchase should be recorded in the purchase register and the number of the purchase order should be marked on the invoice.
- The Accounts department should not make payment to the supplier unless the invoice has been passed for payment by an authorized person after due verification.
- In case any advance sum has been paid to the supplier against the order, it should be adjusted from the total amount of the bill and only the net amount should be paid to him.
- Goods received should also be entered in respective stores ledgers. From there, the relevant entries should be passed in the stock (bin) card.
- In case any goods are rejected on account of being defective or for any other reason, they should be returned to the supplier and not entered either in the stores ledger or the bin cards.
- For the goods returned to the suppliers, credit note should be obtained from him (against a debit note prepared in his name) failing which a debit entry should be passed in his individual account.
- Where only a part of the goods are returned to the supplier as being defective, the items to be entered on the bin cards or stores ledger should be those actually accepted, and the goods received note should be prepared accordingly. In such a case, either the bill is passed only for the value of goods actually accepted, or a fresh bill is demanded from the suppliers. In such a case, as also where the supplier has overcharged in respect of any of the items, a credit note may also be obtained from him.
- All incoming credit notes should be numbered and stamped the same way as invoices. These should also check with the advice note covering the return of rejected goods to the supplier.

You have already studied the concept of Internal Audit earlier in this unit.

6.8.1 Internal Check vs Internal Audit

The main points of distinction between internal check and internal audit are as follows:

1. ***Definition:*** Internal check is an arrangement of jobs in such a manner that the work of each employee is checked by another and no employee is in charge of any work completely from beginning to end. Internal audit is a specific appraisal activity of operations, financial or otherwise and related records thereof.

Notes

2. ***Purpose:*** The main purpose of internal check is the prevention of errors and frauds. The main purpose of internal audit to find errors and frauds.

3. ***Personnel:*** As internal check is an inbuilt process of internal control no separate personnel are required for the job. Whereas for internal audit separate staffs are required to conduct the job.

4. ***Timing:*** Internal check is a continuous process. It begins the moment a transaction start and finishes after all aspects are recorded.

Internal Audit is a post mortem appraisal system and starts after the completion of recording of transactions.

Self Assessment

State whether the following statements are True or False:

16. Internal check is an important process of internal control system.

17. Prevention of errors and frauds is an important objective of internal check.

Task Devise a suitable scheme of internal check as regards cash receipts in a big departmental store.

Case Study

The Ministry of Finance Hosts Workshop on Internal Audit and the Risk Assessment Process

United Arab Emirates: Thursday, March 11, 2010 at 15:19

The joint internal audit section at MoF held a Workshop at the ministry's headquarters in Abu Dhabi on the inception and the development of the Internal Audit and Risk concepts and the importance of the risk assessment process. This builds on the need to continue developing financial control systems for federal bodies at best standards and practices.

The workshop addressed the concept of internal audit - an independent, impartial and affirmative advisory activity that aims at development and adds assists in achieving corporate goals. It has a clear methodology for the development and evaluation of the risk management and control systems, as well as the mechanisms of internal control and governance.

In addition it serves the internal audit system and corporate governance through the development and evaluation of follow-up goals and strategies. It applies risk assessment through following-up and developing the risk management system efficiency. It is linked with the activity, computer systems and control procedures. The third service addresses the internal control procedures, evaluating and developing the level of reliability of various activity data and measures the effectiveness of their performance and asset preserving procedures. Introducing the workshop, HE Ahmed Al Hammadi, Executive Director of the Joint Internal Audit, Ministry of Finance, said:

"We continue to raise awareness about the importance of internal audit for federal government agencies, so that the internal audit is an integral part of any functional system.

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Notes

There are several procedures to be strictly followed by the supervisors of the internal audit in order to achieve the goal of the process."

His Excellency, Ahmed Al Hammadi said, "Risk management is how to deal with future events or facts that may lead to impede achieving the objectives of the ministries and governmental bodies. The main goal of the risk management is to reach a clear strategy and a specific methodology to identify threats to achieving objectives. Risk management does not mean to completely overcome it, but to help senior management to limit the risks and establish a mechanism to deal with the expected effects."

He added, "The workshop is a start of a series of workshops which will be provided by the joint internal audit and its strategic partner, KPMG, to federal ministries to spread the culture of the Internal Audit in the Federal Government. These workshops also play a significant role in building public awareness of risk management, the most important global trend in running leading institutions. It is a call for Federal bodies to coordinate with this sector to set up such workshops in the future."

The Internal Audit covers several parts, including technical or operational audit. It looks to effective use of economic resources, and ensures achievement of defined objectives and financial auditing. It checks the credibility of the financial and accounting procedures. In addition to information systems audit, it reviews the financial and accounting information systems to control and assess its compatibility with policies and internal control procedures.

The internal audit systems saw four stages of development since 1980, starting with the stage of supervision audit and understanding of the processes and procedures in conformity with the legislation. The second phase came after 1980, where the audit depended on the supervision framework, risk identification and corrective action, in addition to the audit of the operational and financial procedures, and its compliance with legislation. In the third phase, after 1990, the auditing process improved to be an auditing on the basis of risk.

And after 2000, the fourth stage came, where the audit started to work on the basis of risk management, comprehensive development, common understanding of the activities used and all the business risks of all types, in addition to auditing the activities focusing on each operational session separately and identify the supervision type that must be followed.

The workshop discussed the concept of risk as an incident likely to affect the organization's ability to achieve operational or strategic objectives. The risks may be internal or external, as they include the risk of missed opportunities. The objective of the risk assessment process is to define the management style and the best way to identify and assess risks that hinder achieving the fundamental objectives of the business, and to effectively address the challenges and risks faced by the institution to achieve the desired objectives through applying a sophisticated approach in risk management in accordance with the world leading practices.

The risk assessment also helps the governmental bodies achieving the strategic goals on the highest degree of efficiency and effectiveness, as the audit process focuses on the most affecting risks that face the activities of the ministries and bodies.

Questions:

1. Discuss the case in brief.
2. What are the four stages of development since 1980?

Source: http://www.ameinfo.com/226511.html

Notes

6.9 Summary

- Internal audit is not only related to checking of financial records but also review and critical evaluation of all other managerial functions which have a bearing on company's objectives.
- As per Companies (Auditor's Report) Order, 2003, in case of some specific companies, the statutory auditor is required to report whether the internal audit system of the company is commensurate with the size and nature of business of the company.
- Internal audit is concerned with ensuring effective and efficient system of accounting control, standard cost control, budgetary control and other functional control.
- It is said that the internal audit functions as an eye of the management.
- Internal audit is basically a review function. On the basis of such review, the internal auditor should in his report, highlight the weaknesses observed and give suggestions for improvement.
- In spite of the various dissimilarities between external auditor and internal auditor, there are ample scope of a gainful cooperation and coordination between them to achieve objectives of auditing.
- Internal check is an important process of internal control system through which it is ensure that the job performed by one employee gets checked, automatically by another employee.
- Their role is to give an opinion of the financials statements reflection of the status and operations of the company being audited. Based on what they witness during the audit they will also produce, for management and board utilization, a management letter. Although a financial statement audit is the most common type of external audit, external auditors may also conduct special purpose audits which might include; performing specific tests and procedures and reporting on the results, a less intensive review, and compilations.

6.10 Keywords

Corporate Governance: It refers to the distribution of rights and responsibilities among different participants in a corporate entity such as shareholders, management, and lenders/creditors.

External Audit: It is an audit conducted by an individual or firm that is independent of the company being audited. These independent auditors audit the books of a company generally once per year after the completion of the company's fiscal year.

Internal Audit: An examination of managerial control system carried out by the employee of the organization or outside audit firm specially appointed for the purpose by the organization.

Internal Auditors: These are those persons who provide independent assurance that an organisation's risk management, governance and internal control processes are operating effectively.

Internal Check: An arrangement through which the task of one employee automatically checked by another employee.

Operational Audit: A review of how an organization's management and its operating procedures are functioning with respect to their effectiveness and efficiency in meeting stated objectives.

Risk: The variability of actual return from the expected return associated with a given asset.

Statutory Audit: An audit which is authorized governed and made mandatory under any law.

Notes

6.11 Review Questions

1. Explain the concept of internal audit.
2. What are the objects of internal audit?
3. Discuss about the scope of internal audit.
4. Narrate the points of dissimilarities between external audit and internal audit.
5. What is internal check? Explain with example.
6. What is the role and scope of Internal Audit?
7. "Coordination with the internal auditor is usually more effective when meetings are held at appropriate intervals during the year". Elaborate this statement.
8. What are the essentials of effective Internal Auditing?
9. Correlate the management functions and scope of internal audit.
10. What do you mean by external audit? Explain its features and activities.

Answers: Self Assessment

1.	True	2.	False
3.	True	4.	False
5.	External	6.	Professional
7.	True	8.	True
9.	External	10.	Activities
11.	Testing	12.	External
13.	Year	14.	Internal
15.	Internal auditor	16.	True
17.	True		

6.12 Further Readings

Books

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

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

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

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

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

Notes

Online links

http://www.ehow.com/about_4894466_what-external-audit.html

http://www.audit.gov.sh/publications/briefguide_extaud.pdf

http://www.deloitte.com/view/en_LU/lu/industries/psf/psf-service-offering-along-development/external-audit/index.htm#.UPU_Xx1fFv4

http://www.cimaglobal.com/Documents/ImportedDocuments/external_audit_guidelines_practical_experience_04.pdf

Unit 7: Audit Sampling

Notes

CONTENTS

Objectives

After studying this unit, you will be able to:

- Define audit sampling and sampling error
- Understand the techniques for audit sampling
- Analyze and differentiate between the different types of sampling errors
- Design a sampling application

Introduction

Sampling is the application of an audit procedure to less than 100% of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of all the items within the balance or class of transactions.

Much of the information included in this manual was taken from the Statement on Auditing Standards No. 39 on Audit Sampling which provides guidance on the use of sampling in an audit of financial statements. This information has been adapted to fit the circumstances most often encountered in tax auditing.

7.1 Meaning and Definition of Audit Sampling

Audit sampling can be defined as the process of applying auditing procedures to under 100% of different items in an organization's account balance in a way that every single unit might have an equal probability of being selected.

Notes

7.1.1 Purpose of audit sampling

Sampling is performed because it is more efficient than testing 100% of a population. In tax audits, if the taxpayer and the Department can agree on a representative sample, it can save both parties time and money.

Did u know? By definition, any procedure that does not examine 100% of the items in question is a sampling procedure.

When not to sample

There are many audit procedures which do not involve sampling.

Inquiry and Observation:

- Reviewing records for the method of accounting and other information.
- Observing accounting procedures.
- Discussing methods of accounting and reporting with taxpayer.
- Scanning documents for possible issues.

Analytical Review Procedures:

- Comparing records reports and other information.
- Recomputing or estimating amounts.
- Reviewing trends in reporting.
- Comparing similar businesses.

One-Hundred Percent Examination:

- Reviewing all fixed asset purchases, where appropriate.
- Examining all contracts, where there are a small number.
- Reconciling each year's gross receipts to CIT A sales factors or Schedule C receipts.

Zero Percent Examination: This occurs when the auditor determines that a type of receipt, deduction, exemption or other item does not need to be tested.

Notes Even though 100% examination may be done where appropriate. It is not mandatory for any particular taxpayers or tax programs.

Sampling procedures discussed below may be more cost effective.

7.1.2 Techniques for Audit Sampling

There are certain important sampling techniques that can be adopted by an auditor. These include:

- ***Haphazard sampling:*** The haphazard sampling technique is the one adopted by the auditor in cases where the sample does not follow a structured technique. Haphazard sampling is, however, not appropriate during the use of statistical sampling. Besides, it is also important

Notes

for the auditor to always ascertain that haphazard sampling is not 'doctored' in a way that by design avoids sampling items which, for instance, are difficult to locate.

Caution All items in the population should get a chance of being selected.

- ***Stratified sampling:*** This sampling technique involves the auditor to split items included in a sample into their different sections. For instance, in a payroll sample the auditor might divide the sample in full-time males, full-time females, part-time males, and part-time females thus working out the percentage of sections in the population.
- ***Systematic sampling:*** The systematic sampling is also referred as 'interval' sampling. This sampling technique involves the auditor to take the number of sampling units in the population and segregate this into the sample size so as to provide a sampling interval.

Example: In a sales invoice, where the sampling interval is 25, the auditor will determine an initial point for sampling and subsequently sample every 25th sales invoice.

- ***Block sampling:*** Block sampling is a sampling technique wherein the auditor applies measures to such items which occur in the same block of sequence or time.

Caution The block sampling technique should be used carefully as valid references cannot possibly be made beyond the examined period or block.

- ***Judgment:*** This sampling technique allows the auditor to use his judgment in making selection of samples. The basic issues influencing the selection of sample are:
  - value of the items
  - relative risk involved
  - representativeness of the sample

Self Assessment

Fill in the blanks:

1. …….. occurs when the auditor determines that a type of receipt, deduction, exemption or other item does not need to be tested.
2. The ……. is adopted by the auditor in cases where the sample does not follow a structured technique.
3. …….. involves the auditor to split items included in a sample into their different sections.
4. …….. is also referred as 'interval' sampling.

7.2 Sampling Risk

Sampling risk is actually occurs when the auditor applies the procedure to the small part of the sample to judge the entire population, the result of it may be different if the population of the data contains variety, this risk is known to be the sampling risk.

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Auditors when wanted to express any opinion, they require a sort of homework in shape of the audit evidences, he wanted to judge the entire sample but practically it's not possible because it's a time taking process and resources are also limited. He therefore cannot apply the procedures for the judgment to the entire population due to limited time and resources. For getting the evidences, he applies the procedure on the sample which is the small part of the population for knowing the judgment; there is always a chance that the result which is obtained by this procedure applied on the sample would be error free, this is known as the sampling risk.

The effectiveness and the efficiency lie on the auditor who can reduce the sampling risk by picking up the reasonable or the correct small part of the population or the sample. Carefully selected sample will decrease the rate of sampling risk. If the rate of the sampling risk shows the increasing position, it means that the auditor has opinioned in the financial statement that everything or every transaction or record here are written finely but he would not have proven of it. Manager of the company will mark the auditor's opinion as illogical as if there is no reasoning behind it and thus the chances of misstatement in the financial report will also increase.

Did u know? The increasing rate of the sampling risk will affect the overall efficiency of the business.

Here auditor has to play a serious job to allocate the reasonable sample for applying the further procedure to reduce the sampling risk.

Overall tax audit risk is made up of the risk of inaccurate records and the risk of misapplication of the tax law. Both of these risks are made up of two components as well.

1. Risk that there are errors (inherent risk).
2. Risk that procedures will not find errors (audit risk).

Audit risk, in turn is made up of two components, the risk that a procedure is not effective and sampling risk. Sampling risk is the probability that the sample results are not representative of the entire population. In general, factors that may lessen sampling risk include:

1. Taking larger size samples
2. Using random sample selection methods
3. Stratifying the sample
4. Properly defining the test objective
5. Properly defining a deviation
6. Exclusion of non-recurring, non-systematic errors.
7. Properly evaluating errors.

Self Assessment

Fill in the blanks:

5. The …….. and the …… lie on the auditor who can reduce the sampling risk by picking up the reasonable or the correct small part of the population or the sample.
6. Carefully selected sample will …… the rate of sampling risk.

Notes

7. Risk that procedures will not find errors is known as …… .

8. …… is the probability that the sample results are not representative of the entire population.

7.3 Meaning and Definition of Sampling Error

Sampling error, generally, refers to a statistical error to which an analyst exposes a model only because he/she is working with sample data instead of population or census data. However, using sampling data involves the risk that results found in an analysis might not represent the results that would be acquired by using data involving the whole population from which the sample was derived.

The use of a sample comparative to a whole population often becomes necessary for various practical and/or financial reasons. Although there are possibilities of some differences to occur between sample analysis results and population analysis results, yet the extent to which these can differ is not projected to be substantial.

The methods of mitigating sampling error include increasing the size of the sample in addition to ensuring that the sample adequately represents the whole population.

7.3.1 Types of Sampling Errors

Following are the types of sampling errors:

(a) ***Random Sampling Errors:*** In statistics, the sampling error can be found by deducting the value of a parameter from the value of a statistic. This type of sampling error occurs where an estimate of quantity of interest, for example an average or percentage, will generally be subject to sample-to-sample variation. An example of the sampling error in evolution would be a genetic drift – a change in population's allele frequencies due to chance. The bottleneck effect and the founder effect can be considered as an example of random sampling error.

- *The Population Bottleneck:* Disasters such as a fire, hurricane, or earthquake reduce the size of a population drastically, killing many unselectively. The resulting genetic makeup of the left over population is not representative of the original population, leading to a bottleneck effect.
- *Founder Effect:* Founder effect occurs when a new colony is started by a few members of the original population. This small population size means that the colony may have:
  - Reduced genetic variation from the original population.
  - A non-random sample of the genes in the original population.
- *Bias Problems:* Sampling bias is likely to be a source of sampling errors. The bias problems lead to sampling errors which have a prevalence to be either positive or negative. These types of errors are also considered as systematic errors.

(b) ***Non-sampling Error:*** Sampling errors can be contrasted to non-sampling errors. The non-sampling error is a catch-all term for the variations from the true value that are not a function of the selected sample, counting different systematic errors as well as any random errors which are not accrued to sampling. Moreover, it is much more difficult to quantify non-sampling errors than the sampling errors.

Notes

Task Prepare a report on the different types of sampling errors and the situations where they are most likely to occur.

Self Assessment

Fill in the blanks:

9. The sampling error can be found by deducting the value of a ……. from the value of a statistic.
10. The ……. and the ……. can be considered as an example of random sampling error.
11. It is more difficult to quantify …….. errors than the …… errors.

7.4 Statistical vs. Non-Statistical Sampling

The difference between statistical and non-statistical sampling is that statistical sampling allows the user to measure the sampling risk associated with the procedure. Statistical sampling applies the laws of probability to determine the percent likelihood that the sample does not accurately reflect the population.

In essence, the laws of probability say that large, relatively homogeneous populations have similar distributions and other features so that if a random sample is taken, it will consistently reflect the population within certain limits. In order for the sample to be a "statistical" sample, the results must be evaluated and two calculations made. These calculations tell the user how likely it is that the sample results are within a given range of the actual population.

Example: A statistical sample would not only tell you that disallowed deductions are estimated at $5,000, but that you have a 95% likelihood (confidence) of being within $50 (precision) of the actual disallowed deductions.

A properly designed and applied non-statistical sample can provide results that are accurate and effective, but will not measure the sampling risk.

Generally, the decision to apply a statistical or non-statistical sampling application to a particular audit test is a matter of cost effectiveness. The department utilizes non-statistical random sampling procedures.

Many audit programs in both the public and private sector have developed standard sampling approaches which use predetermined allowances for acceptable sampling risk, expected and tolerable error. These approaches reduce the time and effort required to determine the sample size and evaluate results. The cost of these approaches is that they usually generate sample sizes somewhat larger than necessary to allow a margin for variance. The New Mexico Taxation and Revenue Department has elected to use fixed sample sizes of 250 and 500 items of interest for variable sampling. The sample sizes apply to homogeneous and non- homogeneous populations respectively. Stratification of a population can reduce sample size in most cases.

A provision for sampling units based on time periods is also provided. In any sampling approach, the auditor must evaluate the population that is being tested, must determine if any stratification should be done, must evaluate the cause of any exceptions and must apply the results from the sample to the remaining portion of the population.

Notes

Self Assessment

Fill in the blanks:

12. Statistical sampling allows the user to measure the ……. associated with the procedure.
13. …… usually require more training for auditors and more time to apply.
14. The decision to apply a statistical or non-statistical sampling application to a particular audit test is a matter of……..

7.5 Designing a Sampling Application

There are several steps in designing a sampling application for an audit or investigation. The steps are discussed in detail in the next pages.

1. Define the objectives of the test.
2. Determine the type of test to be performed:
   (a) Variables Sampling
   (b) Attribute Sampling
3. Define the deviation conditions.
4. Define the population:
   (a) Decide what period will be covered by the test
   (b) Define the sampling unit
   (c) Consider the completeness of the population
   (d) Consider how the error rate will be extrapolated
5. Determine the method of selecting the sample:
   (a) Random-Number sampling
   (b) Systematic sampling
   (c) Other sampling
6. Determine the sample size:
   (a) Variables Sampling
   (b) Attribute Sampling
7. Perform the sample:
   (a) Compare the sample to the population before completing the sample
8. Evaluate the sample results:
   (a) Interpret results
   (b) Extrapolate results
   (c) Consider the qualitative aspects of the deviations
   (d) Reaching an overall conclusion about the population
9. Document the sampling procedure.

Notes

Define the Objectives of the Test Step 1

The auditor must have a definite question to be answered by the test. Examples of questions to be answered are:

1. Does the Sales Summary contain all invoices and is information recorded accurately?
2. How often are invoices voided without explanation?
3. Does the taxpayer record all supplies pulled from inventory in the inventory log?
4. Does the sales supervisor correctly batch sales by destination so that they can be recorded by state in the summary journal?
5. What is the amount of deductions not supported by NTTC's?
6. What is the percentage of sales of services to the government relative to total sales?
7. What percentage of supplies is pulled from inventory held for sale each month?
8. What percentage of supplies purchased outside NM has not had tax paid or accrued?

Auditors should record the objective of the test within the audit narrative and/ or other work papers. Not only does that help the reviewer, but it also clarifies the objective for the auditor so that the proper audit procedure and sampling application can be defined. If the auditor can create a one sentence question, like the ones above, to be answered, he or she is less likely to perform an inappropriate procedure or use the wrong sampling application.

Determine the Type of Test to be Performed Step 2

The type of sampling application, whether statistical or non-statistical, is usually defined by the conclusion which the auditor is attempting to reach. "Variables sampling" is used to reach a conclusion about a population in terms of an amount. Variables sampling is commonly used to determine the dollar size of a population or to determine if the stated dollar size is correct.

"Attribute sampling" is used when the auditor is only concerned with acceptance or rejection of a hypothesis.

It is used to reach a yes or no answer about a question.

The reason that defining the type of application is so important is that sample size is dependent on which type of application is being performed. Below is the same list of questions given on the previous page, and an explanation of the type of application required for each.

Compliance Tests

Compliance tests are most often used by tax auditors to determine if controls which ensure the accuracy of records are in place and working correctly. These tests can be performed directly on the control feature itself or indirectly on the outcome of the control.

An example of a direct test would be a test to determine that invoices are pre-numbered, used in sequence and accounted for by those issuing the invoices. Such a test would be helpful in assuring the auditor that all invoices issued in a period are used or voided.

An example of an indirect test would be a tracing of a sample of invoices to a summary journal to determine that the controls over recording invoices in the summary journal are working. In this case, the controls themselves are not actually tested, but the results of those controls are examined, and the question of whether the summary record is reliable will be answered yes or no.

Notes

Notes The tax auditors do not use formal compliance testing as frequently as other types of auditors.

However, tax auditors do make judgments about the level of risk of incorrect records and the risk of misapplication of the tax law. These are the types of judgments that can be backed up by compliance tests.

The decision to test controls or the accuracy of records is based on auditor judgement and the circumstances of the audit. The decision should be documented. Compliance testing may help to limit the scope of the audit to areas of higher risk or point out problems with records that may have otherwise appeared reliable.

The main reason for performing compliance tests is to reduce the amount of substantive tests that need to be performed. Therefore, the decision of whether to perform compliance tests should weigh the possible compliance tests against the possible substantive tests that could be performed to determine which test will be most efficient and effective.

For instance, if an auditor decides that he can either test the taxpayer's summary records or use them to perform the audit, or, rely on comparing reports to bank statements, then he or she should determine which method will be more efficient. If a compliance test of the summary records is performed and the records prove to be unreliable, then the auditor may still have to rely on bank statements. However, it may be that using the summary records will be much more efficient than using bank statements. Therefore, testing those records is worth the time needed and the risk that the test results will be negative.

Caution Before relying on the summary records the auditor should perform a test of transactions to determine the records are reliable.

Substantive Tests

Substantive tests are used to determine the amount, usually the dollar amount, of a specific group of items. If the auditor seeks to determine the amount of disallowed deductions, for instance, the result of the sample will be a dollar figure of disallowed deductions found in the sample. The assumption is that the same proportion of disallowed deductions will exist in the population. Therefore, the final result of the test will be a dollar amount of disallowed deductions for the population which will be used as a basis for assessment.

Often, samples can be designed to serve both compliance and substantive tests. When it is likely that records will be needed for both types of applications, the auditor should strive to pull one sample. This is called dual purpose testing.

Caselet

Ira Icandoit's Problem

This case study identifies Ira Icandoit's problem performing and engagement regarding the attribute sampling approach to selecting an appropriate sample for a manufacturing company in western Kansas. Ira thinks he found 6 deviations, because the sample invoices returned were not as expected. For instance, He had to call a

Contd....

Notes

vendor to determine that a missing invoice was legitimate, three invoices were not signed, and two invoices involved dollar errors. Ira has a due diligence requirement to specifically, "identify, analyze, evaluate, and record sufficient information to achieve the engagement's objectives" (Reding 2007) as specified in Standard 2300. Even more specifically it is his responsibility to, "identify a specific internal control objective and the prescribed control activity aimed at achieving that objective, define what is meant by a control deviation, define the population and sampling unit, determine the appropriate values of the parameters affecting sample size, determine the appropriate sample size, randomly select the sample, audit the sample items selected and count the number of deviations from the prescribed control activity, determine the achieved upper deviation limit, and evaluate the results" (Reding 2007). Also, if Ira did make a mistake he is required to disclose this to the involved parties as specified in Standard 2421.

Most importantly, Ira skipped the first step of determining which specific control the audit was testing. For instance he could have been testing to see that all invoices were filed correctly and one deviation was that an invoice was missing. He could have been testing to see that all invoices were signed and found three deviations in that respect. And, he could have been testing to determine that all amounts were correct and found two deviations. As a result his rate of failure was too high, and the new rate of failure corresponding with the specific focus should be reported to management.

Otherwise, Ira Icandoit preformed a decent statistical control analysis except, that simultaneously separating the sample into one quarter with a certain limitation and three quarters with a different limitation does not determine the appropriate values of the parameters affecting sample size.

Finally, he should ask if there are at least two supervisors that can sign invoices, and disclose if the manager actually signed the invoices after he told Ira they were correct. Lastly, a six percent failure to uphold controls doesn't sound like it should be relied upon by management. The upper management of that company was being sued by the employees for negligence to fraud involving pension money. That example exemplifies why a six percent failure rate in purchasing is a risk that is too serious to accept.

Source: http://nowwhatresearch.blogspot.in/2011/01/internal-auditing-case-study.html

Define the Deviation Conditions Step 3

If you are performing a direct test of controls, such as checking for supervisor approval before selling goods free of tax, a deviation will be any noted lapse in the control. In this case if the control is documented in some way, such as with initials of the supervisor on the invoice, a deviation would be the lack of initials. If the control is not documented, you will have to rely on direct observation of the control being performed, or on indirect evidence.

If you are testing controls indirectly, you would look at the error which the control is intended to prevent and would base your deviation on what defines that error. In the case above, the control in place is intended to prevent salesmen from not charging tax on sales that should be taxed. A deviation would therefore be defined as an invoice that did not have tax and should have.

If you are performing a substantive test, the item(s) you are picking up might not necessarily be thought of as deviations. For instance, you may be trying to determine the average New Mexico inventory value over a period for testing the CIT property factor. However, the same principle applies. You need to define which items meet the criteria necessary to reach the objective of the test. In this example, that might be inventory control log entries backed up by shipping and receiving reports.

Notes

Caution Auditors should be careful not to include factors in the deviation, which do not affect the objective of the test.

For instance, in the first test described above, invoices where the customer name was misspelled would not affect the objective of the test and should not be treated as deviations. On the other hand, auditors should also be careful to include all factors, which may affect the objective of the test. For instance, if an invoice contains the initials of a supervisor from another Department who is not familiar with the customers who have Non Taxable Transaction Certificates (NTTCs) on file, the invoice should be picked up as a deviation, even though it contains a supervisor's initials.

Some of the most common problems faced by auditors performing any kind of test come from not properly defining the deviation, and finding out after the test has been performed that there were other conditions that should have been considered.

Define the Population Step 4

The auditor should determine if the population from which the sample is selected is appropriate for the specific audit objective, because sample results can be projected to only the population from which the sample was selected. If a change in the business results in more than one distinct population, then each needs to be tested separately. The auditor should also evaluate the reliability of the data presented as the population. The data should be complete and should also tie to other records such as CRS-1s, journals, summary reports, etc.

Analysis may reveal that the taxpayer changed a specific control procedure during the period under audit. The auditor needs to decide whether to design one sample and test both controls or do two separate samples. The auditor might also discover that the non-taxable sales do not match the CRS-1 reports due to the exclusion of a particular type of sale or due to the inclusion of non-New Mexico sales.

Decide What Period will be Covered by the Test

Generally, a sample should be drawn from the entire period to which the test results will be applied. However, there are many situations when this is not practical. In any test where the auditor decides to limit the period from which the sample will be drawn, the auditor should evaluate sample results, as well as the period outside the sample, and determine the following:

1. What were the results of the sample and could they reasonably be expected to apply to the period not sampled?
2. What is the nature of the remaining period, does it have similar characteristics to the period tested?
3. How large is the remaining period? Ideally, the period from which the sample is drawn should be as large as possible. Limiting the period to a day out of each year or a week from the total audit period is not a sound basis for extrapolating results to the period not sampled. The more the sample is spread throughout the audit period, the more reliable the results will be.
4. What is the nature and amount of the transactions involved? The more homogeneous the population and the greater the size, the more likely a sample taken from only part of the period under audit will be representative.

Notes

5. What tests can be done of the remaining period to further substantiate the sample results?
6. What other matters are relevant to the sample results? Have conditions which might affect the results changed in the remaining period?

Define the Sampling Unit

A sampling unit is any of the individual elements constituting the population. The auditor should define the sampling unit in light of what is being tested and the type of records kept by the taxpayer. A sampling unit may be, for example, a document, an entry in a journal, a line item, or a single transaction.

It is possible to sample based on time period representations such as days, weeks, or months. The department has set minimums of 30, 25, and 9 respectively. The days, weeks, or months should be randomly selected from the entire audit period. Random sampling within the selected days, weeks, or months is encouraged.

Regardless of the type of time period selected the number of items of interest (invoices, line items, transactions, etc.) must be achieved for the population type. In most time period samples the items of interest will exceed the minimum required.

Consider the Completeness of the Population

The population is physically represented by some form of record. For instance, sales invoices, entries in a sales journal or summary entries in a ledger may represent total sales. The auditor actually selects sampling units from this physical representation and so must confirm that all sample units from this record are included in the entire population. If the physical representation differs from the actual population, the auditor might make erroneous conclusions about the population.

Example: Testing a depreciation schedule where a page of the schedule is missing.

Therefore, the auditor should be careful to determine that the records used to draw the sample are complete and reflect the actual population being tested. One means of doing this is comparing different records and reconciling differences found.

Determine the Method of Selecting the Sample Step 5

Sample items should be selected in such a way that the sample can be expected to be representative of the population. Therefore, all items in the population should have an equal opportunity to be selected.

Random-Number Selection

The auditor may select a random sample by corresponding random numbers generated by a computer or selected from a random number table with document numbers. The random number generating software programs utilized by the department provide seed numbers which can be used to duplicate a specific list of random numbers. The seed number should be documented within the audit work papers.

Examples of Random Selection: When a listing is available, even if the items are unnumbered or have non-continuous or non-systematic numbering systems, the random number sampling can be accomplished by making use of the page and line number.

Notes

For instance, the auditor might want to obtain a random number sample of items sold to one customer.

Assume that a computer listing is available which consists of pages containing a total of 20,000 items. The pages of the listing can be easily numbered or their numbers determined by counting. There may be the same number of lines on most pages, with perhaps fewer on some.

Assume that there are 400 pages in the listing with 50 lines on most pages. The auditor would draw two lists of random numbers, one for three digit numbers between 1 and 400 and one for two digit numbers between 1 and 50. Items would then be selected by pairing numbers from the first and second list to identify the page and line on which the item to be selected is located.

Systematic Selection

For this method, the auditor determines a uniform interval by dividing the number of physical units in the population by the sample size then rounding up. A starting point is randomly selected and each item after that is selected at the uniform interval. If the population is arranged randomly, systematic selection is essentially the same as random number selection. However, if the population is not randomly arranged, for instance, if sales are listed by item, rather than in the order made, there may be problems with this method.

One way to ensure more randomness in a systematic sample is to re-compute the interval each time by use of a random-number table. In this approach the auditor would select a list of random numbers. The first number would be the starting point. The second number would tell the auditor the interval to count to the next item to be selected. For instance, if the first two random numbers are 503 and 219, the auditor would select item 503 to start, then item 722 (503 + 219). In this approach, the auditor might have to go through the population more than once to finish drawing all the items. The number of digits to be used for the random numbers should make intervals that are large enough to go through the entire population a least once.

Determine the Sample Size Step 6

Attribute Sampling (Yes/No)

To perform an attribute test, sample size should be determined as follows:

1. If the sample is drawn from the entire audit period, use an initial sample of 50 items. If the sample is drawn from a block, or if the population is limited in some other way, the initial sample should be 100 items.
2. If one or more deviations are found in the sample, the auditor must either reject the item being tested, or may expand the sample. If the auditor chooses to expand the sample, an additional number of items equal to the initial sample should be tested.
3. If one or more additional deviations are found, the auditor must either reject the item being tested, or may expand the sample to the appropriate variables sample size and use the results to estimate the amount of error in the item being tested.

Variables Sampling (Numbers)

A critical question must be answered before the sample size for a variables sample can be computed. Is the population relatively homogeneous?

Homogeneous populations can be tested using smaller size samples since there are fewer exceptional items to skew the results. Non-homogeneous populations require larger size samples.

Notes

Homogeneity is the tendency of items in a population to be similar, or closer to the same dollar value.

Example: A population containing sales of three kinds of mid-priced property will be far more homogeneous than a population containing all sales of a Department store.

If a population is non-homogeneous, the auditor can reduce the sample size through stratification and identifying individually significant items. See Step 7 on performing the sample for an explanation of how stratification should be done.

The Audit Sampling Work paper, AUD-21, can be used to document whether a population is homogeneous or not. Whether or not this work paper used, the auditor should document why the population was either determined to be homogeneous or non-homogeneous.

Sampling Application Analysis

Sampling applications can also be classified by the type of audit procedure in which they are used.

"Compliance tests" are tests which determine whether controls are being complied with. The answer to a compliance test is yes or no. "Substantive tests" are tests which determine the amount of some class of items.

Attribute sampling is most often used in compliance tests and variables sampling is most often used in substantive tests.

Sampling Size Table

This table gives sample sizes for any population over 500 items where variable testing is performed.

Perform the Sample Step 7

After the sampling plan has been designed, the auditor selects the sample and examines the selected items to determine if they contain deviations. The sample should also be evaluated to determine if it is representative of the population. The average value of the sample should be similar to the average value of the population.

The following problems may arise during the sample procedure:

- ***Voided Documents:*** If an auditor randomly or otherwise selects a voided item to be included in the sample, and has reasonable assurance that the item was properly voided, it should be replaced with another item selected in accordance with the sampling procedure. The rule here is not absolute, the auditor or supervisor may make a judgement decision based on the circumstances associated with the voided transaction.
- ***Credits:*** Most populations will contain credits. It may be possible in certain situations to remove the credits prior to sampling, but care should be taken to avoid inflating the population's total value. When stratifying a population it is necessary to use absolute values in order to keep credits and matching debits within the same strata. One example of a credit that might generate a reduction in a compensating tax exception total is the return of an item which had compensating tax accrued and paid at the time of purchase. A reduction would be acceptable if a reversal of the accrual did not take place and if the auditor has reasonable assurance that the return is not an unusual event.
- ***Unused Or Inapplicable Documents:*** The auditor's consideration of unused or inapplicable documents is the same. For example, a sequence of vouchers might include unused vouchers

or an intentional omission of certain numbers. If the auditor selects such a document, he should obtain reasonable assurance that the voucher number actually represents an unused voucher and does not represent a deviation. The unused voucher may then be replaced with an additional voucher.

- ***Errors in Random-Number Selection:*** In a situation where the auditor generates a random number that is not part of the population, that number should be replaced with another random number which is part of the population.
- ***Inability to Examine Selected Items:*** If an item selected is missing and it cannot be determined what happened to the item, it should normally be considered a deviation.

Stratification

In order to make a population more homogeneous for variables sampling, the auditor can use stratification. It is important to note that generally, stratification requires that the sample results be extrapolated to each stratum separately. Stratification is most often performed during computer assisted audits. Computer software applications can easily segregate a population and provide subtotals. It is required that auditors contact the Computer Assisted Audit Team when working with a high volume of transactions or with large data files.

The following are some methods of stratification:

- ***By Dollar Amount -*** This is the most common type of stratification used by auditors. The auditor needs to identify the number of different ranges, and their dollar values, into which the population most usually falls.
- ***By Nature of the Items -*** An easy way to stratify a total population is to stratify based on the nature of the transactions, such as sales of tangibles and sales of services.
- ***By Nature of the Test -*** Another way to stratify a population is to divide the items into groups according to the nature of the test to be performed.

Evaluating the Sampling Results Step 8

After completing the examination of the sampling units and summarizing the deviations from prescribed control procedures, the auditor evaluates the results. Whether the sample is statistical or non-statistical, the auditor uses judgment in evaluating the results and reaching an overall conclusion.

The auditor must determine how the outcome of the sample affects the test conclusions and the overall audit approach. If the auditor is testing the reliability of a certain record, the outcome of the attribute sample will either show deviations or no deviations.

Extrapolating Results (when 5 or more deviations are found)

If the test is a variables sample and five or more errors are found, the auditor must extrapolate the results to the remainder of the population. This procedure calculates the percentage of error (POE) found in the sample and applies that result to the population tested.

Notes If fewer than five deviations are found in a non-stratified sample the auditor should detail the exceptions instead of extrapolating. If working with a stratified sample the auditor should detail the errors in each strata sample that contains fewer than three errors.

Notes

There are three rules for extrapolating:

1. The numerator should be the sample representation of what the auditor is trying to determine about the population (or strata).
2. The denominator should be the sample representation of the population (or strata).
3. The population should be complete and should not include items that do not represent the population as defined by the test.

Considering the Qualitative Aspects of Deviations

In addition to evaluating the frequency of deviations, the auditor should consider the qualitative aspects of the deviations. Qualitative characteristics of the nature and cause of the deviations are:

- Whether the deviations are errors or irregularities,
- Whether the deviations are due to misunderstanding instructions or carelessness, and
- The relationship of the deviations to other phases of the audit.

Non-recurring errors are defined as errors that are caused by factors that do not affect the rest of the population. An example of a non-recurring error is a sale that was never recorded due to the fact that the salesman died right after closing the sale.

Non-systematic errors are errors that are caused by factors that may affect the rest of the population but whose effects are not predictable. An example of a non-systematic error is an error caused by the taxpayer's occasional use of salesmen to do accounting work.

Document the Sample Procedures Step 9

Examples of items the auditor should include in the documentation of the sampling test are:

A description of the purpose of the test

1. The definition of the population, the sampling unit, and the item of interest (if different).
2. How was the sample size determined?
3. Was the population determined to be homogeneous or not and how was the determination made?
4. The definition of a deviation.
5. How were the sampling procedures performed?

If a variables sample is planned, the population must be tested to determine if it is homogeneous.

Self Assessment

Fill in the blanks:

15. ……. is used to reach a conclusion about a population in terms of an amount.
16. …… is used when the auditor is only concerned with acceptance or rejection of a hypothesis.
17. ……. are used by tax auditors to determine if controls which ensure the accuracy of records are in place and working correctly.
18. Non-homogeneous populations require …… size samples.

Notes

Case Study

Critique of Attribute Sample Application

Baker, CPA, was engaged to audit Mill Company's financial statements for the year ended September 30, 20X1. After obtaining an understanding of Mill's internal control structure, Baker decided to obtain evidential matter about the effectiveness of both the design and operation of the policies and procedures that may support a low assessed level of control risk concerning Mill's shipping and billing functions. During the prior years' audits Baker used non-statistical sampling, but for the current year Baker used a statistical sample in the tests of controls to eliminate the need for judgment.

Baker wanted to assess control risk at a low level, so a tolerable rate of deviation or acceptable upper precision limit (UPL) of 20 percent was established. To estimate the population deviation rate and the achieved UPL, Baker decided to apply a discovery sampling technique of attribute sampling that would use a population expected error rate of 3 percent for the 8,000 shipping documents, and decided to defer consideration of allowable risk of assessing control risk too low (risk of over reliance) until evaluating the sample results. Baker used the tolerable rate, the population size, and the expected population error rate to determine that a sample size of 80 would be sufficient. When it was subsequently determined that the actual population was about 10,000 shipping documents, Baker increased the sample size to 100.

Baker's objective was to ascertain whether Mill's shipments had been properly billed. Baker took a sample of 100 invoices by selecting the first 25 invoices from the first month of each quarter. Baker then compared the invoices to the corresponding pre-numbered shipping documents.

When Baker tested the sample, eight errors were discovered. In addition, one shipment that should have been billed at $10,443 was actually billed at $10,434. Baker considered this $9 to be immaterial and did not count it as an error.

In evaluating the sample results, Baker made the initial determination that a reliability level of 95 percent (risk of assessing control risk too low 5 percent) was desired and, using the appropriate statistical sampling table, determined that for eight observed deviations from a sample size of 100, the achieved UPL was 14 percent. Baker then calculated the allowance for sampling risk to be 5 percent, the difference between the actual sample deviation rate (8 percent) and the expected error rate (3 percent). Baker reasoned that the actual sample deviation rate (8 percent) plus the allowance for sampling risk (5 percent) was less than the achieved UPL (14 percent); therefore, the sample supported a low level of control risk.

Question:

Describe each incorrect assumption, statement, and inappropriate application of attribute sampling in Baker's procedures.

Source: http://www.chegg.com/homework-help/questions-and-answers/baker-cpa-engaged-audit-company-s-financial-statements-year-ended-september-30-20x1-obtain-q2543454

7.6 Summary

- Sampling is the application of an audit procedure to less than 100% of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of all the items within the balance or class of transactions.

Notes

- Sampling is performed because it is more efficient than testing 100% of a population.
- Zero percent examination occurs when the auditor determines that a type of receipt, deduction, exemption or other item does not need to be tested.
- The haphazard sampling technique is the one adopted by the auditor in cases where the sample does not follow a structured technique.
- This sampling technique involves the auditor to split items included in a sample into their different sections.
- The systematic sampling involves the auditor to take the number of sampling units in the population and segregate this into the sample size so as to provide a sampling interval.
- Sampling risk is actually occurs when the auditor applies the procedure to the small part of the sample to judge the entire population, the result of it may be different if the population of the data contains variety, this risk is known to be the sampling risk.
- Overall tax audit risk is made up of the risk of inaccurate records and the risk of misapplication of the tax law.
- Sampling error refers to a statistical error to which an analyst exposes a model only because he/she is working with sample data instead of population or census data.
- Statistical sampling applies the laws of probability to determine the percent likelihood that the sample does not accurately reflect the population.
- A properly designed and applied non-statistical sample can provide results that are accurate and effective, but will not measure the sampling risk.
- Compliance tests can be performed directly on the control feature itself or indirectly on the outcome of the control.
- The main reason for performing compliance tests is to reduce the amount of substantive tests that need to be performed.
- Homogeneous populations can be tested using smaller size samples since there are fewer exceptional items to skew the results. Non-homogeneous populations require larger size samples.

7.7 Keywords

Audit risk: The risk that an auditor will not discover errors or intentional miscalculations (i.e. fraud) while reviewing a company's or individuals financial statements.

Audit sampling: SAS No. 39 defines audit sampling as the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class (AU 350.01).

Bias problems: Unknown or unacknowledged error created during the design, measurement, sampling, procedure, or choice of problem studied.

Block sampling: Block sampling is a system of sampling that involves choosing segments of contiguous transactions for a sampling application.

Compliance tests: Audit undertaken to confirm whether a firm is following the rules and regulations (prescribed by its internal authority or control system) applicable to an activity or practice.

Notes

Haphazard sampling: A non-probability sampling scheme in which population elements are chosen based on convenience.

Inherent risk: The probability of loss arising out of circumstances or existing in an environment, in the absence of any action to control or modify the circumstances.

Judgment: Judgmental sampling is a non-probability sampling technique where the researcher selects units to be sampled based on their knowledge and professional judgment.

Sampling error: Sampling error is an error that occurs when using samples to make inferences about the populations from which they are drawn.

Sampling risk: Refers to the possibility that the sample drawn is not representative of the population and that, as a result, the auditor will reach an incorrect conclusion about the account balance or class of transactions based on the sample.

Sampling unit: A single section selected to research and gather statistics of the whole.

Stratified sampling: A sampling in which each element in the population has an equal chance of being chosen for the sample.

Substantive tests: A procedure used during accounting audits to check for errors in balance sheets and other financial documentation.

Systematic sampling: A method of sampling where units are selected from the sampling frame by every "nth" unit.

7.8 Review Questions

1. Explain the definition and concept of Audit Sampling.
2. What is the purpose of audit sampling?
3. Explain the various techniques of audit sampling.
4. What is sampling risk?
5. What is sampling error? Discuss the various types of sampling error.
6. Explain the steps of designing a sampling application.
7. Differentiate between statistical and non-statistical sampling.
8. Explain compliance test and substantive tests.
9. How does the increasing rate of the sampling risk affect the overall efficiency of the business? Explain with examples.
10. Write short notes on:
    (a) Haphazard sampling
    (b) Stratified sampling
    (c) Non-sampling error
    (d) Sampling risk
    (e) Bias problems.

Notes

Answers: Self Assessment

1.	Zero Percent Examination	2.	haphazard sampling technique
3.	stratified sampling technique	4.	systematic sampling
5.	effectiveness; efficiency	6.	decrease
7.	audit risk	8.	Sampling risk
9.	parameter	10.	bottleneck effect; founder effect
11.	non-sampling; sampling	12.	Sampling risk
13.	Statistical applications	14.	Cost effectiveness
15.	Variables sampling	16.	Attribute sampling
17.	Compliance tests	18.	Larger

7.9 Further Readings

Books

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

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

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

Jeanette Franzel (2009). *Single Audit: Opportunities Exist to Improve the Single Audit Process and Oversight*, DIANE Publishing.

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

Online links

http://220.227.161.86/17732Annexure%205.pdf

http://www.caclubindia.com/articles/audit-sampling-2298.asp#.UTRNI9mPlkg

http://www.readyratios.com/reference/audit/audit_sampling.html

http://www.tax.newmexico.gov/SiteCollectionDocuments/audit-sampling-manual.pdf

Unit 8: Auditing in Computerized Environment

Notes

CONTENTS

Objectives

After studying this unit, you will be able to:

- Describe the Impact of Technology Revolution on Auditing
- Explain Specific Aspects of Auditing In a Computer-Based Environment
- Discuss Controls in Computer Systems
- Explain General Auditing Software (GAS)

Notes

- Explain Computer Assisted Audit Techniques & Tools (CAATTs)
- Describe Specific Problems of Electronic Data Process relating to Internal Control
- Describe Internal Control in an Electronic Data Process Environment
- Explain Appraisal of Accounting Systems and related Internal Control
- Discuss how to Improve Audit Effectiveness

Introduction

In developing audit procedures the auditors have to understand how the accounting information system record, classify and summarize data. An audit trial can be described as the series of cross references that enable the auditor to follow transactions from the start to the end to check the operation performed at each stage of processing e.g. individual may manually record sales order on a paper form, authorize credit, prepare invoices and record the sales in sales journal. In such cases the auditor can follow the transaction from the start to the end which is referred to as audit trial.

Internal Auditors have a big role in an organization. They provide an independent and objective assurance to the organization that the systems of an organization are working in tune with the business needs. Their concerns about the organization involve safeguarding of its assets including data/information and effectiveness and efficiency of its systems.

In a computerized environment, most of the processes and information reside on the computer systems and an organization depends crucially on proper functioning of these systems for proper functioning of its business. Further, organizations also depend heavily on the data stored in these systems for decision-making. As such, the data residing on the computer systems must meet the three criteria of security viz., Confidentiality, Integrity and Availability for its proper functioning. To ensure that the systems (whether personnel, hardware, software or data) of an organization are working in desired way and the data meets the criteria mentioned above, it is necessary that the computer systems are protected from misuse by unauthorized users and are secured from any external or internal threat.

8.1 Impact of Technology Revolution on Auditing

"If the automobile and airplane business had developed like the computer business, a rolls Royce would cost $2.75 and would for 3 million miles on one gallon of gas. And a Boeing 767 would cost just $500 and would circle the globe in 20 minutes on five gallon of gas." (Tom Forester in his book 'The Information Technology Revolution')

Information Technology (IT) has a deep impact on society in general and accounting and auditing in particular. After miracle advent of IT, the process of business operations (including Accounting) are changing so fast that even experts in the field are finding it difficult to keep pace with the changes. The hardware and software are becoming obsolete in no time. Even before, you become acquaintance with one software, that become obsolete, in no time and another version or new software taken its place. In this scenario, it is very important for accounting as well as auditing professionals to know what the current IT trends are and how they would influence accounting and auditing world.

As the field of IT is very vast, we are going to discuss the topic only in reference to accounting and auditing. The concept and objectives of internal control in both condition i.e. (manual environment and computerized environment) remain the same. However, differences exist between the two in the method of achieving the objectives. The prime objectives of Electronic

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Data Processing (EDP) based internal control system are to determine whether computer systems safeguard assets, maintain data integrity, achieve organizations goals effectively and used resources efficiently.

Caution A proper system of internal control is necessary to ensure that these objectives are achieved.

The impact of technology revolution on auditing is as follows:

- Widespread end user computing could sometimes result in unintentional errors creeping into systems owing to inexperienced persons being involved. Also, coordinated program modifications etc. may not be possible.
- Improper use of Decision Support System can have serious repercussions. Also, their underlying assumptions must be clearly documented.
- Auditor's participation to a limited extent in systems development may become inevitable to ensure, that adequate controls are built in.
- Usage of sophisticated audit software would become a necessity, since conventional methods of auditing would no longer be sufficient.
- Data communications and networking would introduce new risk, which an auditor must be aware of. He must have sufficient knowledge in this area to recommend the necessary data security and control measures.

The move towards paperless Electronic Data Interchange would eliminate much of the traditional audit trail, radically changing the nature of audit evidence.

The rapid advancements in information technology would not doubt have a dramatic impact on auditing. Auditors must adapt themselves to the changing environment and acquire the necessary additional skills.

Task Prepare a write up on the latest developments in the field of Information Technology.

Self Assessment

State whether the following statements are True or False:

1. The hardware and software are becoming obsolete in no time.
2. Improper use of Decision Support System does not have serious repercussions.

Caselet

History of Information Technology Auditing

Information Technology auditing (IT auditing) began as Electronic Data Process (EDP) Auditing and developed largely as a result of the rise in technology in accounting systems, the need for IT control, and the impact of computers on the ability to perform attestation services. The last few years have been an exciting time in the world of IT auditing as a result of the accounting scandals and increased regulation. IT auditing has

Contd....

Notes

had a relatively short yet rich history when compared to auditing as a whole and remains an ever changing field.

The introduction of computer technology into accounting systems changed the way data was stored, retrieved and controlled. It is believed that the first use of a computerized accounting system was at General Electric in 1954. During the time period of 1954 to the mid-1960s, the auditing profession was still auditing around the computer. At this time only mainframe computers were used and few people had the skills and abilities to program computers. This began to change in the mid-1960s with the introduction of new, smaller and less expensive machines. This increased the use of computers in businesses and with it came the need for auditors to become familiar with EDP concepts in business. Along with the increase in computer use, came the rise of different types of accounting systems. The industry soon realized that they needed to develop their own software and the first of the Generalized Audit Software (GAS) was developed. In 1968, the American Institute of Certified Public Accountants (AICPA) had the Big Eight (now the Big Four) accounting firms participate in the development of EDP auditing. The result of this was the release of Auditing & EDP. The book included how to document EDP audits and examples of how to process internal control reviews.

Around this time EDP auditors formed the Electronic Data Processing Auditors Association (EDPAA). The goal of the association was to produce guidelines, procedures and standards for EDP audits. In 1977, the first edition of Control Objectives was published. This publication is now known as Control Objectives for Information and related Technology (CobiT). CobiT is the set of generally accepted IT control objectives for IT auditors. In 1994, EDPAA changed its name to Information Systems Audit and Control Association (ISACA). The period from the late 1960s through today has seen rapid changes in technology from the microcomputer and networking to the internet and with these changes came some major events that change IT auditing forever.

The formation and rise in popularity of the Internet and E-commerce have had significant influences on the growth of IT audit. The Internet influences the lives of most of the world and is a place of increased business, entertainment and crime. IT auditing helps organizations and individuals on the Internet find security while helping commerce and communications to flourish.

Source: From Wikipedia, the free encyclopedia

8.2 Specific Aspects of Auditing in a Computer-Based Environment

Information Technology (IT) is integral to modern accounting and management information systems. As auditors have to assure proper functioning of the systems of an organization, in a computerized environment we can divide the normal activity of audit in two parts. One is the normal audit in which actual transactions are looked in detail to ensure that they are in accordance with the business objective.

In a computerized environment, as the data resides on computer systems, it is far easier to process the same using computers themselves rather than depending on print-outs or hard copies and processing them manually for ensuring accuracy of auditing.

Notes It is imperative that auditors should be fully aware of the impact of IT on the audit of a client's financial statements, both in the context of how it is used by a client to gather, process and report financial information in its financial statements, and how the auditor can use IT in the process of auditing the financial statements.

Notes

The other form of audit is called as Information System Audit, in which a study of the Information Systems is made to ensure that they are functioning in desired way and controls to prevent their misuse or abuse are properly functioning. In many organizations, auditors are also involved at the time of development of the software, so as to assure the organization that the software, which they intend to use, have the desired security and control features to prevent their misuse or abuse and to ensure that the software serves the intended purpose in efficient and effective way. This basically raises some major concerns to the auditors. These concerns relate to controls over computer systems, security of the systems, and functionality of the system and accessibility of data for auditing.

Caution The auditors may also ensure that the software development life cycle (SDLC) is properly followed and systematic systems documentation is done for future references.

8.2.1 Control Risks in Computer Systems

In earlier systems, processing of financial transactions was manual and one could examine the paper documents and accounts. The authorizations by concerned authorities were very much visible and their authenticity was verifiable from the papers and signatures of the authorities. However, every thing changed as reliance on computer processing increased. Not only, transactions are being created on computers, these are being authenticated on computers using various techniques and hence auditors have to ensure whether sufficient controls exist in the computer systems to avoid any fraud and misuse of the systems. As present day organizations depend more and more on networking for resources sharing and efficiency, this increases the risks, as physical controls to such systems become insufficient - as data can be assessed from anywhere and anytime.

8.2.2 Security of the Computer Systems

As dependence on computer system for carrying out business increases, maintaining computer systems for their all-round availability for business becomes important, as their non-availability can cause serious damage to organization's interests and reputation. However, these systems are basically machines and hence prone to risks other than control risks. While some components of system are physical such hardware (including storage media and peripherals), facilities (such as uninterrupted power supply, air-conditioning etc.), personnel, documentation and supplies; other important components are software and data. These computer system assets of an organization are not only prone to damage from fire, water, variations in power supply, pollution and unauthorized intrusion, these are also susceptible to misuse of software, data, services and virus attacks. Although, present day organizations have a different security system for such risks to computer systems, auditors have to take into account the effectiveness and efficiency of such a system.

Caution Controls and security always come at a cost and hence before putting them in place, a detailed view of the issues involved, particularly their cost benefit analysis is important before management takes a view.

There should also be some prioritization of the applications for implementation of security and controls. Here Control objectives for Information and related Technology (better known as CobiT principles) developed by Information Systems Audit and Control Association (ISACA website is www.isaca.org) come to our help a lot, but more about it later.

Notes

As already indicated above auditors cannot depend on hard-copy for data, as printed outputs need not necessarily show all the information from underlying records. Further, it may not readily allow totalling, sorting, classifying, summarization, analysis, extraction, sa mpling or comparison of records of financial importance. On the contrary, data in electronic form can be independently examined and processed using what is called as audit software. For electronically processing data, auditors depend on certain audit software tools, among which, most important are General Audit Software (like ACL or IDEA). Many auditors also use high-level languages like SQL (Structured Query Language) and industry specific or embedded audit software tools developed for a particular application. Audit software can also be used to accomplish following audit tasks:

- Examine quality of data.
- Examine quality of system processes.
- Examine the existence of the entities the data purports to represent.
- Undertake analytical review.

In a computerized environment there are traditionally two ways of auditing. The first method, which is easier to operate, is called "Auditing around the computer". Auditing around the computer involves gathering of evidence and expression of opinion on the basis of internal control system for the computerized information system and input and output. This method is performed typically in batch processing environment, which is simple in operation and where not much changes take place from one batch to another and detail reports are generated. This method is used for generalized software package or a tailor made package.

The other method is known as "Auditing with the Computer". Auditors are increasingly using computers in planning and performing audit work. In some cases, they use computers for preparation of audit plans, audit budget, maintenance of information of departments, scheduling of audit work, etc. They also use computers as a tool for collection and evaluation of evidence.

Self Assessment

State whether the following statements are True or False:

3. Auditors are increasingly using computers in planning and performing audit work.
4. Audit software can not be used to examine quality of data.
5. Present day organizations have a different security system for various risks to computer systems.

8.3 Controls in Computer Systems

Present-day organizations have made large-scale investments in Information Technology (IT); although the cost of investment is high the investment creates new opportunities for organizations and reduces variable cost drastically. However, due to this increased dependence and consequent vulnerability of organizations on IT, there is a need to keep efficient controls over Computer Systems. The vulnerabilities in IT arise as creation and authentication of financial transactions on computer systems is done electronically and if sufficient controls and security features are not incorporated in computer systems, fraudulent transactions can enter the system. In short, although use of technology brings efficiency, it also brings along with it certain risks, which need to be taken care of to safeguard the organizations from consequent financial risks.

The two basic principles on which such controls are established are the principle of least privilege and that of maker and checker. The principle of least privilege means that every individual is

Notes

given access to the sensitive information strictly on the need to know basis and is given only those rights to access data and programmes, which are in line with his job duties and nothing more. While giving lesser rights than required may decrease the efficiency of working, giving more rights has associated risks of misuse or possible frauds. The principle of maker and checker means that for each transaction, there must be at least two individuals necessary for its validation. While one individual may create a transaction, the other individual should be involved in confirmation or authentication of the same. Here the segregation of duties plays an important role. Thus, strict control is kept over system software and data keeping in mind functional division of labour between all classes of employees.

However, these principles are very broad and it is necessary and important to go into the exact details of the complete environment, which includes the operating systems, data base management systems, application packages and networking software used or likely to be used, for deciding the controls over the systems. As such, it is important that the user management, experts on the systems as well as auditors decide on the exact nature of controls required by the organization. In other words, there is an inherent need to involve the auditors in the decision making process regarding the controls from the beginning itself, whether the related software is developed in-house or outsourced.

In this connection, it may be mentioned that it is the management, who has to decide what to reasonably invest for security and control in Information Technology (IT) and how to balance risk and control investment in an unpredictable IT environment; as information systems security and control helps manage risks and not eliminate them. In addition, exact level of risk can never be known since there is always some degree of uncertainty. Excessive controls sometimes result into inconvenience, inefficiency, poor customer service and higher cost of its implementation. Ultimately, management must decide on the level of risk it is willing to accept. Judging what level can be tolerated, particularly weighted against cost and inconvenience, is a difficult management decision. Therefore, management needs a framework for generally accepted IT security and control practices to benchmark existing and planned IT environment.

To solve this problem, Information Systems Audit and Control Association have developed the CobiT Framework, the main objective of which is the development of clear policies and good practices for security and control in IT. CobiT is designed for use by three distinct audiences, (i) Management: to help them balance risk and control investment in an often unpredictable IT environment, (ii) Users: to obtain assurance on security and controls of IT services provided by internal or third parties and (iii) Information System Auditors: to substantiate their opinions and/ or provide advice to management on internal controls.

The objectives of CobiT are (i) to bridge the gap between control requirements, technical issue and business risks, (ii) enable development of clear policy and good practices for IT control and (iii) breakthrough in it risk management and governance. For this CobiT has divided IT processes in four domains for high-level classification containing in all 34 processes and these processes are further divided into 302 control objectives.

- ***Planning and Organization:*** This domain covers strategy and tactics, and concerns the identification of the way IT can best contribute to the achievement of the business objectives. Furthermore, the realization of the strategic vision needs to be planned, communicated and managed for different perspectives. This domain contains 11 processes divided into 100 control objectives.
- ***Acquisition and Implementation:*** To realize the IT strategy, IT solutions need to be identified, developed or acquired, as well as implemented and integrated into the business process. In addition, changes in and maintenance of existing systems are covered by this domain to make sure that the life cycle is continued for these systems. This domain contains 6 processes divided into 68 control objectives.

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- ***Delivery and Support:*** This domain is concerned with the actual delivery of required services, which range from traditional operations over security and continuity aspects to training. In order to deliver services, the necessary support processes must be set up. This domain includes the actual processing of data by application systems, often classified under application controls. This domain contains 13 processes divided into 126 control objectives.
- ***Monitoring:*** All IT processes need to be regularly assessed over time for their quality and compliance with control requirements. This domain thus addresses management's oversight of the organization's control process and independent assurance provided by internal and external audit or obtained from alternative sources. This domain contains 4 processes divided into 24 control objectives.

Here, it may be important to mention that the CobiT principles lay down the control objectives and are independent of the level of the technology or software.

Example: Under Acquisition and Implementation domain, one of the processes is Acquire and Maintain Application Software, within which under Application Software Testing, CobiT has to say that, "Unit testing, application testing, integration testing, system testing and load and stress testing should be performed according to the project test plan and established testing standards before it is approved by the user. Adequate measures should be conducted to prevent disclosure of sensitive information used during testing."

8.3.1 Operating System Controls

Operating System is an interface between user and computer. It manages memory, devices, peripherals and various tasks; controls computer's resources and provides base for writing application programmes. The operating systems fall into categories of single user and multi-user (network) environment. The most common type of single user operating system is DOS (Disk Operating System). This also forms the base of some other single user operating systems such as Windows 95/98. Those, who have worked on Windows 95/98 operating systems, might have noticed that before this operating system boot, certain DOS commands are run. Actually these operating systems are based on DOS. However, Windows 2000 is independent of DOS. The only security available in DOS is the boot level password, which can be set up by the owner. It may appear that once a boot level password is set up for the system it may not allow one to boot, but the fact is that just by opening the CPU and replacing the battery will remove the boot level password. As such, no security is available with boot level password.

Multi-user operating systems have better security features. Novell Netware, which generally works on client server architect, provides security at Net-user level as well as for accessing database. In this operating system, one can create new users, manage rights to different users, create drive mappings and assign rights to file system / directories (S: Supervisory rights; R: Read right; W: write right; C: create right; E: erase right; M: modify right; F: File scan and A: Access control).

Did u know? One needs a server console and to login as supervisor from server console, no password is required? Hence, one has to have physical controls to server room access in Novell Netware system.

The UNIX operating system, which is generally used for server cantered processing, requires the password for booting. UNIX divides the universe of users into three categories i.e. user,

members of a group and others. Thus in UNIX environment, those working on a common project could be assigned to the same group and can share access each other's file. More generally, the system administrator decides who goes into which group. Further, for each of these three types of users, the system also keeps track of three sorts of permissions: read, write and execute.

Example: If one possesses a read permission for a file, one can use commands that read a file without altering it. Write permission allows one to alter a file and one could edit or delete a file. Similarly, execute permission lets one run a file containing a programme.

8.3.2 Relational Database Management System (RDBMS) Controls

There are no controls available in simple database management systems such as dBase, FoxPro and MS Access. However relational database systems such as Oracle and Sybase provide for different types of controls, the integrity of these is dependent on controls in any application programs that process transactions against database. In RDBMS, database is distributed and may be accessed by different users simultaneously. As such, an important part of RDBMS is to allow different users of database to share the same data source, for which it allows certain concurrency and access controls measures.

RDBMS also allows existence controls, which restore the data in the event of a local or global loss due to application programme error, system software error, procedural error, hardware failure or environmental failure. Apart from this, file-handling controls in RDBMS prevent accidental destruction of data contained on a storage media. These controls are exercised by hardware, software and operators, who mount and dismount storage media used for database. RDBMS also allows for creation of audit trails, which maintain chronology of events (such as creation, modifications, deletions and retrievals) that occur either to database or to database definitions.

8.3.3 Application Software Controls

Apart from the above, access controls can also be created in application software for identification and authentication by users and generation and authentication of exception reports, audit trails etc. Other identification or access controls are use of plastic cards, Personal Identification Number (PIN) and now biometrics too. As regards input controls, check digits, batch totals/controls, data coding errors, data validation controls can also be built into application software. One can also have various type of processing controls such as real memory controls (controls over memory to detect and correct errors that occur in memory cells and protect areas of memory assigned to a program from illegal access by another programme), operating system integrity controls (such threats may be accidental or deliberate causing system to crash or process erroneously).

Self Assessment

Fill in the blanks:

6. The vulnerabilities in IT arise as creation and authentication of financial transactions on computer systems is done……...
7. The principle of least privilege means that every individual is given access to the …… information strictly on the need to know basis.
8. The most common type of single user operating system is ……..

Notes

8.4 General Auditing Software (GAS)

No audit is complete unless an auditor substantiates findings with the evidence collected by them. To collect the evidence, it is necessary for auditors to process the data residing on computer systems using some type of software. Worldwide auditors use General Audit Software (like ACL or IDEA) or high-level languages like SQL (Structured Query Language) and industry specific or embedded audit software tools.

These can also be used to analyse audit trails recorded by an operating, database management or application systems. General Audit Software (GAS) can be used to access different types of file formats, file re-organization (such as sorting, merging, joining etc.), selecting records on certain logic, carrying out arithmetical operations (like addition, subtraction, multiplication and division), classifying the data according to some given criteria, frequency and statistical analysis, and editing and formatting output for preparing reports. In GAS such as ACL, the entire processing of the data can be done without materially affecting the data under examination and a log of audit procedure is also recorded for evidence and reporting.

General Audit Software (GAS) can also be used to accomplish following audit tasks:

- ***Examine quality of data:*** Auditors can use GAS to examine existence, accuracy, completeness, consistency and timeliness of data maintained on computer systems.

> *Notes* It may be noted that quality of data reflects the quality of personnel who developed the system, maintain it and use the system.

  Even if a system is well designed and maintained the data supplied by users may be low in quality.

- ***Examine quality of system processes:*** Even if quality of data is high, quality of system process may be poor.

Example: Though data in accounts receivable may be accurate, complete, consistent and timely, there may be a large number of overdue accounts reflecting adversely on accounts receivable application system and personnel using the system.

- ***Examine the existence of the entities the data purports to represent:*** Data may be accurate, complete and consistent and may not still represent an object in real world and may represent a bogus entry. In GAS, powerful reporting features can be used for confirmation or sample inventory for physical observation.

- ***Undertake analytical review:*** The purpose of this is to obtain key ratios and totals from the data for comparison with previous year's data or that of industry for analytical review.

> *Notes* General Audit Software (GAS) does not require any special skills from auditor.

To use it auditor need only understand the GAS and a good understanding of the databases and ODBC, file structures and the ability to create logical queries using the software.

Notes

8.4.1 Advantages of using GAS

The open standards in hardware and software make hardware and software, compatible with each other. Due to this, new versions, new products and new brands are coming to the market very fast. The rate at which new products and versions are launched, make it difficult for an individual to keep track of these changes. This is especially true for an external auditor. External auditor has to audit various clients each using different hardware, software, and database and application software. Even the same client may be using different version of operating systems, database and application software. No one can learn so many Embedded Audit Modules (even if there is one) and utility software. With the use of GAS, auditing becomes independent of application, database and operating system.

General Audit Software (GAS), however, has certain limitations in as much as that:

- It can undertake only ex-post auditing and not concurrent auditing i.e. it enables evidence to be collected only on an application system after the fact, when the data has already been processed. As such, situations where the time lag between occurrence of an error in application system and its possible identification using GAS are critical (for example where multiple users access a shared database) auditors must use specialized rather than GAS.
- GAS has limited ability to verify processing logic of an application system. To overcome this problem, test data must be designed specifically to determine how application system handles exceptional conditions.
- GAS has limited ability to determine propensity of error. Auditors are concerned with whether application systems have been designed appropriately to accommodate change; otherwise errors are likely to result when changes to the system must be undertaken. Unfortunately, auditors can obtain little evidence using GAS on application system's capability to accommodate change. Instead, evidence must be obtained in different ways.

Example: Reviewing management control framework, examining ways application systems are designed and program codes are written.

8.4.2 Other Auditing Software

- Some types of audit software packages have been developed for specific use in financial, insurance and health services. Although these packages are generalized, they are oriented towards a particular industry and provide commands that invoke common audit functions needed within that industry. One such package is CAPS package developed by Brisbane based Kendall Chartered Accountants. This package provides for loan arrears audit, interest audit, term deposit interest audit, ledger balances and transactions audit, dormancy audit and legislative compliance audit. Advantages of such audit software over GAS are that they run efficiently and are easier to use by the auditors within the specific industry. However, more limited domain is also disadvantageous to that extent.
- Similarly an organization dealing with uniform operating and database management systems and application packages can also develop in-house packages or programmes, which may answer standard audit queries, generate pre-designed statements and exception reports. However, for each new query, a new programme may have to be developed. Such embedded audit software is very easy to use and serve good purpose for internal auditing where auditors have to audit the same system again and again.

Notes

- Auditors can also use high-level languages (such as SQL in a relational database system) to select data that satisfy certain criteria and format this data for reporting purposes. However, such high-level languages may not have statistical sampling capabilities. Auditors overcome such difficulties by using macros, which allow writing programmes to perform a particular function and then invoke these programmes with a single command.

8.4.3 Concurrent Auditing Techniques

Concurrent auditing techniques were developed in 1960s and 1970s to address problems related with computer based information systems particularly disappearing paper-based audit trails and secondly continuous monitoring required by advanced systems. There are four major concurrent audit techniques:

- ***Integrated Test Facility:*** This technique involves establishing a dummy entity on application system files and processing audit test data against the entity to verify processing authenticity, accuracy and completeness. However, it requires two major design decisions for the system one, what method will be used to enter data and two what method will be adopted to remove its effects. For this, one may either tag the dummy (ITF) transaction and application system may be programmed to recognize this tagged transaction. Then system may prepare two updates one for their master files record and other for dummy entity. The second method is designing new test data (with a key field to denote it is ITF transaction) and entering into the application system. The effects of ITF entries can be removed either by modifying application system (so that it recognizes such transactions and ignores them in any processing that may effect users); or submitting additional input that reverses the effect of ITF transactions or to submit trivial entries so that effect of ITF transactions on output is minimal (this is simple however, users will have to be advised of ITF testing.
- ***Snapshot/Extended Record:*** This technique involves software taking "pictures" (or snapshots) of a transaction as it flows through application system. For this auditors embed the software in application where they deem material processing occurs. For this auditors must decide where to locate snapshot points, when they will capture the snapshots and regarding reporting of the snapshot data that is captured. The embedded software must provide sufficient identification and time stamp information of each transaction to enable auditors to determine the transaction for which it applies and the sequence of changes as they occur. A reporting system must also be designed and implemented to present data in a meaningful way. A modification of this technique is extended record technique in which a single record is constructed built up from the images captured at each point. This has the advantage of having all information in one place and facilitates audit evaluation. These techniques can be used in conjunction with ITF technique.
- ***System Control Audit Review File (SCARF):*** This involves embedding audit software modules within host application system for continuous monitoring of system's transactions. The information is written to a special audit file SCARF master file. Auditors them examine the information contained on this file to see if some aspects need follow up.
- ***Continuous and intermittent Simulation (CIS):*** This (CIS) technique can be used whenever application systems use a database management system (DBMS). CIS uses DBMS to trap exceptions of interest to auditor and application system is left intact. When application system invokes services provided by DBMS, DBMS indicates to CIS that a service is required. CIS then determines whether it wants to examine activities carried out by DBMS on behalf of application system or not. The main advantage of CIS is that it does not require any modification to application system.

Notes

All the concurrent audit techniques described above have their benefits as well as limitations. When auditors implement these techniques, all the necessary decisions (including those relating to expertise available in the organization) regarding software or application will have to be taken as are taken in normal circumstances. They have also to seek the support of the groups affected by concurrent auditing. Concurrent audit techniques have the advantages of being viable alternative to ex-post auditing and auditing around computer; and surprise test capability.

Self Assessment

Fill in the blanks:

9. …….auditors use General Audit Software like ACL or IDEA or high-level languages like Structured Query Language (SQL) and industry specific or embedded audit software tools.
10. Quality of data reflects the quality of …… who developed the system.
11. General Audit Software (Gas) has limited ability to verify …….. Logic of an application system.

8.5 Computer Assisted Audit Techniques and Tools (CAATTs)

Computers can be used by auditors in many more ways, other than just processing of transaction or data files using Audit Software. One of the ways to use computers is using General Audit Software, which has already been described in detail above. Let us discuss some of the other ways in which Computers can be used.

8.5.1 Electronic Work Papers

The ability to search for information in text, databases, or other audit records is enabling auditors to coordinate their efforts and examine findings from prior or concurrent audits. Requiring standardized audit forms and formats can improve both the quality and consistency of audit work papers. The management of current and archived work papers in a centralized audit file or database assists audit management in coordinating concurrent audits, assuring they consider findings from prior or related projects. Expert systems provide an opportunity to add broad support and increased functionality to audit work paper tools. To illustrate, an expert system may evaluate responses to a questionnaire and automatically generate links to additional related questions. Expert systems may also look at patterns in information, findings, recommendations of related concurrent or previous audits, and provide reports indicating potential related or systemic problem areas.

8.5.2 Information Retrieval and Analysis

Historically auditors have relied on samples of transactions to perform their tests. Now, with the use of automated retrieval and analysis tools, it is usually easier to assess all records than to evaluate a sample. Furthermore, auditors can set parameters in their software to identify all records meeting selection criteria. Full selection of known error type records can eliminate the problem of estimating error rates. Instead, error analysis can focus on those records whose data are outside the range of expected transaction values, but still within the limitations of defined error conditions. Actual sampling techniques may be applied at the time records are selected from the production system, or all records of a given type may be selected and sampling or more detailed selection may be applied in the analysis process.

Notes

Did u know? Record selection criteria may be based on prior audits, but auditors should continually assess opportunities to improve audit coverage especially if this can be accomplished at reduced overall cost.

8.5.3 Retrieval and Analysis Software

Information retrieval and analysis tools can present significant technical challenges to auditors because audit information may reside in diverse and distributed system types with varying degrees of control and standardization. Data may be stored under the control of various machine types and operating systems using differing formats; they may move across environments using different protocols; they may be stored or archived by various database management systems using fixed or variable length fields or records, and subject to differing database standards; and lastly, they may even reside in numerous physical locations as in a distributed database or data environment.

Many auditing departments use technical specialists to locate and evaluate data sources. These specialists provide the software tools to extract data, converting them into a form that can be used by audit analytical tools. In some companies, information is stored according to specified standards that do not change frequently and multiple audits may be performed on information in a common format. In such cases, libraries of information retrieval routines can be maintained, called and executed by any auditor. Once information is stored in a form usable by audit analytical tools, auditors with varying degrees of technical expertise actually perform and review the results of analysis. Many office software tools such as spreadsheets or databases may be able to access and analyze information stored in an ODBC format.

8.5.4 Trends in Information Retrieval and Analysis

A trend in auditor information retrieval and analysis is to include greater intelligence in auditing or monitoring software embedded in business systems and networks. As auditors identify risk elements and develop software to detect errors or suspicious transactions, it is often a simple process to embed the tests or monitors into the systems. In such cases, auditors can then be informed of errors or changes in data patterns soon after they occur. Auditors planning to deploy embedded system audit features can be identified as users of systems under development. Rather than acting on the design and development team as control specialists, auditors act as any other system user or interfacing system representative. They specify the record selection and data format criteria for embedded monitors, as well as any special features such as the ability to modify, expand or suspend such monitoring. Case in point, auditors may expect certain systems to process transactions at expected volumes or within certain monetary ranges.

8.5.5 Audit Reporting

Some audit tools today provide automatic linking between work performed, information gathered, auditor assessments, and information used in or supporting audit reports. Intelligent work papers may note answers in internal control questionnaires (ICQ) that indicate actual or potential weaknesses and automatically prepare a section in the audit report to document the weakness or resolution of the problem. Audit reporting; too, can automatically provide information about sections of audits performed by individual auditors as they are completed so the audit supervisor will know the ongoing status of audit projects. Such reporting will also allow the supervisor to concentrate on audit processes that indicate problems and/or provide additional resources in areas falling behind schedule. The audit report can easily contain links to work papers, worksheets, graphs or other information that will be automatically updated as data changes.

Notes

Did u know? Audit team members and management can share report files by implementing simple controls over access such as read-only access to those not authorized to change the files.

8.5.6 Database of Audit History

The audit history database should provide a historical perspective for all audits on the plan or schedule. Audit histories can identify recurring or unresolved issues or problems, or indicate areas of risk. Moreover, many sections of audit work papers can be copied from prior files and updated to save auditors time and effort. Audit reports can be indexed by key words to facilitate review or searching, or may be searched in their entirety depending on the techniques employed. Similarities in data patterns, audit findings, or recommendations can be found using indexing or search technology, and can support expansion or reduction of audit scope.

8.5.7 Computer Based Training

Embedded training and help features are included in most audit software tools today. Many software vendors offer both generic and specific training for the use of software tools. However, computer based training can span the broad range of auditing and auditing activities, and should not be limited by previous experience. Training can be informal and self-motivated, or it can be formal through audit administration providing feedback to the trainee as well as to audit management. Using computer based training, as an audit tool is most likely to be self-motivated. It may be limited by the time and tools available, the speed at which the tools operate, or the auditor's energy, imagination and exposure to information.

Example: If auditors don't have access to the Web, they can't use it to search for information. If their access path is slow, then the time requirements may quickly outpace the value received or reduce the auditor's enthusiasm for such learning. If travelling auditors do not have remote access to their central files or e-mail, they can't search audit histories to seek input from others on a problem or question.

Ultimately, audit management, in keeping with its budget, will determine the tool set provided to auditors, but the auditors themselves will determine how effectively the tools are being used. Training should focus on how to seek out and learn new information and approaches, not merely on how to perform previously defined tasks or use existing software features.

Self Assessment

Fill in the blanks:

12. Expert systems provide a …….. to add broad support and increased functionality to audit work paper tools.
13. Record selection criteria may be based on ……audits.

Task You have been appointed as the auditor of Hitech Limited which maintains its account on computers. Prepare a note on the approach you would follow in checking the internal control system of Hitech Limited.

Notes

8.6 Improving Audit Effectiveness

Audit effectiveness is a partnership between regulators, audit firms, and the accounting and auditing experts that lead and work for these firms. That is, audit effectiveness is a function of both standards and performance. Standards — whether auditing, quality control, or independence — provide a floor for auditor performance. Importantly, audit firms should have incentives to go beyond the floor and compete on the basis of quality. This occurs not only from enlightened self-interest, but when, for example, audit quality carries a premium and clients are willing to pay more for higher quality services. And, this introduces another party to the audit effectiveness partnership — namely clients, including management and audit committees.

First, you must recognize, for public companies post-SOX, audit effectiveness needs to be viewed from the perspective of an integrated audit — that is, an audit of both the financial statements and Internal Control over Financial Reporting (or ICFR).

Even so, unlike financial statement audits before the Securities Acts, prior to SOX, for the most part, companies other than financial institutions didn't have ICFR audits. There was almost no voluntary demand for audits of ICFR for reporting to investors in public companies. However, this does not necessarily mean audits of ICFR do not have value. Everyone agrees that controls are important — even those running and investing in non-public companies, including those in the private equity market, want companies with good controls.

Similarly, it has been a challenge to get an effective integration of the ICFR and financial statement audits which is a key point. It's all about improving the quality of financial reporting by mitigating the risk of material misstatement. To do so, the financial statement audit needs to inform the audit of ICFR and vice versa. Once barriers to achieving integration are removed and appropriate incentives established, it's likely that integrated audits will be viewed as big step forward in audit effectiveness.

Notes Through an audit, an organization can identify a system's ineffectiveness, take corrective action, and ultimately support continuous improvement. Unfortunately, a poorly deployed auditing system can lead to increased, non value-added costs, many hours of wasted resources, and an eventual, inevitable QMS breakdown.

Management must buy into the fact that the internal audit process is just as critical and important an activity as any other process within the QMS. An internal auditing system must have the commitment of senior management. Without their approval, support, and encouragement, the internal audit process is doomed for failure and worse–time and money wasted. When scheduled audits are routinely postponed, management is sending a clear message, "Auditing is a low priority, and we only perform them because it's a necessary evil."

Self Assessment

Fill in the blanks:

14. Audit effectiveness is a …….. of both standards and performance.
15. An internal auditing system must have the ……..... of senior management.

Notes

Case Study

Conducting Audit in an EDP Environment

Rohan Sharma has recently joined Mehta and Mehta an audit firm as a senior audit assistant. Mr. Kamlesh Mehta, partner of the firm ask Rohan to attend a seminar on "Audit in an EDP environment" organized by The Institute of Chartered Accountants of India. He has also been asked to note down the important points raised by learned speakers in the seminar.

Rohan has noted the following points:

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:

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 as its actual use by the business. It is possible that although 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.

Checking the records: After checking the reliability of the internal control system, the 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.

Explanation and information: Auditor should make inquiries from the management and staff regarding the work. Based on such inquiries he can decide upon the truthfulness of the financial records.

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.

Question:

Prepare a note on the audit process you would follow in conducting audit in an EDP environment.

Source: http://www.blog.kpoweb.com/27/audit-process-in-an-edp-environment/

8.7 Summary

- Information Technology (IT) has a deep impact on society in general and accounting and auditing in particular. After miracle advent of IT, the process of business operations (including Accounting) are changing so fast that even experts in the field are finding it difficult to keep pace with the changes.
- The hardware and software are becoming obsolete in no time. Even before, you become acquaintance with one software, that become obsolete, in no time and another version or new software taken its place.

Notes

- In this scenario, it is very important for accounting as well as auditing professionals to know what the current IT trends are and how they would influence accounting and auditing world.
- As dependence on computer system for carrying out business increases, maintaining computer systems for their all-round availability for business becomes important, as their non-availability can cause serious damage to organization's interests and reputation.
- For electronically processing data, auditors depend on certain audit software tools, among which, most important are General Audit Software (like ACL or IDEA). Many auditors also use high-level languages like SQL (Structured Query Language) and industry specific or embedded audit software tools developed for a particular application.
- Due to the increased dependence and consequent vulnerability of organizations on IT, there is a need to keep efficient controls over Computer Systems. The two basic principles on which internal controls are established are the principle of least privilege and that of maker and checker.
- Management needs a framework for generally accepted IT security and control practices to benchmark existing and planned IT environment.
- Operating System is an interface between user and computer. It manages memory, devices, peripherals and various tasks; controls computer's resources and provides base for writing application programmes. The operating systems fall into categories of single user and multi-user (network) environment. The most common type of single user operating system is DOS (Disk Operating System).
- Windows NT identifies users and knows what each user is allowed to do. It can compare the list of permissions of each user with its user id and determine what access is allowed to each user.
- Relational database systems such as Oracle and Sybase provide for different types of controls, the integrity of these is dependent on controls in any application programs that process transactions against database.
- In RDBMS, database is distributed and may be accessed by different users simultaneously.
- General Audit Software (GAS) can also be used to accomplish following audit tasks: Examine quality of data, Examine quality of system processes, Examine the existence of the entities the data purports to represent, Undertake analytical review.
- Many auditing departments use technical specialists to locate and evaluate data sources. These specialists provide the software tools to extract data, converting them into a form that can be used by audit analytical tools.
- In some companies, information is stored according to specified standards that do not change frequently and multiple audits may be performed on information in a common format.
- Audit effectiveness is a partnership between regulators, audit firms, and the accounting and auditing experts that lead and work for these firms. That is, audit effectiveness is a function of both standards and performance.
- Through an audit, an organization can identify a system's ineffectiveness, take corrective action, and ultimately support continuous improvement.
- Unfortunately, a poorly deployed auditing system can lead to increased, non value-added costs, many hours of wasted resources, and an eventual, inevitable QMS breakdown.

Notes

8.8 Keywords

Benchmark: A standard or point of reference against which things may be compared or assessed.

Database Management: A collection of programs that enables you to store, modify, and extract information from a database.

Electronic Data Processing (EDP): Automatic data processing by electronic means without the use of tabulating cards or punched tapes.

Embedded training: Embedded training is defined as training provided by capabilities built into or added onto operational systems, subsystems, or equipment, to enhance and maintain the skill proficiency of personnel.

External auditor: An external auditor is an audit professional who performs an audit in accordance with specific laws or rules on the financial statements of a company, government entity, other legal entity or organization, and who is independent of the entity being audited.

Framework: A basic structure underlying a system, concept, or text.

General Audit Software (GAS): Generalized audit software is software designed to read, process and write data with the help of functions performing specific audit routines and with self-made macros.

Information Retrieval: The tracing and recovery of specific information from stored data.

Plastic Cards: The generic name for the range of payment-related cards.

Simulation: Imitation or representation, as of a potential situation or in experimental testing.

8.9 Review Questions

1. What is the Impact of Technology Revolution on Auditing?
2. What are the Specific Aspects of Auditing in a Computer-Based Environment and how one can control risks in computer systems?
3. What do you understand by Controls in Computer Systems? Explain the two principles on which controls are established.
4. Explain General Auditing Software (GAS) and discuss its advantages.
5. Explain how information is retrieved and analysed through Computer Assisted Audit Techniques & Tools (CAATTs)?
6. What are the trends in information retrieval and analysis?
7. Explain the retrieval and analysis software.
8. What do you mean by computer based training?
9. Discuss how to improve the effectiveness of audit?
10. Describe concurrent auditing techniques.

Answers: Self Assessment

1.	True	2.	False
3.	True	4.	False

Notes

5. True
6. Electronically
7. Sensitive
8. DOS (Disk Operating System)
9. Worldwide
10. Personnel
11. Processing
12. Opportunity
13. Prior
14. Function
15. Commitment

8.10 Further Readings

Books

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

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http://www.qualitydigest.com/inside/standards-article/improving-effectiveness-internal-auditing.html

http://ezinearticles.com/?Generalized-Audit-Software-(GAS)&id=327704

http://journals.cluteonline.com/index.php/RBIS/article/download/5386/5471

Unit 9: Audit of Limited Companies

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Objectives

After studying this unit, you will be able to:

- Explain the concept of company audit
- Discuss Commencement of Audit
- Describe Audit of Share Capital
- Describe Audit of calls
- Explain Issue and Redemption of Preference Shares
- Explain Issue of Bonus Shares
- Explain Issue of Share Certificates
- Elaborate on Share Transfer Audit
- Discuss Presentation and Disclosure of Share Capital

Introduction

In this unit you will learn that before the commencement of the audit of a company, the auditor must fulfil certain preliminary steps. Particularly, the auditor must acquaint himself with (i) articles and' memorandum of association 'to 'verify the constitution and powers under which the company operates, (ii) system of internal control, and (iii) other relevant provisions of the Companies Act, 1956 (hereinafter referred to as the Act), affecting financial statements, etc. Then, you already know the general principles of auditing which are applicable normally to all types of entities irrespective of their nature, size and form. However, certain specific aspects of such as audit of share capital transfer of shares, and audit of dividends, depreciation and reserves that are peculiar to companies etc. were not covered. In this unit, after covering the preliminaries before commencement of the audits of a company we shall primarily deal with audit of share capital which is conducted in order to ensure that the share capital has been issued in accordance with the relevant provisions of the Companies Act, 1956 and properly recorded in the books of account and duly reflected in the balance sheet of the company.

9.1 The Company Audit

The shareholders of the company are the real owners of the Company. They invest their money in the company. However the management of the company lies in the hands of the directors. Generally the shareholders do not have the skills required to understand the financial statements. Thus audit of account of company has been made compulsory in order to protect the interest of the shareholders. Audit of accounts ensures that the statements of account are properly drawn up and they disclose all the requisite information. Auditor must also ensure that the company has not violated any of the provisions contained in the Companies Act, 1956. Although compliance with the relevant provisions of the Companies Act, 1956 is the responsibility of the directors and officers of the company, nevertheless the auditor must make a report to the shareholders where non compliance results in affecting the accounts materially.

9.1.1 Appointment of Company Auditor

The following are the important considerations regarding the appointment of the company auditor:

Notes

Who can be Auditor: Section 226 of the Companies Act, 1956 deals with the qualification of company auditors? It intends to ensure that the auditors are independent of the companies they audit. A body corporate cannot be appointed as an auditor because it has a limited liability. Clause (b) of sub-section (3) of Section 226 of the Act disqualifies an officer or employee of the company from being appointed as its auditor. According to a clarification of the Department of Company Affairs the legal position is as follows:

"Where the chartered accountant is employed whole-time, he is an employee of the company. In other cases, generally speaking there would appear to be only a contract for service and not a contract of service between the company and chartered accountant. In Dhrangadhra Chemicals Works v. State of Saurashtra (1957 S.CA, p. 216) the Supreme Court has laid down that the prima facie test for determination of the relationship between master and servant is the existence of the right in the master to supervise and control the work done by the servant not only in matter of directing that work the servant is to do, but also the manner in which he shall do his work, or to borrow the words of Lord Uthwatt, the proper test is whether or not the hirer had authority to control the manner of execution of the act in question. Applying this test in any case, where the chartered accountant is consulted only professionally on income tax matters by a company, he can not be said to be an officer or employee of the company."

"A Chartered Accountant's main business is to render professional service for reward like a lawyer or a doctor. Where such service is rendered professionally and not as an officer or employee of the company, a chartered accountant is not disqualified under Section 226(3) (b) of the Companies Act, 1956."

It is, however, clear that there is no prohibition on a relative of a director or a partner of such relative to be appointed as an auditor. The provisions of Section 297(1) would also not apply to the appointment of such a person as an auditor because an audit is in the nature of rendering personal service obtained not on the basis of the lowest tender but on account of professional expertise irrespective of cost involved. However, the appointment of an auditor who is a relative of a director or a firm of auditors in which a director of the company or his relative is a partner would be an office of profit under Section 314 requiring the consent of the company by a special resolution, if the total monthly remuneration exceeds prescribed limits (Section 314). Prior consent of the company and approval of Central Government (Company Law Board) would also be required in appropriate cases. Moreover, a chartered accountant in practice shall be deemed to be guilty of professional misconduct under the Chartered Accountants Act, 1949 if he expresses his opinion on the financial statements of any enterprise, in which he, his firm or a partner in his firm or any of his relatives have a substantial interest, unless he discloses the interest also in his report. The term "relatives" is to be construed with reference to Section 6 of the Companies Act. Similarly, the expression "substantial interest" is to have the same meaning as is assigned thereto under Explanation 3 to Section 13 of the Income Tax Act, 1961. Further, clause (d) of sub-section (3) of Section 226 of the Act states that a person indebted to the company for an amount exceeding ₹ 1,000 or a person who, has given any guarantee or provide any security in connection with the indebtedness of any third person to the company for an amount exceeding ₹ 1,000 is not qualified for appointment as an auditor. Some special situations are discussed below:

(a) In this context, a question may come up as to whether such indebtedness would arise in cases where, in accordance with the terms of appointment by a client, the auditor recovers his fees on a progressive basis as and when a part of the work is done without waiting for the completion of the whole job. According to the Research Committee of the Institute "a question often arises as to whether indebtedness arises in cases where in accordance with the terms of his engagement by a client (e.g. resolution passed by the general meeting) the auditor recovers his fees on a progressive basis as and when a part of work is done without waiting for the completion of the whole job. In these circumstances, where in accordance

Notes

with such terms, the auditor recovers his fees on a progressive basis, he cannot be said to be indebted to the company at any stage.

(b) A question of indebtedness may also be raised where an auditor of a company purchases goods or services from the company audited by him. In such a case, if the amount outstanding exceeds ₹ 1,000, irrespective of the nature of the purchase or period of credit allowed to other customers, the provisions concerning disqualification of auditors as contained in Section 226(3)(d) will be attracted.

(c) Another question which arises for consideration is whether a partner is disqualified from appointment as auditor when the firm of which he is a partner is indebted to the company in excess of the limit prescribed and whether the firm is disqualified from appointment as auditor when a partner of the firm is indebted in excess of the prescribed limit. In both cases disqualification will apply because when a firm is appointed as an auditor, each partner is deemed to be so appointed and when a firm is indebted each partner is deemed to be indebted.

(d) There may also be situations in which, though the appointment is made in the individual name of a partner, the work is in fact carried out by the firm and the fees are credited to the account of the firm. In such situations, the firm will be deemed to be acting as auditor and the disqualification will be attracted in the case of indebtedness either of firm or a partner.

Section 226(3) has been amended by the Companies (Amendment) Act, 2000 whereby a person holding any security carrying voting rights after a period of one year from December 13, 2000 shall be disqualified from being appointed as auditor of the company. The aim of the provision is to curb possible insider trading on the part of auditors.

9.1.2 Difference between Partnership Audits and Company Audits

Before we take up the preliminaries before commencement of the audit of a company and the audit of share capital and divisible profits etc. let us understand the difference between the partnership audit and company audit.

The difference between the two types of audit is as follows:

Table 9.1: Difference between Company Audit and Partnership Audit

Company Audit	Partnership Audit
It is legally compulsory for every limited company to get its accounts audited every year.	It is not necessary for a firm to get its accounts audited
The purpose is to satisfy the information needs of the shareholders of the company on whose behalf audit is conducted.	It is mainly to avoid differences or disputes amongst the partners.
The Act defines the qualifications, disqualifications, duties, powers and process of appointment of auditor, His statutory powers cannot be limited or taken away by directors or shareholders	The firm may have its own decision in the appointment of auditor, and in determining his qualification, duties and powers.
The audit fee for the year must be shown in the Profit and Loss Account of the company	It is not essential for the firm to disclose the amount of audit fee paid to auditors.

Contd....

Notes

The Act guides the auditor in respect of the principles and processes of accounting to be followed by the company and the form of reporting to be adopted by him.	The auditor has to refer to the different clauses of the Partnership Deed with regard to the responsibility for maintaining accounts, methods of accounting, profit-sharing ratio of partners, terms of borrowing and the type of audit reporting relevant to the nature of the assignment.
It *is* statutory responsibility of a specified and definite nature	The responsibility of the auditor is flexible; he gets clear instructions from the firm with regard to the nature and extent of his work.
The audit assignment is only for verification of books of account and for and for auditor's report thereon	The audit assignment may include preparing books of account as well.

Self Assessment

State whether the following statements are True or False:

1. In a partnership audit it is necessary for a firm to get its accounts audited.
2. The audit fee for the year must be shown in the Profit and Loss Account of the company in case of company audit.
3. Company audit is statutory responsibility of a specified and definite nature.

9.2 Commencement of Audit

Commencement of audit of a company involves two stages:

1. When a new company comes into existence and the first auditor is appointed; and
2. When the company is already established, but a new auditor is appointed (i.e. the old auditor is substituted by a new auditor) for the subsequent audit of the company.

In the first case, the auditor of a new company has to be a little more careful in making himself conversant with the accounting system and the rules and regulations affecting the company.

In the second case, the new auditor has to follow the professional ethics of obtaining consent of the retiring auditor before accepting his appointment. Although the company is old, the auditor is new to that company. He should, therefore, exercise the same care as would have been necessary in the case of the first audit of the company.

Consideration required at the commencement of a new audit is:

1. to ensure that the company has followed the statutory provisions in regard to registration, incorporation, allotment and commencement of business;
2. to refer to the relevant regulations of the company, contained in its articles, memorandum or prospectus; and
3. to confirm that his appointment is in conformity with the Act and the Articles.

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9.2.1 Letter of Engagement

Once the appointment has been accepted, it is a normal practice to issue a letter of engagement to the company specifying the terms and conditions of the assignment. The auditor should incorporate in the letter the precise scope of work and nature of duties to be performed by him in the company.

Notes A letter of engagement is a confirmation of acceptance of offer made by the company.

The principal contents of a letter of engagement are:

1. The nature of the assignment in the case of a statutory audit, it highlights the requirements imposed by the Act which cannot be changed either by the company or auditor and the significance of the audit report;
2. the way the auditor would normally approach the job, including the assistance and cooperation which he expects from the company; and
3. the audit fees to be charged for the purpose.

A copy of the letter of engagement is also sent to the company for signature as an acknowledgement of agreement as to terms. It is then returned to the auditor for his records.

Task Prepare the format of letter of engagement.

9.2.2 Preliminaries

By now you must have seen that audit is a professional assignment which demands its own expertise. Preliminaries before commencement of the audit of a company need the following approaches:

1. 'Obtain a clearance from the previous auditor of the company whether there is-any professional reason why the audit should not be accepted — this being a professional etiquette.
2. Ensure that the appointment is in conformity with the provisions of the Act.
3. Consult the Articles and Memorandum of Association with special reference to the clauses affecting accounts and audit.
4. Outline the nature and scope of work and, duties and the time of completion of audit report.
5. Examine the system of accounting followed by the company and point out the weaknesses, if any.
6. Get a list of books maintained in the company, persons responsible for maintaining them and their specimen signatures.
7. Collect a list of officers of the company with their powers, duties and specimen signatures.
8. Familiarize with the technical knowledge about the company.
9. Enquire about the system of internal control in practice and evaluate its effectiveness.

Notes

10. Ask for a copy of the audited balance sheet and auditor's report of the company for the previous year.
11. Advise the company to complete the accounting records, balance the books prepare the final accounts, arrange the vouchers serially, and prepare schedules of different categories of debtors and creditors.
12. Identify the events and transactions likely to have a significant effect on the financial statements of the company.
13. Design the nature and extent of audit tests appropriate to the company.

Although the exact manner of conducting audit largely depends upon the size and nature of the company, a systematic approach is essential to achieve the audit objectives. Moreover, the different aspects of audit work are closely interrelated. Hence, it is useful to distinguish between the essential phases through which the audit work proceeds and progresses in the company.

9.2.3 Role of Company

At the time of commencement of audit, the company must also be ready to extend its cooperation to the auditor. Besides other arrangement, the company's approach to audit should be on the following lines:

1. Keep a correct record-of the day-to-day transactions of the business.
2. Maintain documentary and other, evidences in support of the transactions in proper sequence to facilitate their audit reference.
3. Obtain bank statements periodically and reconcile them with the cash records of the company.
4. Compile a list of debtors and creditors of different categories showing the amount in respect of each.
5. Record all important decisions pertaining to financial matters, preferably in the form of resolutions.
6. Arrange all relevant communications issued or received by the company affecting' accounting records.
7. Provide necessary information and explanations which may be required by the auditor in course of his preliminary evaluation.
8. Prepare supplementary statements or additional reports relating to significant transactions as a basis to information to the auditor.

Notes The effectiveness and promptness of audit is virtually a joint responsibility of the company and its auditor.

Their mutual cooperation and understanding, therefore, help the process of audit.

Self Assessment

Fill in the blanks:

4. A letter of engagement is a ..... of acceptance of offer made by the company.

Notes

5. A copy of the letter of engagement is also sent to the company for …….. as an acknowledgement of agreement as to terms.

9.3 Audit of Share Capital

The audit of share capital assumes significance particularly in, the first year itself since a company raises share capital immediately after incorporation and subsequently, in the later years when it decides to further raise its share capital. It the intervening years, the auditor may perform routine checks to verify authorized, issued and subscribed share capital.

An issue of share capital involves three stages, namely, the application stage, the allotment stage and the call stage. However, a company is also required to comply with a number of requirements before actually going for public subscription. In this context, the auditor should:

1. Study the conditions of issue contained in the Memorandum and Articles of Association, Prospectus or Statement in lieu of Prospectus, and examine whether all of them have fully been complied with.
2. Verify that the first allotment had not been made until the amount of minimum subscription stated in the Prospectus had been subscribed and that until then the amount received was kept deposited in a scheduled bank.
3. Confirm that the brokerage and underwriting commission had been paid only at the rates authorized by the prospectus or the Articles of Association.
4. Verify that preliminary contracts, if any, for purchase of a property or business, for creating an organization for management of the company, etc. had been carried out strictly according to the terms stated in the prospectus.
5. Ensure that the company intending to offer shares to the public for subscription by the, issue of a prospectus had, before such issue, made an application to one or more recognised stock exchanges for permission for the shares intending to be so offered within the stock exchanges or each exchange.
6. Confirm that the guidelines issued by the Securities and Exchange Board of India (SEBI) had been duly followed.

   Having taken the above steps, the auditor may specifically examine

   (i) Shares issued for cash and

   (ii) Shares issued for consideration other than cash, if any.

9.3.1 Shares Issued for Cash

As stated earlier, there are three stages in the issue of shares for cash viz., application stage, allotment stage and calls stage. Each stage has its own peculiarities and involves the following steps for their audit.

Application Stage

1. Check entries in the Application and Allotment Sheets with the original applications;
2. Check entries in the Application and the Allotment sheets as regards deposits of /honey, received with the applications, with those in the Cash Book;
3. Check that the application money was deposited 'in a scheduled bank till the grant of the 'Certificate to Commence Business';

Notes

4. Vouch amounts refunded to the unsuccessful applicants with copies of Letters of Regret;
5. Check the total columns in the Application and Allotment Sheets and confirm the journal entries; and
6. Examine that the issue is within the limits authorized by the Memorandum and Articles of Association.

Allotment Stage

1. Examine Director's Minutes Book to verify approval of allotments.
2. Compare copies of letters of allotment with entries in the Application and Allotment Book.
3. Trace entries in the Cash book and the Application and Allotment Sheets for the verification of amounts collected on allotment.
4. Check totals of amounts payable on allotment and verify the journal entries.
5. Examine whether relevant requirements of Reserve Bank of India have been complied with in case of allotment to non-residents.
6. Verify that the amount of the shares allotted do not exceed the authorized or nominal capital of the company.
7. Check that the return of allotment has been filed with the Registrar of Companies.

Calls Stage

1. Examine the Director's resolution making the call.
2. Vouch amounts received with the counterfoils of receipts.
3. Verify the journal entry, debiting the Call Account and crediting Share Capital with totals of the amounts due.
4. Compare the application and allotment books with the schedule of calls in arrears showing the difference between calls due and calls received.
5. Check the calls received in advance either in the cash book or through the journal are transferred to a separate account.

9.3.2 Shares Issued for Consideration other than Cash

Shares may also be issued for consideration other than cash. Such instances may arise where a company issues shares to vendors of business against purchase consideration; to promoters who have borne preliminary expenses, to underwriters against settlement of under-writing commission, etc. The audit procedure followed in this regard involves the following:

1. Examine the contract under which shares have been allotted for consideration other than cash. In case of purchase of property or business, the contract will show the amount of purchase consideration. In case shares have been issued as remuneration to underwriters for services rendered by them, the auditor should ascertain the terms and conditions of payment from the contract with them. Where shares have been issued to promoters, the contract with them should be examined to ascertain the nature of consideration.
2. Examine the prospectus for details as to the amount payable to vendors, underwriters and promoters, and the mode of payment.

Notes

3. Refer to Board of Directors' Minutes Book and check whether the resolution was passed by the directors for allotment of shares to vendors, underwriters, promoters, etc. Check the journal entries concerning the issue of shares for consideration other than cash.

Verify that a copy of the contract as required by Section 75(9)(b) of the Act has been filed with the Registrar of Companies within one month of the date of allotment and, in the absence thereof, a memorandum in writing stating particulars of the contract has been filed.

9.3.3 Shares Issued at a Premium

Where a company has issued shares at a premium, whether for cash or otherwise, Section 78 of the Act prescribes that a sum equal to the amount of the premium 'collected should be transferred to the Share Premium Account. As per Section 78 of the Act the auditor must also ensure that the amount of premium is utilized only for the specific purposes such as (a) issuing fully-paid bonus shares, to members of the company; (b) writing off the preliminary expenses or the commission paid or discount allowed on any issue of shares or debentures of the company, or (c) providing for the premium payable on the redemption of any redeemable preference shares or any debentures of the company.

9.3.4 Shares Issued at a Discount

A company may issue shares at a discount as per the following conditions specified in section 79 of the Act:

1. The issue should be authorized by an ordinary resolution of the company and sanctioned by the Company Law Board.
2. The maximum rate of discount should not exceed 10% unless the Company Law Board is of opinion that a higher rate of discount may be allowed under the special circumstances of the case.
3. The shares must be issued within two months of the sanction by the Company Law Board but not earlier than one year after the date of commencement of business.
4. The shares should be of a class already issued by the company.

It is the duty of the auditor to confirm that all the aforementioned conditions had been complied with by the company at the time the allotment was made. Normally, it is advisable to write-off the amount of such discount over a period 5 to 10 years.

Caution The amount of discount, until written off, should be shown separately in the Balance Sheet under the head "Miscellaneous Expenditure not written off".

Self Assessment

Fill in the blanks:

6. The auditor should confirm that the …… issued by the Securities and Exchange Board of India (SEBI) had been duly followed.
7. The auditor must verify that the amount of the …….. allotted do not exceed the authorized or nominal capital of the company.

Notes

9.4 Audit of Calls

In this regard, the auditor should also examine compliance with the provisions of the Articles of Association, and inspect Director's Minute Book, to ensure that the resolution states the time and place of payment, and see that the calls were made on a uniform basis as regard's all shares falling under the same, class. Then he may proceed at audit the calls in arrears and calls in advance.

9.4.1 Calls in Arrears

The sum of money still due from shareholders on account of calls made by the company is known as, calls-in-arrears. Audit procedure in this regard is as under:

1. Verify calls-in-arrears from the share register.
2. Verify the interest adjustment in case the Articles provide for a charge of interest on calls-in-arrears.
3. See that the amount of calls in arrears is properly shown on the liabilities side of the Balance sheet by deducting it from the amount of called-up capital.

Caution Ensure that the amount of calls due from directors should be separately shown in the Balance sheet.

9.4.2 Calls in Advance

A company may, if so authorized by its Articles of Association, accept from any member the whole or a part of the amount uncalled on any shares held by him as calls inadvance.

Did u know? The amount so received cannot be treated as part of the capital for purposes of any voting rights.

But according to Section 93 of the Act, a company may, if so authorized by its Articles, pay dividend in proportion to the amount paid up each share where a larger amount is paid up on some shares than on others.

Where the company does not exercise its right under Section 93, the shareholders have paid calls in advance shall be entitled to receive interest at the rate prescribed in the Articles of Association. Such interest is chargeable against profits but in case profits are not available for the purpose, it can be paid out of capital.

Example: In the case of winding up, repayment of calls in advance along with interest accrued thereon, will take precedence over return of capital.

Audit procedure in respect of calls in advance can be summarized as under:

1. Check the amount of calls in advance with entries in the Share Register and the Cash Book.
2. Ensure that calls in advance are shown separately in the Balance Sheet, and not shown as part of capital.

Notes

3. See that the shareholders concerned are paid interest on calls in advance at the rate specified in the Articles provided the Articles do not permit payment of dividend in respect thereof.

Self Assessment

State whether the following statements are True or False:

8. In view of the utility of auditing, it is essential for every form of business organization to get its accounts audited.
9. If a company is passing through a financial crisis, it need not get its accounts' audited for a few years.

9.5 Issue and Redemption of Preference Shares

Audit procedure to be followed in respect of issue of preference share is as under:

1. Examine whether the Articles of Association authorize for company to issue redeemable preference shares.
2. Check compliance with relevant legal provisions of the Companies Act, 1956 e.g., Section 80(5A) prohibits any company to issue any preference share which are irredeemable or redeemable after the expiry of a period of 20 years from the date of the issue.
3. Check whether the terms of redemption or conversion are stated in the balance sheet together with the earliest date of redemption or conversion.
4. Vouch receipt of moneys on the issue of preference shares.

9.5.1 Redemption of Preference Shares

In case of preference shares redeemed during the year, the audit procedure is as under:

1. Examine whether the redemption is in accordance with the relevant requirements of the Companies Act, 1956 and the terms of issue.
2. Verify the payment made to preference shareholders on redemption with reference to bank statement and receipts issued by the shareholders.
3. Confirm that the requirements of Section 80 of the Act as stated below have been complied with
   - (i) That the shares redeemed were fully paid up;
   - (ii) That the shares were redeemed out of profit, otherwise available for distribution as dividend, or out of proceeds of a fresh issue made for purpose of redemption;
   - (iii) That the premium, if any, on redemption was provided for either out of the Share Premium Account or out of divisible profits of the company; and
   - (iv) That if the shares were redeemed out of profits, otherwise available for dividend, an amount equal to nominal amount of shares redeemed has been transferred to the Capital Redemption Reserve Account.

Self Assessment

Fill in the blanks:

10. Examine whether the Articles of Association is in ……. for company to issue redeemable preference shares.

Notes

11. If there is any premium on ……. that was provided from either out of the Share Premium Account or out of divisible profits of the company.

9.6 Issue of Bonus Shares

A company, subject to certain conditions, may decide to capitalize its undistributed profits or reserves by issue of fully paid-up bonus shares. Audit procedure in this regard is as under:

1. Ascertain whether the articles of association permit capitalization of profits.
2. Inspect resolution passed by the board of directors and shareholders authorizing the issue of bonus shares.
3. Confirm that all statutory requirements relevant to the issue of shares have been complied with.
4. Ensure that SEBI Guidelines in respect of listed companies relating to issue of bonus shares have been complied with.
5. Examine the sources from which bonus shares have been issued i.e. general reserves, capital redemption reserve, share premium account, etc.

Notes It may be noted that bonus shares cannot be issued out of revaluation reserve.

9.6.1 Alteration of Share Capital

Section 94 of the Act empowers a company having share capital to alter its share capita by passing an ordinary resolution' without confirmation of the Court. Alteration of share capital may involve (i) increase of share capital by issuing new shares; (ii) consolidate and divide share capital into shares of larger amount; (iii) convert fully-paid up shares into stock or vice versa; (iv) sub-divide its shares into smaller amount; or (v) cancel its share capital not called up. Whatever the form the audit procedure to be followed is as under:

1. Verify that the alteration of capital is authorized by the Articles.
2. Inspect the minutes of the shareholders meeting authorizing the alteration.
3. Obtain allotment lists containing details of the new holdings of share or stock by each member and verify the same with the entries.
4. Inspect the directors' resolution with regard to allotment, consolidation, conversion or sub-division passed pursuant to the resolution of the members.
5. Examine the cancelled share certificates, if any, and tally the same with the counterfoils of new certificates issued;
6. See that the procedure, prescribed by the Articles in this regard, has been complied with;
7. Verify that the share capital account is correctly shown in the Balance Sheet;
8. Ensure that the necessary intimation has been sent to the Registrar of Companies.
9. Ensure that each alteration made should be noted in every copy of the Memorandum and Articles of Association issued subsequent to date of the alteration.

Notes

9.6.2 Reduction of Share Capital

Section 100 of the Act deals with the reduction of share capital and you know that it lays down quite a cumbersome procedure to be followed for the purpose. Its audit therefore has to be conducted very carefully which may involve the following:

1. Verify Shareholders' Minutes book that the necessary special resolution has been passed.
2. Confirm that the Articles of Association authorize reduction of share capital.
3. Examine the order of the Court confirming the reduction and ensure that copies of the court order and the relevant minutes have been filed with the Registrar of Companies.
4. Inspect the Registrar's Certificate in this regard.
5. Vouch the journal entries recorded to reduce the capital and to write down the assets by reference to the resolution of shareholders and other documentary evidence, and also ensure that the requirements of Part I of Schedule VI, to the Act have been complied with.
6. Confirm that the reduction in value of assets has been properly disclosed in the Balance Sheet.
7. Verify the adjustment made in the members' accounts in the Register of Members and confirm that either the paid up amount shown on the old share certificates have been duly altered or new certificates have been issued after cancelling the old ones.
8. Confirm that the words "and reduced", if required by the order of the Court, have been added to the name of the company in the Balance Sheet.
9. Verify that the Memorandum of Association of the company has been suitably altered.

Self Assessment

Fill in the blanks:

12. Alteration of share capital involves …….. fully-paid up shares into stock or vice versa.
13. Auditor should examine the cancelled share certificates and tally the same with the ……. of new certificates issued.

9.7 Issue of Share Certificates

Every company, within three months after the allotment and within two months after the application for registration of the transfer, must have ready for delivery the certificates of all shares, debentures and the debenture stock, allotted or transferred. Audit procedure in this regard is as under;

1. Check share certificate certifying that the allottee is the holder of the specified number of shares in the company.
2. Verify entries in the Register of members with the counterfoils of the share certificates.
3. Ensure that all the books and documents concerning the issue of share certificates are properly maintained and preserved and certificates surrendered to the company are duly defaced by the word "cancelled".

Notes

9.7.1 Issue of Share Warrants

A public company limited by shares may convert its fully-paid up shares into share warrant if the following conditions are satisfied:

1. The shares are fully paid up.
2. The Articles authorize the issue of share warrants.
3. Prior approval of the Central Government has been obtained.
4. The share warrants are issued under the common seal of the company.

A share warrant entitles the bearer to the shares specified therein, and it may be transferred merely by delivery of possession. The company may provide for payment of the future dividends on the share warrants, by attaching coupons for the dividend with the warrant itself. Dividend is then payable to the bearer of the coupon. Every-share warrant, in fact, is a negotiable instrument.

Caution Examine the Articles to ensure that the issue of share warrant is duly authorized therein.

Self Assessment

State whether the following statements are True or False:

14. A public company limited by shares may convert its fully-paid up shares into share warrant.
15. A share warrant entitles the bearer to the shares specified therein, and it may be transferred merely by delivery of possession.

9.8 Share Transfer Audit

Normally, audit of transfer of share is beyond the scope of independent financial audit. But, it is quite common that an auditor may be given a specific assignment to audit the transfer of shares to ensure that such transfers are being carried out properly. The audit procedure to be followed is as under:

1. Ascertain and evaluate internal control system relating to share transfers with particular reference to segregation of duties, maintenance of records, etc.
2. Ascertain whether notices were sent in every case to the transferors and, in case of joint-holders, to each of the holders and the objections, if any, raised by them were taken into consideration before the transfers were registered.
3. Verify that in case of partly paid shares, where the application for registration was made by the transferor, a notice has been sent to the transferee and the transfer registered only if the transferee does, not make any objection within two weeks from service of notice on him.
4. Scrutinize transfer deeds to ensure the following:
   (a) It is in the prescribed form.

Notes

(b) It bears stamp or other endorsement of the prescribed authority showing the date on which it was presented to such authority.

(c) It has been delivered to the company within the time-limits laid down in this behalf.

(d) It is accompanied by the related share certificates.

(e) Any correction, erasure, overwriting, or crossing out, is properly authenticated.

(f) Number of shares to be transferred is correctly stated in figures and in words.

(g) Amount of consideration is correctly stated in figures and in words.

(h) Particulars such as folio no., name of the transferor etc. as stated in the transfer deed tally with those in the register of members.

(i) Transferor's signature on the transfer deed tally with his specimen signature as per the company's records.

(j) If it is signed by an individual against whom insolvency proceedings are pending, it is duly certified and countersigned by the official assignee.

(k) If it is signed by or on behalf of a company against which the liquidation proceedings are pending, it is certified and counter-signed by the liquidator.

(l) Transferor's signatures are duly witnessed.

(m) It contains the requisite particulars of the transferee.

(n) If it is duly signed by the transferee.

5. Verify by reference to the Minutes Book of the Board of Directors that all the transfers recorded in the Transfers Journal have been approved by the Board.

6. Check the postings of distinctive numbers of shares transferred and the name of transferors and transferees into the Register of Members from the Share Transfer Journal.

7. Verify that every duplicate Shares Certificate in lieu of the one lost or destroyed has been issued under the consent of the Board and on the conditions prescribed by the Board as regards production of evidence or execution of a Bond of Indemnity.

9.8.1 Transmission of Shares

Sometime shares are transferred to another person by operation of law on account of death or insolvency of a shareholder. The auditor should:

(i) Ensure that the procedure prescribed by the Articles in this regard has been strictly followed.

(ii) Confirm that the documents testifying the authority of the legal representative have been properly verified.

(iii) Ascertain whether the order of the Court and other relevant documents have also been duly examined in the case of transmission of shares on insolvency.

(iv) Examine the relevant minutes of the meetings of the Board of Directors.

Notes

Caselet

Judicial Rulings on Ascertainment of Profits

The fact of the three cases given below should be studied carefully:

In Re. Spanish Prospecting Co. Ltd. (1911), the company had contracted to pay a certain salary to some of its staff subject to the condition that they shall not be entitled to draw their salary "except only out of profits" if any, arising from the business of the company. The salary was cumulative. Any arrears were to be payable out of future profits. The company dealt in shares and securities. The company went into liquidation and some of the securities held were sold by the liquidator. It was contended that the proceeds should be credited to the Profit and Loss Account (their book value was nil) in order to enable the staff to receive their arrears to salary. This contention was rejected at first but was upheld by the Court of Appeal. This case establishes the fundamental nature of profit (impliedly the economist's profit).

In Re. Crabtree Thomas vs. Crabtree (1912), the testator left his business to be carried on by trustees and to pay thereof to his wife while she lived and on her death, to a residuary legatee. The trustee charged in the accounts depreciation on machinery. It was contended on behalf of the life tenant that the profits before charging depreciation were paid to her. But it was ruled out on the ground that depreciation must be charged on the assets of a business to arrive at the amount of profit.

Edwards vs. Saunton Hotel Co. Ltd. (1942), a director of the company was to be paid by way of remuneration 20% of the profit "available" for distribution each year. It was held that depreciation on assets calculated on the straight line, method must be deducted from the surplus to arrive at the amount of profit, 20% whereof was payable to the director, but the income tax payable by the company was not to be deducted.

Source: http://www.archive.org/stream/practicalauditin00spicuoft/practicalauditin00spicuoft_djvu.txt

Self Assessment

Fill in the blanks:

16. The auditor needs to ensure that the procedure prescribed by the …….. regarding transmission of shares has been strictly followed.
17. The auditor must confirm that the …… testifying the authority of the legal representative have been properly verified.

9.9 Presentation and Disclosure of Share Capital

As per the established audit procedure, the auditor is also required to verify whether share capital has been properly presented in the financial statements. Compliance with the requirements of the Part I of Schedule VI to the Act required to be seen by auditor is given below:

1. Authorized share capital should be shown separately stating the class of shares, the number of shares and the face value, of each share.

Notes

2. Similarly, the number of shares issued and subscribed, and the face value of each share should be stated together with the amount called-up per share. While showing the issued and the subscribed capital, a distinction has be made again between the various classes of capital i.e., ordinary share capital and preference share capital, and if there are different classes of preference shares, their particulars should also be given.
3. In the case of redeemable preference shares, the terms of redemption or conversion should also be stated, together with the earliest date of redemption or conversion.
4. In case the company under audit is a subsidiary of another company, the number of shares held by the holding company as well as by the ultimate holding company and its subsidiaries should be separately stated in giving the particulars of the subscribed capital,
5. The number of shares allotted as fully paid-up pursuant to a contract, without payments being received in cash, and the number of shares allotted as fully paid-up bonus shares should also be stated. The source from which bonus shares are issued should also be specified.
6. If any calls are unpaid, the amount involved should be clearly stated, distinguishing between the calls unpaid by directors and those unpaid by others.
7. The amount originally paid-up on forfeited shares, not yet reissued, should be shown separately.
8. If there are any options on unlisted share capital, the particulars of the same should be given.

Example: If the foreign collaborators of a company are entitled to subscribe to a specified percentage of any further issue of share capital, the same should be stated.

9. The amount of share capital included in the total of the balance sheet is the amount of share capital called-up, minus calls unpaid plus the amount originally paid-up on forfeited shares.

Self Assessment

State whether the following statements are True or False:

18. In the case of redeemable preference shares, the terms of redemption or conversion should also be stated, together with the earliest date of redemption or conversion.
19. The amount originally paid-up on forfeited shares, not yet reissued, should be shown separately.
20. The source from which bonus shares are issued need not be specified in disclosure of share capital.

Case Study

South African Breweries Limited

SAB Ltd. (South African Breweries Limited), is a division of SAB plc, manufactures and distributes beer and non-alcoholic beverages in Europe, Asia and Africa. More than 200 of the organisation's 7,000 employees work in the information systems field. After learning about COBIT (Control Objectives for Information and related

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Notes

Technology) from the Gartner Group, SAB Ltd. used COBIT to develop an IT and enterprise architecture strategy document. The SAB Ltd. approach fostered partnering opportunities between IS audit and the IT community. The IS audit team implemented value-added components to the reviews, which allowed a more rigorous interpretation of IT risk. Once the business benefits of COBIT were communicated, senior business executives realised the framework could help determine accountability for processes and improve IT governance. By using the framework as the basis for an accountability matrix, SAB Ltd. began achieving a role-based IT organisation with defined process measures to ensure customer value.

Background

SAB Ltd. (South African Breweries Limited) is a division of SAB plc, which has more than 34,000 employees working for 70 breweries in 21 countries, as well as substantial hotel and gaming interests in Southern Africa. SAB plc was first registered in London in 1895 as SAB Limited. It was registered on the Johannesburg Stock Exchange in 1897 as the first industrial share. Since then it has grown to manufacture and distribute beer and non-alcoholic beverages in Europe, Asia and Africa.

SAB Ltd. generates 53 percent of the SAB plc operating profit and employs 6,500 full-time and 500 part-time employees. More than 200 of these employees work in the information systems field.

Process

SAB Ltd. first heard about Control Objectives for Information and related Technology (COBIT) through the ISACA web site (www.isaca.org) and soon after used COBIT when developing the SAB Ltd. IT/enterprise architecture strategy document. Gartner Group research was used extensively in the development of this document. After thoroughly researching COBIT's methodology to improve IT governance at SAB Ltd., Stuart MacGregor, then manager of SAB Ltd's Information Resource Management (IRM) team, was invited to Chicago, IL, USA to participate in ISACA's development of the COBIT.

SAB Ltd. began its implementation by developing a COBIT questionnaire that assessed the IT management team's perception of IT process effectiveness, risk and the relative priority for improvement. This approach increased the IT organisation's readiness to adopt COBIT as its primary IT governance tool.

SAB Ltd. then used several techniques to gain senior management support for adopting COBIT. Presentations were given to groups including regional IT managers, the IT steering committee and IT managers. Pre-presentation reading, such as the COBIT Executive Summary, was distributed widely throughout the business and IT departments.

Although there was early resistance to the COBIT framework, the education campaign fostered a critical mass and resulted in strong support from the IT management team, which recognized that the COBIT framework could assist in assigning accountability for processes and improving governance within the IT organisation. SAB Ltd. then used the framework as the basis for an accountability matrix. The strategy was to move toward a role-based IT organisation with defined process measures to ensure customer value.

Using COBIT as a resource, SAB Ltd. developed an IT and enterprise architecture strategy document. This document served to further increase awareness of COBIT's benefits among SAB Ltd.'s IT and business communities. For each of the 34 COBIT processes, the development team documented the SAB Ltd.:

- Target environment

Contd....

Notes

- Business objectives
- IT portfolio services or deliverables from the IT process
- Current situation analysis
- Strategy and action items required to move from the current situation to the desired situation.

At this point, PricewaterhouseCoopers (PwC) added its capabilities to the implementation process. Together with PwC, SAB modelled COBIT IT processes using the ARIS (Architecture of Integrated Information Systems) business process modelling tool set. Additional best practice information was obtained from the IT Infrastructure Library (ITIL) and the BS7799 standard. Content from BS7799 was captured into ARIS and linked to COBIT processes. The models were designed to answer the six interrogatives of what, how, where, when, who and why from different perspectives.

The SAB Ltd. team used portions of the COBIT 3rd Edition draft version to develop an IT customer satisfaction survey. The survey applied balanced scorecard concepts developed by Robert S. Kaplan and David P. Norton, and was sent to the SAB Ltd. board of directors, general managers, heads of departments and regional executives. Several factors contributed to the positive feedback and high response level of this survey, including the web-based approach to collect the survey responses, the questionnaire design and the statistical processing of the survey results.

Next, SAB Ltd. deployed an intranet COBIT web site that included the draft Management Guidelines IT process maturity models and eventually the final 3rd edition release. The intranet site includes the ARIS process models of the COBIT IT processes and the ability to assess current and desired IT process capability maturity. It also provides easy access to the COBIT open standard content and has received positive reviews from the SAB Ltd. IT community.

The SAB Ltd. IT departments use the COBIT intranet site to gain a detailed understanding of the COBIT processes and control objectives. This is especially useful when they are in the process of answering PwC's Tr-ICS (Technology Related In-Control Services) questionnaires. Tr-ICS is a simplified and practical risk analysis methodology which borrows from SPRINT (Simplified Process for Risk Identification), a risk analysis methodology developed by the Information Security Forum (ISF). IT risk is assessed for each COBIT IT process, with specific questions derived from 302 high-level control objectives.

SAB Ltd. extended the Tr-ICS tool to enable intranet based scoring and management of the review, to support, for example, assigning the questionnaires, tracking the progress, and storing and processing the results. In essence, there is a Tr-ICS question for each COBIT control objective. Coupling Tr-ICS reviews with the easy intranet access to control objectives and the COBIT 3rd Edition content has resulted in an overall improvement in corporate-wide understanding and appreciation for IT governance.

This implementation approach also is a good example of partnering opportunities between IS audit and the IT community. The IS audit team has implemented value-added components to the reviews, which resulted in a change of focus that allows a more rigorous interpretation of IT risk. As of the development of this case study, eight reviews were successfully performed and results were published by IS audit on the SAB Ltd. intranet.

Mr. Macgregor was then selected as a core member of the team that developed the SAB plc global IT strategy. In addition to providing a framework for IT control, COBIT's process

Contd....

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maturity models were used extensively in the definition of the SAB plc global IT strategy to:

- Assess IT process capability maturity (actual and desired) for South Africa, Africa and Europe IT departments.
- Identify the steps or actions required to improve IT process capability maturity.
- Identify and understand areas of knowledge sharing across the group.
- Facilitate IT organisational design, e.g., determine the level of process consolidation and level of consistency for COBIT processes on a global, regional and local basis.
- Define IT services based on COBIT IT processes.
- Identify the key headlines, or what should be the focus, to support the business in achieving desired capabilities. This was essential in establishing business and IT alignment.

Conclusion

The SAB Ltd. team found that the extensive education campaign, supported by pre-reading materials and presentations prior to implementation, greatly increased awareness and support of COBIT among SAB Ltd's IT and business communities. Once the overall business benefits of COBIT were communicated, senior business executives realised the framework could help determine accountability for processes and improve IT governance. By using the framework as the basis for an accountability matrix, SAB Ltd. began achieving a role-based IT organisation with defined process measures to ensure customer value.

Question:

Analyse the case and write down the case facts.

Source: http://www.isaca.org/Knowledge-Center/cobit/Pages/South-African-Breweries-Limited.aspx

9.10 Summary

- The audit of a company differs from the audit of a partnership in various ways and involves many preliminaries.
- The auditor has to (a) make sure that his appointment is in order, (b) obtain a letter of engagement, and (c) acquaint himself with articles and memorandum of association, the scope of work, the system of accounting and internal control, etc. For the whole audit assignment he must follow the normal procedure of audit, the relevant statutory provisions and the guidelines of auditing standards.
- Audit of share capital assumes significance at the time of incorporation of the company as well as subsequently when fresh share capital is issued.
- Audit of share capital should be conducted at three stages viz, application stage, allotment stage and call stage. The auditor must ensure that in case of shares issued for cash, bash has actually been received.
- In case of shares issued for consideration other than cash the relevant contract may be examined. If the shares had been issued at a premium or at a discount, the auditor should examine compliance with all legal requirements and proper disclosure in the financial statements.

Notes

- The audit of calls on shares requires examination of calls-in-arrears and calls received in advance. In case some shareholders fail to pay money due on calls, companies may be forced to forfeit shares and reissue the same.
- Redemption of preference shares can be made either out of fresh issue of shares or out of profits. An equivalent amount should be transferred to capital redemption reserve account in case these are redeemed out of distributable profits.
- If bonus shares have been issued, the auditor is required to check compliance with all statutory and other procedural requirements in this regard.
- A company may after its share capital in various ways. The auditor has to ensure that necessary procedure, has been followed for the purpose and alterations are duly reflected in all the relevant documents and records.
- Finally, audit of share transfers does not form part of normal audit work but companies get audited transfer of shares on a regular basis to ensure accuracy of the share transfers.

9.11 Keywords

Authorised Share Capital: The number and par value, of each class of shares that an enterprise may issue in accordance with its instrument of incorporation. This is sometimes referred to as nominal share capital.

Bonus Shares: Shares allotted by capitalization of the reserves or surplus of a corporate enterprise.

Call: A demand pursuant to terms of issue to pay a part or whole of the balance remaining payable on shares or debentures after allotment.

Called-up Share Capital: The part of the subscribed share capital which shareholders have been required to pay.

Capital Redemption Reserve: A reserve created for the redemption of preference shares out of its distributable profits.

Issued Share Capital: Portion of the authorized share capital which has actually been offered for subscription is known as issued share capital. It includes any bonus shares allotted by the corporate enterprise.

Paid-up Share Capital: That part of the subscribed share capital for which consideration in cash or otherwise has been received. This includes bonus shares allotted by the corporate enterprise.

Preliminary Expenses: Expenses relating to the formation of an enterprise. These include legal, accounting and share issue expenses incurred for formation of the enterprise.

Reduction of Share Capital: The extinguishment or reduction of shareholders' liability on in respect of the subscribed share capital.

Share Capital: Aggregate amount of money paid or credited as paid on the shares and/ or stocks of a corporate enterprise.

Share Issued for Consideration other than Cash: The shares issued to vendors as consideration for the assets acquired from them.

Subscribed Share Capital: Portion of the issued share capital which has actually been subscribed and allotted is known as subscribed capital. It includes any bonus shares allotted by the corporate enterprise.

Unissued Share Capital: That portion of the authorized share capital for which shares have not been offered for subscription.

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9.12 Review Questions

1. Distinguish between audit of a firm and the audit of a limited company.
2. Discuss the preliminaries before commencement of the audit of a company.
3. State briefly the procedure for checking the share capital of a newly started company in the first year of its existence.
4. What are the duties of an auditor of a company in regard to:
   (i) Issue of shares at a premium?
   (ii) Issue of shares at a discount?
5. List the conditions under which a company may reduce its share capital.
6. State the purposes for which share premium can be utilized.
7. What is the procedure of transfer of shares from one person to another person by operation of law on account of death or insolvency of a shareholder?
8. What is the procedure followed by an auditor to verify whether share capital has been properly presented in the financial statements or not?
9. What are the steps undertaken for the alteration of share capital?
10. Briefly describe calls in arrears and calls in advance.

Answers: Self Assessment

1.	False	2.	True
3.	True	4.	Confirmation
5.	Signature	6.	Guidelines
7.	Shares	8.	False
9.	False	10.	Accordance
11.	Redemption	12.	Converting
13.	Counterfoils	14.	True
15.	True	16.	Articles
17.	Documents	18.	True
19.	True	20.	False

9.13 Further Readings

Books

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

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

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

Notes

Jeanette Franzel (2009). *Single Audit: Opportunities Exist to Improve the Single Audit Process and Oversight*, DIANE Publishing.

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

Online links

http://www.blog.kpoweb.com/32/audit-of-a-share-capital/

http://www.caclubindia.com/articles/transfer-of-shares-procedural-analysis-4692.asp#.UTR0LaL-LfI

http://www.dummies.com/how-to/content/auditing-basics-how-to-prepare-an-engagement-lette.html

http://www.shareyouressays.com/92964/what-is-the-procedure-of-share-transfer-audit

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Unit 10: Government and Independent Financial Audit: Comparison

CONTENTS

Objectives

After studying this unit, you will be able to:

- Define government auditing and its importance.
- Understand the audit of government companies.
- Differentiate between government financial audit and independent financial audit.

Introduction

Each year, the government awards billions of dollars in grants, loans, loan guarantees, property, cooperative agreements, interest subsidies, insurance, food commodities, and direct appropriations and federal cost reimbursements which are subject to audit requirements. The Indian Audit and Accounts Department, functioning under the Comptroller and Auditor General, derives its authority and the powers for performance of its duties on his or her behalf under the

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provisions of Section of 21 of the CAG's DPC Act, 1971. Under the directions given by the Comptroller and Auditor General of India, the Accountants General and other offices and establishments of the Indian Audit and Accounts Department perform such duties and functions as are imposed on or undertaken by the CAG under the provisions of the Constitution of India, or of any law made by Parliament.

10.1 Government Auditing: An Introduction

Audit forms an indispensable part of the financial administration and is one of the important organs necessary to ensure the sound functioning of a Parliamentary Democracy. It is the main instrument to secure accountability of the Executive to the Legislature. Audit assists Parliament/ Legislature in exercising its financial control over the Executive, to ensure that funds voted by the Parliament/Legislature have been utilized for the purpose intended and the funds authorized to be raised through taxation and other measures have been assessed, collected and credited to the Government properly.

The primary function of audit is to verify the accuracy and completeness of accounts to secure that all revenue and receipts collected are brought to account under the proper head, that all expenditure and disbursements are authorized, vouched and correctly classified and the final account represents a complete and a true statement of the financial transactions it purports to exhibit. It is the function of audit to verify that financial rules and orders satisfy the provisions of Law and or otherwise free audit objections and the rules & orders are properly applied.

10.1.1 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.

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.

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8. To facilitate for estimating the annual budget by providing historical financial data of government revenues and expenditures.

10.1.2 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.

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.

Self Assessment

Fill in the blanks:

1. The Indian Audit and Accounts Department functions under the ……
2. …….. forms an indispensable part of the financial administration.
3. …….. aims to ensure accountability of the executive in respect of public revenue and expenditure.
4. Initially government auditing in India is primarily …… oriented.

10.2 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 fit. Such comments or supplementary report shall be placed before the annual general meeting along with the audit report.

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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 619B 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.

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 maybe ought to 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.

Self Assessment

Fill in the blanks:

5. The auditor of a Government Company shall be appointed or reappointed by the Central Government on the advice of the …….. of India.
6. The annual report on the working and affairs of the company shall be prepared within ……. months of the annual general meeting.
7. The ……. Act, 1974 has enlarged the concept of Government Company for the purposes of audit.

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10.3 Government Auditing Standards

Auditing is essential to government accountability to the public. Audits and attestation engagements provide an independent, objective, non-partisan assessment of the stewardship, performance, or cost of government policies, programs, or operations, depending upon the type and scope of the audit. For financial audits, certain standards of the Auditing Standards Board (ASB) that affect Government Auditing Standards become effective prior to these dates.

10.3.1 Use and Application of GAGAS

The professional standards and guidance contained in this document, commonly referred to as Generally Accepted Government Auditing Standards (GAGAS), provide a framework for conducting high quality government audits and attestation engagements with competence, integrity, objectivity, and independence. These standards are for use by auditors of government entities and entities that receive government awards and audit organizations performing GAGAS audits and attestation engagements. GAGAS contain requirements and guidance dealing with ethics, independence, auditors' professional competence and judgment, quality control, the performance of field work, and reporting. Audits and attestation engagements performed under GAGAS provide information used for oversight, accountability, and improvements of government programs and operations. GAGAS contain requirements and guidance to assist auditors in objectively acquiring and evaluating sufficient, appropriate evidence and reporting the results. When auditors perform their work in this manner and comply with GAGAS in reporting the results, their work can lead to improved government management, better decision making and oversight, effective and efficient operations, and accountability for resources and results.

Laws, regulations, contracts, grant agreements, or policies frequently require audits in accordance with GAGAS. Many auditors and audit organizations also voluntarily choose to perform their work in accordance with GAGAS. The requirements and guidance in this document apply to audits and attestation engagements of government entities, programs, activities, and functions, and of government assistance administered by contractors, non-profit entities, and other nongovernmental entities when the use of GAGAS is required or is voluntarily followed.

Did u know? GAGAS use two categories of professional requirements, identified by specific terms, to describe the degree of responsibility they impose on auditors and audit organizations, as follows:

(a) ***Unconditional requirements:*** Auditors and audit organizations are required to comply with an unconditional requirement in all cases in which the circumstances exist to which the unconditional requirement applies. GAGAS use the words must or is required to specify an unconditional requirement.

(b) ***Presumptively mandatory requirements:*** Auditors and audit organizations are also required to comply with a presumptively mandatory requirement in all cases in which the circumstances exist to which the presumptively mandatory requirement applies; however, in rare circumstances, auditors and audit organizations may depart from a presumptively mandatory requirement provided they document their justification for the departure and how the alternative procedures performed in the circumstances were sufficient to achieve the objectives of the presumptively mandatory requirement. GAGAS use the word should to specify a presumptively mandatory requirement.

Notes

10.3.2 Ethical Principles in Government Auditing

Because auditing is essential to government accountability to the public, the public expects audit organizations and auditors who conduct their work in accordance with Generally Accepted Government Auditing Standards (GAGAS) to follow ethical principles. Management of the audit organization sets the tone for ethical behaviour throughout the organization by maintaining an ethical culture, clearly communicating acceptable behaviour and expectations to each employee, and creating an environment that reinforces and encourages ethical behaviour throughout all levels of the organization. The ethical tone maintained and demonstrated by management and staff is an essential element of a positive ethical environment for the audit organization. The ethical principles presented in this unit provide the foundation, discipline, and structure as well as the climate which influence the application of GAGAS. Because the information presented in this unit deals with fundamental principles rather than specific requirements, this unit does not contain additional requirements.

Conducting audit work in accordance with ethical principles is a matter of personal and organizational responsibility. Ethical principles apply in preserving auditor independence, taking on only work that the auditor is competent to perform, performing high-quality work, and following the applicable standards cited in the audit report. Integrity and objectivity are maintained when auditors perform their work and make decisions that are consistent with the broader interest of those relying on the auditors' report, including the public.

Example: Individual auditors who are members of professional organizations or are licensed or certified professionals may also be subject to ethical requirements of those professional organizations or licensing bodies.

Notes The ethical principles contained in the following sections provide the overall framework for application of GAGAS, including general standards, field work standards, and reporting standards. Each principle is described, rather than set forth as a series of requirements, so that auditors can consider the facts and circumstances of each situation within the framework of these ethical principles. Other ethical requirements or codes of professional conduct may also be applicable to auditors who conduct audits in accordance with GAGAS.

The ethical principles that guide the work of auditors who conduct audits in accordance with GAGAS are:

1. the public interest;
2. integrity;
3. objectivity;
4. proper use of government information, resources, and position; and
5. professional behaviour.

Self Assessment

Fill in the blanks:

8. …… is essential to government accountability to the public.

Notes

9. Conducting audit work in accordance with …….. is a matter of personal and organizational responsibility.

10.4 Government Financial Audit

A Government Financial Audit, or more accurately, an audit of financial statements, is the verification of the financial statements of a legal entity, with a view to express an audit opinion. The audit opinion is intended to provide reasonable assurance, but not absolute assurance, that the financial statements are presented fairly, in all material respects, and/or give a true and fair view in accordance with the financial reporting framework. The purpose of an audit is provide and objective independent examination of the financial statements, which increases the value and credibility of the financial statements produced by management, thus increase user confidence in the financial statement, reduce investor risk and consequently reduce the cost of capital of the preparer of the financial statements.

The government spends a lot of public money every year, so it must find a way to ensure responsible and honest use of public resources. Financial audit of a government agency that uses public resources accomplishes this goal. Such audits assess whether the information in the agency's financial records is fairly presented.

10.4.1 Field Work Standards for Government Financial Audits

The GAGAS also sets the approach that auditors must follow. These standards are typical around the globe. Auditors must plan their work to meet audit objectives and also must document their planning. GAGAS also requires that auditors set significance or immateriality levels to decide the scope and extent of their audit work. This should be done in conjunction with audit risk perceptions. Auditors must have sufficient and appropriate audit evidence to provide opinions and reasonable assurance that the audit evidence supports the findings.

For financial audits, GAGAS incorporate the AICPA field work and reporting standards and the related Statements on Auditing Standards (SAS) unless specifically excluded or modified by GAGAS. Under AICPA standards and GAGAS, auditors must plan and perform the audit to obtain sufficient appropriate audit evidence so that audit risk will be limited to a low level that is, in their professional judgment, appropriate for expressing an opinion on the financial statements. The high, but not absolute, level of assurance that is intended to be obtained by auditors is expressed in the auditor's report as obtaining reasonable assurance about whether the financial statements are free of material misstatement (whether caused by error or fraud). Absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud. Therefore, an audit conducted in accordance with generally accepted auditing standards may not detect a material misstatement.

The three AICPA generally accepted standards of field work are as follows:

1. The auditor must adequately plan the work and must properly supervise any assistants.
2. The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.
3. The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.

Notes

GAGAS establish field work standards for financial audits in addition to the requirements contained in the AICPA standards. Auditors should comply with these additional standards when citing GAGAS in their audit reports. The additional government auditing standards relate to:

1. auditor communication during planning;
2. previous audits and attestation engagements;
3. detecting material misstatements resulting from violations of provisions of contracts or grant agreements, or from abuse;
4. developing elements of a finding; and
5. audit documentation.

Notes Under AICPA standards and GAGAS, auditors should communicate with the audited entity their understanding of the services to be performed for each engagement and document that understanding through a written communication. GAGAS broaden the parties included in the communication and the items for the auditors to communicate.

10.4.2 Reporting Standards for Government Financial Audits

The GAGAS includes all of the auditing standards established by the American Institute of Certified Public Accountants, as well as additional standards for conducting financial audits. The communication and previous audit standards provide guidance for the pre-audit stage, while the standards of non-compliance with regulations, developing elements of findings of the engagement and audit documentation provide guidance for the actual audit. The GAGAS also follows the AICPA standards in the reporting area and imposes additional standards. Auditors must report on the internal control and compliance with provisions of the law and must report any deficiencies in internal control and compliance. Additionally, auditors must report on the views of responsible officers and confidential information.

For financial audits, GAGAS incorporate the American Institute of Certified Public Accountants (AICPA) field work and reporting standards and the related statements on auditing standards (SAS) unless specifically excluded or modified by GAGAS.

AICPA Reporting Standards

The four AICPA generally accepted standards of reporting are as follows:

1. The auditor must state in the auditor's report whether the financial statements are presented in accordance with Generally Accepted Accounting Principles (GAAP).
2. The auditor must identify in the auditor's report those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
3. When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor's report.
4. The auditor must either express an opinion regarding the financial statements, taken as a whole, or state that an opinion cannot be expressed, in the auditor's report. When the auditor cannot express an overall opinion, the auditor should state the reasons therefore in the auditor's report. In all cases where an auditor's name is associated with financial

Notes

statements, the auditor should clearly indicate the character of the auditor's work, if any, and the degree of responsibility the auditor is taking in the auditor's report.

GAGAS establish reporting standards for financial audits in addition to the standards contained in the AICPA standards. Auditors should comply with these additional standards when citing GAGAS in their audit reports. The additional government auditing standards relate to:

1. reporting auditors' compliance with GAGAS;
2. reporting on internal control and compliance with laws, regulations, and provisions of contracts or grant agreements;
3. reporting deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse;
4. communicating significant matters in the auditors' report;
5. reporting on the restatement of previously-issued financial statements;
6. reporting views of responsible officials;
7. reporting confidential or sensitive information; and
8. distributing reports.

Caution When providing an opinion or a disclaimer on financial statements, auditors must also report on internal control over financial reporting and on compliance with laws, regulations, and provisions of contracts or grant agreements.

Self Assessment

Fill in the blanks:

10. A ……. is the verification of the financial statements of a legal entity, with a view to express an audit opinion.
11. …… is not attainable because of the nature of audit evidence and the characteristics of fraud.
12. GAGAS establish reporting standards for financial audits in addition to the standards contained in the ……. standards.

10.5 Independent Financial Audit

The independent financial audit is a complex of necessary and mutually connected procedures, determined in the International Audit Standards, on the basis of which an independent opinion is expressed with regard to the credibility in all aspects of materiality of the financial accounts, prepared in compliance with the Bulgarian accounting legislation. The independent financial audit is performed by statutory auditors, members of the Institute of Certified Expert – Accountants. The statutory auditors and the Institute of Certified Expert Accountants are subject to independent public oversight.

This Act regulates:

1. The objective and principles of the independent financial audit;
2. The professional standards of organization, documentation and execution, as well as conclusions of the independent financial audit;

Notes

3. The acquisition of diploma, license and practice of the audit profession by the statutory auditors;
4. The rights and obligations of the statutory auditors conducting independent financial audit;
5. The status of the Institute of Certified Expert Accountants;
6. The system for public oversight of the statutory auditors.

10.5.1 Objectives and Principles of the Independent Financial Audit

Following are the objectives and principles of the Independent Financial Audit:

1. The objective of the independent financial audit is the expression of independent audit opinion regarding the credible presentation on all aspects of materiality in the financial accounts of:
   - the financial condition of the undertaking;
   - the reported financial result of the activities of the undertaking;
   - the cash flows of the undertaking and changes in them;
   - the own capital of the undertaking and changes in it.
2. The independent audit opinion under par. 1 is expressed with regard to the compatibility of the financial accounts with the applicable accounting standards, as well as with any other nationally adopted accounting base for preparation of financial accounts.
3. Formation and expression of the independent audit opinion are conducted in compliance with the International auditing standards.

   The independent financial audit covers procedures for determination of reasonable security through inspection of:
   - The observance of the accounting principles;
   - The consistency in implementation of the announced accounting policy;
   - The methodological soundness of the current reporting for comprehensive and credible reflection of assets, liabilities and the activity of the undertaking, limited to achievement of the audit's objectives;
   - The effectiveness of the internal control limited to achievement of the audit's objectives;
   - The process of financial clearance;
   - The credibility and comprehensiveness of the information presented in the financial accounts, necessary for the users;
   - Compatibility between the information in the financial accounts, the information in the activity report and any other information, which the management bodies of the undertaking submit along with the audited account.

While performing independent financial audit the statutory auditors observe the Code of Ethics for Professional Accountants, adopted by the International Federation of Accountants. The ethical principles guiding the professional behaviour and responsibilities of the auditors are:

1. ***Independence -*** the statutory auditors are not affiliated, including through their partners and personnel, with the inspected undertaking, its managers or persons related to them in material, personal or any other aspect;

Notes

2. ***Objectivity, impartiality, prevention of any bias***, conflict of interests or other influence, which may impede the realistic assessment of the auditor;
3. ***Professional competence –*** maintenance of sufficient necessary professional knowledge in the sphere of commerce, accounting and tax legislation, International Accounting Standards and International auditing standards, which are in force;
4. ***Confidentiality –*** protection of confidentiality of information on the activities of the client undertaking, received as a result of the independent financial audit;
5. ***Professional behaviour –*** every auditor performs his/her professional work in a manner corresponding to the good name of the audit profession and refrains from actions which would impede the reputation of the profession;
6. ***Integrity –*** the auditor is honest, straightforward and objective while conducting the audit;
7. ***Knowledge and implementation of professional standards –*** the auditor performs the independent financial audit in compliance with the adopted professional standards and the national legislation;
8. ***Responsibility –*** the statutory auditor is personally responsible for the opinion expressed; a specialized audit firm is responsible for the audit opinion expressed on its behalf.

Caselet

Magyar Telekom Telecommunications Public Limited Company

In Y2011, the Audit Committee of Magyar Telekom Plc. (the "Company") has performed its work in accordance with the Articles of Association of the Company and the Rules of Procedure of the Audit Committee, based on its accepted Working Schedule, and in case of the occurrence of an extraordinary case, with a focus on its review without delay and on the interest of making the appropriate decision. In Y2011, the Audit Committee held meetings on 7 occasions, and furthermore, it made resolutions without holding a meeting, via written (fax) voting on 13 occasions. The Audit Committee kept in continuous contact with the Chief Financial Officer, the Chief Legal and Corporate Affairs Officer (chief legal counsel) of the Company, the Head of Internal Audit, the Group Compliance Officer, and the independent external auditor. The Audit Committee, in accordance with its purpose, oversaw the integrity of the Company's financial statements, the Company's compliance with legal and regulatory requirements falling within the scope of authorities and responsibilities of the Audit Committee, the qualifications and independence of the Company's independent external auditor and the performance of the Company's internal audit function and independent external auditor. In the course of overseeing the work and performance of the independent external auditor, the Audit Committee reviewed and evaluated the Management Letter, and regularly monitored the services provided by the independent external auditor and their fees. The independent external auditor, with the general or specific pre-approval of the Audit Committee, provided audit and audit-related, and various other services, salary and benefits survey and training services for the Company in 2011. The Audit Committee reviewed the 2011 consolidated annual financial statements prescribed by the Accounting Act according to the requirements of the International Financial Reporting Standards (IFRS) as endorsed by the EU to be submitted to the General Meeting by the Board of Directors, the proposal of the Board of Directors for their acceptance, and listened to the relevant report of the independent external auditor.

Source: http://www.telekom.hu/static/sw/download/20120323_AC_jelentes_ENG.pdf

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10.5.2 Organization, Documentation and Conclusions of the Independent Financial Audit

The independent financial audit is performed on the basis of contract between the trustee undertaking and the statutory auditor as a natural person, or through the undertaking of the auditor, or the specialized audit firm by identifying the statutory auditor responsible for the independent financial audit. Statutory auditors with whom a contract for independent financial audit is signed may be dismissed only if appropriate reasons exist. Difference in opinions with regard to the accounting treatment or the audit procedures are not appropriate grounds for dismissal. The audited trustee-undertaking and the statutory auditor notify within one month the Commission for Public Oversight of the Statutory Auditors for the dismissal or resignation of the statutory auditor, submitting as well the reasons for that action.

The acceptance of obligation for performance of independent financial audit is documented with a letter of acceptance of audit engagement. The content of the letter is determined under the International auditing standards. The documentation of the independent financial audit and the procedures on its implementation are performed in compliance with the requirements of the legislation in force and the International auditing standards. The management of the undertaking presents to the statutory auditor the financial account prepared by it, ready for issuance of an audit report. The financial account is presented together with the report on the activity and any other information, which the management bodies submit together with the audited account, as well as a confirmation or representation letter signed by the management in compliance with the International auditing standards.

1. The conclusions of the statutory auditor after the independent financial audit are reflected in the audit report.
2. The audit reports are prepared in compliance with the International auditing standards.
3. (Repeal, SG No. 54/2010)
4. The audit report must contain clearly expressed opinion on the audited financial accounts as a whole.
5. The opinion expressed on the financial account is verified by the:
   (a) Statutory auditor, if the audit report is issued personally by the auditor – with signature and seal of the auditor;
   (b) Specialized audit firm, if the audit report is issued on its behalf – with the signature of the person representing the firm, with the seal of the specialized audit firm, and with the personal signature of the statutory auditor, responsible for the audit.
6. The signature and seal are affixed on the audit report and the accounting balance, expense and income statement/income statement, and the own capital statement, for which the independent audit opinion has been expressed.

The seal of the statutory auditor has an ellipsoid form. The name, family name and the number of the statutory auditor in the register of the statutory auditors of the Institute of Certified Expert – Accountants, are written on the seal. The specialized audit firm uses for the purposes of audit a seal with an ellipsoid form. The following is written on the seal: "specialized audit firm", the company name and registered office, and the number in the register of the statutory auditors of the Institute of Certified Expert Accountants. The personal seal of the statutory auditor and the seal of the specialized audit firm are used for verification of the audit of the financial accounts and in other cases envisaged by the law.

Self Assessment

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Fill in the blanks:

13. Formation and expression of the independent audit opinion are conducted in compliance with the …….. .
14. Statutory auditors with whom a contract for independent financial audit is signed may be dismissed only if …… exist.
15. The acceptance of obligation for performance of independent financial audit is documented with a …….. of audit engagement.
16. The seal of the …….. has an ellipsoid form.

Case Study

COBIT- Government of Dubai Financial Audit Department

The Financial Audit Department (FAD) is the supreme audit institution of Dubai. This office is headed by a Director General and reports to the Ruler of Dubai.

The FAD was established by the law No (1) of 1995 issued by His Highness the Ruler of Dubai on 29 January 1995 and was subsequently amended by the Law No (5) of 2000. Subsequent amendment by Law No. (3) of 2007 made FAD further independent, by empowering a direct reporting channel to His Highness the Ruler of Dubai.

The audit jurisdiction of FAD covers all government departments, public corporations, companies in which the Government shareholding is above 25 percent, organizations for which the Government provides a financial subsidy, and/or any other body where an audit is commissioned by His Highness the Ruler of Dubai.

The FAD conducts regular financial audits, information systems audits and performance audits for ascertaining the extent of legality, adequacy of financial prudence and management of financial operations. The objectives include reviewing of efficiency, effectiveness and economy in planning, directing, execution, controlling and monitoring of operations.

Dubai

Dubai is one of the seven emirates in the UAE, which is on the eastern coast of the Arabian Peninsula in the south-western corner of the Arabian Gulf. The total area of the UAE is approximately 77,700 square kilometres.

Dubai's economic growth from 2000-2005 has been remarkable, with double-digit Gross Domestic Product (GDP) growth and relatively high per capita income, despite negligible dependence on oil. The driving force behind Dubai's economic performance has been the Government, through investments and other initiatives, supported by the private sector, guided by Dubai Strategic Plan 2015. Since the year 2000, Dubai's real GDP has been growing at a compounded annual growth rate of 13 percent.

The FAD recognized the need to promote, formalize and improve IT governance practices within Dubai as the extensive usage of information technology is widely accepted as an essential component in providing services to citizens, residents and business entities.

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The Government of Dubai has a strong commitment in the use of technology as a business enabler in achieving its strategic positioning as a business hub of the region. The direct benefits of this have been realized through greater interactions among the government departments and the ease of doing business in Dubai. The Government has reinforced its commitment to good corporate and IT governance to provide services, secure information, protect privacy and nurture best practices to meet the growing challenges of adapting to economic advancement and social changes.

Information Systems Audits

To provide assurance on IT governance and encourage the adoption of leading practices for IT governance within government entities, an information system/technology audit function has been commissioned since 2000. The following mission statement was adopted for the Information System Audit section of the FAD.

Mission

To assess whether the governance, control and risk management of information systems:

1. Safeguard assets
2. Maintain integrity, confidentiality and availability
3. Achieve organizational goals effectively
4. Consume resources efficiently
5. Comply with the leading practices and applicable regulations
6. Align with the vision of the Government of Dubai

Benefits of using COBIT as a framework

Team members of the information systems audit section of FAD are mostly members and certified professionals of ISACA, either they hold the Certified Information Systems Auditor (CISA) or Certified Information Security Manager (CISM) or Certified in the Governance of Enterprise IT (CGEIT) designation. The team assumes the responsibility as internal champions for adopting ISACA/ITGI resources as required.

The *Control Objectives for Information and related Technology* (COBIT), IT governance framework, developed by ISACA's affiliate, the IT Governance Institute (ITGI), had already been adopted as the resource serving as the overall framework for information systems audit methodology since 2000.

The information systems audit section of FAD recognized the need to be proactive. Hence, from merely using COBIT resources for assurance, the team decided to promote the best practices of COBIT resources among its audit community. COBIT provides control objectives, control practice statements and other resources supporting assurance processes as a global reference framework and benchmark.

As a significant step, the section has pioneered and implemented an IT Governance maturity model assessment as an integral part of all major IS Audits, since 2001. This is based on the COBIT maturity model and was a unique audit methodology in the government sector within UAE/GCC countries.

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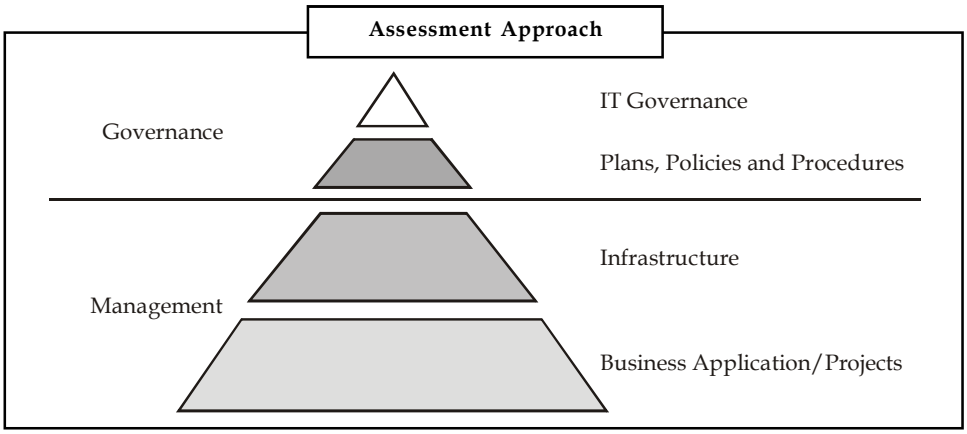
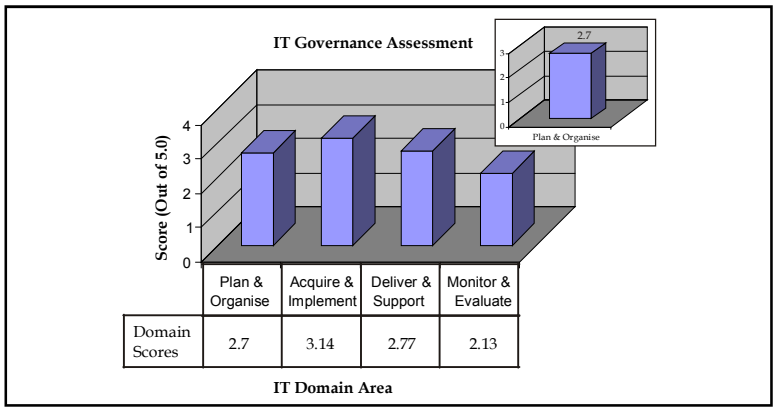
The following is the high-level approach diagram of information system audits:



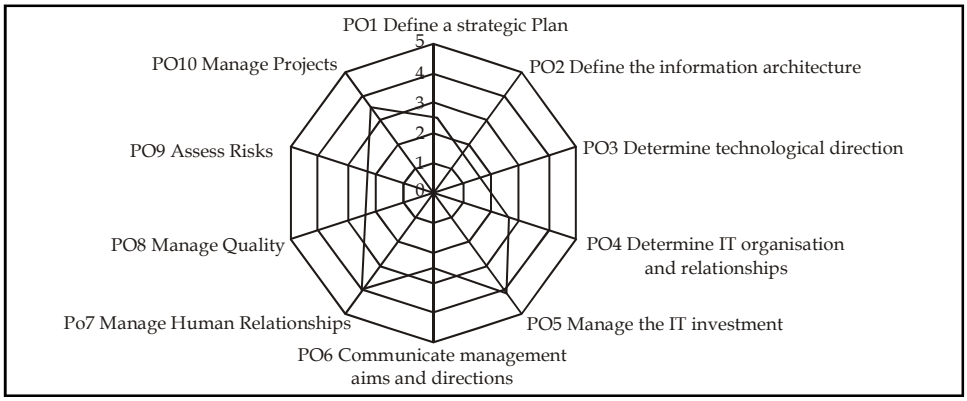
Improving process maturity using COBIT

COBIT-based maturity model assessment/rating is mandatory components in all major audit assignments. This necessitates adopting the best practices suggested by COBIT by the auditees and mandates the need for demonstrating improved maturity on IT-related processes. In turn, this drives internal programs to identify and improve upon process maturity on prioritized areas that are supported by the business. The IT governance assessment has been supported by an internally designed tool for arriving at the scores. An indicative presentation of overall score and domain scores would be as follows:

Overall Score



Domain Scores



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FAD has undertaken IT governance assessments using COBIT and has introduced the advantages of COBIT in many Government entities. In many entities, multiple assessments have been undertaken since 2000. So far, FAD has done more than 40 IT Governance assessments using COBIT. The following is a sample list of entities that had been subject to IT Governance assessments, where the best practices of COBIT have been introduced successfully.

Obtaining Senior Management Support

IT governance assessments promoted the benefits of raising the level of process maturity as a way towards building and sustaining IT governance culture. To achieve the mission and objectives most effectively, apart from conducting IS/IT audits, FAD mooted an initiative named Information Technology Governance Assurance Forum (ITGAF). ITGAF (*www.ITGAF.ae*) was founded in 2006 as a not-for-profit professional organization exclusively to promote IT governance in Dubai. This was formed to propagate IT governance, more specifically, to build, sustain and improve IT governance practices within the Government of Dubai and its establishments.

Commitment from the Director General (DG) of the Financial Audit Department (FAD), on the concept of setting up the ITGAF, followed as a natural outcome of thought leadership. The DG of the FAD assumed the role of the founding chairman of ITGAF and the key sponsor of the initiative. This gave ITGAF the impetus to design and authority to deliver various programs, making significant progress in pursuing and accomplishing the stated mission and objectives.

The following have been formally adopted as the mission and high-level objectives of ITGAF.

ITGAF Mission

To provide support to boards and executive managements of Government community on the direction, successful usage and governance of information technology towards achieving organizational goals.

ITGAF Objectives

1. Promote IT governance practices as an integral part of corporate governance among Dubai Government community.
2. Brainstorm on the leading practices/frameworks for effective IT governance.
3. Establish a forum of IT decision makers to network and facilitate continuous improvement on the stated objectives.
4. Facilitate continuous educational support to the Government Community.
5. Empower the audit departments of the Government Community by building IS control/audit strengths.

ITGAF Activities

The following are the highlights of key activities that were undertaken by ITGAF.

1. ***Conferences:*** The conferences of 2006, 2007 and 2008 were focused on adopting, implementing and sustaining leading practices on IT governance, respectively.

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Presenters at the conferences included IT governance/Corporate governance leaders such as Mr. Erik Guldentops, advisor to the ITGI board, Dr. Nasser Al Saidi, Executive Director, Hawkamah, The Institute of Corporate Governance, etc.

2. ***Workshops:*** Propagating COBIT as a model framework by conducting workshops on a regular basis. ITGAF conducted several workshops in 2007 and 2008 on related topics, including Implementing IT Governance Practices. A workshop titled Using COBIT for Effective IT Management and Implementing IT Governance was held in November 2008 and repeated in February 2009.

3. ***Awards:*** Commencing 2006 through 2008, ITGAF instituted an award that is bestowed to the IT department among the Government of Dubai that demonstrates highest level of process maturity in IT governance. The award is named as "ITGAF Process Maturity Award". The criteria for evaluation of process maturity are based on the COBIT maturity model framework. The maturity model score collation and evaluation are done using an in-house-developed tool for standardized evaluation.

4. In 2008, FAD developed and rolled out a pilot project to conduct IT Governance Maturity Model Assessments as a Control Self Assessment (CSA) initiative. Once this project is fully implemented, all Dubai Government Departments will assess and report the outcome of CSA to FAD. To support this activity, an exercise of identifying "Champions" within all Dubai Government Departments and a workshop was organized to equip the Champions, who will in turn lead the CSA projects. While this was a pilot project, it is expected to become a formal activity in 2009. Upon gathering the feedback, this is expected to be extended to all other entities owned by the Government.

5. Scope, applicability and reach of ITGAF extends beyond one organization. In effect, the above activities have actually made significant contribution towards adoption and implementation of good governance practices in government departments and in more than 40 other major to medium establishments, where the Government of Dubai has a stake.

6. ITGAF/FAD has an existing Memorandum of Understanding (MOU) with the local chapter of ISACA for collaborative efforts in the areas of IT governance. This has been in place since 2007. ITGAF, as an initiative, advocates the cause of IT governance and that of ISACA/ITGI. The following are the stated objectives in the MOU between ITGAF and the ISACA UAE Chapter.

7. ITGAF/FAD in the past has designed, developed and delivered customized training sessions on IT governance, information security, IS audits and preparation of the CISA examination since 2001.

8. ITGAF has announced and is in the process of gathering and distributing case studies on successfully implemented IT governance initiatives within all Dubai Government establishments.

Roles of the Board of Directors

ITGAF has the following structure. Presently, the chairman, president and vice presidents constitute the board of directors.

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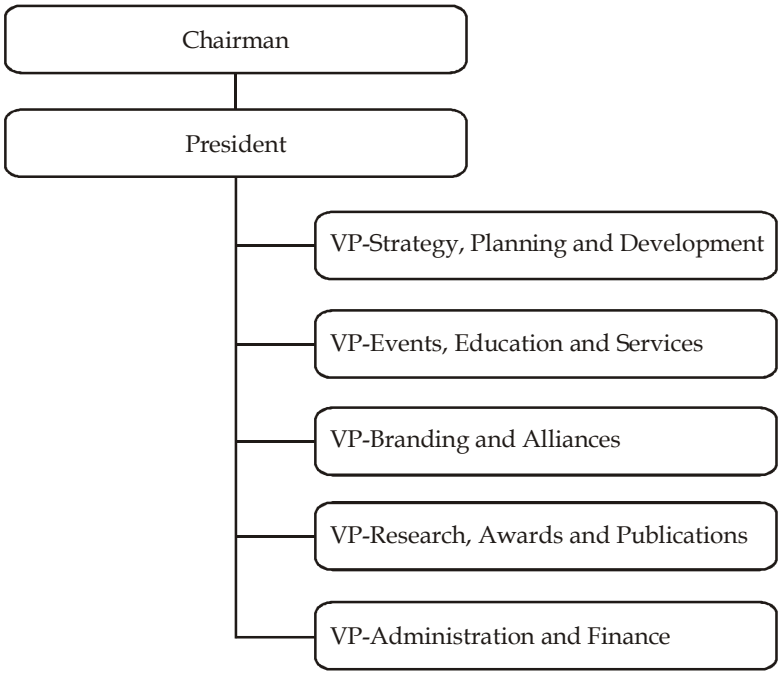

Goals Achieved in enhancing IT Governance Practices

The risk of not having a framework toward the usage of technology has been addressed. The next endeavour is to work on expanding adoption and sustenance of practices.

The information systems audit/IT governance assessments drive and forge a learning enthusiasm towards COBIT. This creates the need for all auditees to develop and acquire skills and knowledge of COBIT resources. The training initiatives of ITGAF are positioned to fill the required resource gaps through trainings, workshops and conferences. The ITGAF Process Maturity Award gives the incentive to demonstrate a high level of process improvement. Thus, a full life-cycle process for continuous improvement has been set in place.

According to Mr. Yassir Amiri, Director General of the Financial Audit Department and Chairman of ITGAF:

"ITGAF is the next step to reiterate our commitment to assure information technology governance and encourage adopting leading practices for IT governance within government departments/organizations/companies. I hope these initiatives gain further momentum in the coming years, and we expand research and educational activities to lead the thinking and ultimately be in service to the community and region."

According to Mr. Tariq Al Ghaith, Director of Information Systems Audit and President of ITGAF:

"Today, for most organizations, success in the achievement of business goals depends directly on the extent and capability of technology enablement. In such an environment, governance over technology usage is as critical as any other corporate governance function. Effective information technology governance helps ensure that it supports business goals, maximizes business investment in technology, and appropriately manages information technology-related opportunities and risks."

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Future Landscape

The goals set for implementing the best practices suggested in COBIT within the Government of Dubai:

1. Establish COBIT as the preferred framework of leading practices for the IT professionals within the Government Departments/Establishments.
2. Develop CGEIT as the most preferred certification for eligible IT professionals within the Government Departments/Establishments.
3. Further propagate the benefits of CISA certification within the Government Audit Community.

The adoption of COBIT by the Financial Audit Department, the Government Audit Department of Dubai, has driven the need by the auditee management for knowing, understanding and using COBIT resources within the IT and business community. In turn, this has led to the wide acceptance and practical adoption of best practices of COBIT among auditee entities within the Government of Dubai. Many of these organizations have adopted the COBIT framework, in principle, as a *de facto* standard.

Question:

Analyze the case and write down the case fact in your own words necessitating the need of auditing?

Source: http://www.isaca.org/Knowledge-Center/cobit/Pages/Government-of-Dubai.aspx

10.6 Summary

- The Indian Audit and Accounts Department, functioning under the Comptroller and Auditor General, derives its authority and the powers for performance of its duties on his or her behalf under the provisions of Section of 21 of the CAG's DPC Act, 1971.
- Audit forms an indispensable part of the financial administration and is one of the important organs necessary to ensure the sound functioning of a Parliamentary Democracy.
- The primary function of audit is to verify the accuracy and completeness of accounts.
- It is the function of audit to verify that financial rules and orders satisfy the provisions of Law and or otherwise free audit objections and the rules and orders are properly applied.
- Government audit aims to ensure accountability of the executive in respect of public revenue and expenditure.
- According to section 617 of the Companies Act, a government company is one in which not less than fifty-one per cent of the paid up share capital is held by the Government.
- Integrity and objectivity are maintained when auditors perform their work and make decisions that are consistent with the broader interest of those relying on the auditors' report, including the public.
- A Government Financial Audit or an audit of financial statements is the verification of the financial statements of a legal entity, with a view to express an audit opinion.
- While performing independent financial audit the statutory auditors observe the Code of Ethics for Professional Accountants, adopted by the International Federation of Accountants.

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- The documentation of the independent financial audit and the procedures on its implementation are performed in compliance with the requirements of the legislation in force and the International auditing standards.
- The personal seal of the statutory auditor and the seal of the specialized audit firm are used for verification of the audit of the financial accounts and in other cases envisaged by the law.

10.7 Keywords

Auditing Standards Board: The Auditing Standards Board (ASB) is the AICPA's senior committee for auditing, attestation, and quality control applicable to the performance and issuance of audit and attestation reports for non-issuers.

Comptroller and Auditor General: Audits and assists the state and central institutions on their accounts and accountability.

Financial Transactions: Financial transactions are transactions in financial assets and liabilities between institutional units, and between them and the rest of the world.

Government Audit: A systematic examination of financial or accounting records by a specialized inspector, called an auditor, to verify their accuracy and truthfulness.

Government Auditing Standards: The set of accounting standards for performance audits and financial audits of government agencies, produced by the Government Accountability Office.

Indian Audit and Accounts Department: IAAS or Indian Audit and Accounts Service are an Indian Central Government service, free of control from any executive authority, under the Comptroller and Auditor General of India.

Paid up Share Capital: The amount of money stockholders have paid for the issued capital shares of stock.

Statutory Auditor: A legally required review of the accuracy of a company's or government's financial records.

10.8 Review Questions

1. What do you understand by government auditing? Explain. Mention its objectives.
2. Explain audit jurisdiction.
3. Discuss in detail the audit of government companies.
4. Elaborate the uses and applications of GAGAS.
5. Explain the Field Work Standards for Government Financial Audits.
6. Discuss the Reporting Standards for Government Financial Audits.
7. What are the objectives and principles of the Independent Financial Audit?
8. Explain in detail the organization, documentation and conclusions of the Independent Financial Audit.
9. Differentiate between Government financial audit and Independent financial audit.
10. Write a short note on Ethical Principles in Government Auditing.

Notes

Answers: Self Assessment

1.	Comptroller and Auditor General	2.	Audit
3.	Government audit	4.	Expenditure
5.	Comptroller and Auditor General	6.	Three
7.	Companies' Amendment	8.	Auditing
9.	Ethical principles	10.	Government Financial Audit
11.	Absolute assurance	12.	AICPA
13.	International auditing standards	14.	Appropriate reasons
15.	Letter of acceptance	16.	Statutory auditor

10.9 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

http://en.wikipedia.org/wiki/Financial_audit

http://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AU-00110.pdf

http://www.gao.gov/govaud/govaudhtml/d07731g-6.html#pgfId-1034321

http://www.gao.gov/govaud/govaudhtml/index.html

http://www.img.kerala.gov.in/docs/downloads/audit.pdf

http://yourbusiness.azcentral.com/describe-financial-audit-under-government-auditing-standards-10436.html

Notes

Unit 11: Introduction to Special and Efficiency Audit

CONTENTS

Objectives

After studying this unit, you will be able to:

- Discuss the concept of Special Audit
- Identify the special auditing techniques
- Explain the concept of efficiency audit
- Discuss measuring efficiency

Introduction

A special review entails a comprehensive and objective examination of the business underlying the numbers. It assists management to identify and focus on key areas and issues and provides insights and comfort to them as well as to outside interests. We provide services on specific audit assignments like cost audits, fraud investigations, investment audits, compliance audits, salary audits, certification of sales and other special assignments necessary to provide assurance to management and interested parties.

11.1 Concept of Special Audit

A special audit report is the report issued by an auditor after inspecting the financial records of a company following a directive for the audit to be performed before the usual annual audit. The

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government may order a special audit conducted on a corporation if there is evidence that its financial affairs are not being run in accordance with proper accounting practice. Shareholders of a company may also pass a resolution to have a special audit done on their company if they feel recent management decisions have put its survival in jeopardy.

Unqualified Opinion

This is a special audit report whose conclusion is that the financial records of the company are in order. This means that the company management has presented a true reflection of the real financial transactions without hiding some or exaggerating others. The company's financial reporting has complied with the Generally Accepted Accounting Principles (GAAP).

Qualified Opinion

A qualified opinion special audit report is issued when an auditor discovers anomalies in the financial statements of an organization. Situations that make an auditor give a qualified opinion report include when a company's financial statements have failed to include certain transactions over a certain period or to reflect depreciation in the value of asserts. The auditor gives an opinion that they should be corrected.

Adverse Opinion

An adverse special audit report is issued when an auditor discovers outright distortions that make the financial statements of a company unreliable. In most cases, these discrepancies are a deliberate attempt to conceal the real financial position of the company being audited. An American company may, for instance, fail to state that it sold its South African subsidiary for $3 million so as to hide the fact that the money was siphoned out of the business after the sale.

Disclaimer of Opinion

A disclaimer of opinion special audit report is issued when an auditor is unable to conduct an audit of a particular organization. The reasons range from the deliberate failure of the organization's management to provide crucial financial information to interference in his audit. An extreme case of this interference would be an attempt to bribe the auditor so that he can give a positive report.

Internal Audit

This is a special audit report that is commissioned by a company's management. It may be initiated by the company's executive management or the board of directors. The aim of the internal audit may be to establish the value of the company or investigate internal fraud.

External Audit

External special audit report is commissioned from outside the company. A multinational company that owns subsidiaries in foreign countries may commission a special audit of these subsidiaries so as to determine their viability. A government may also commission a special audit of one of its ministries to establish how money for a certain project was used. External audits are usually the most credible though critics have accused audit firms of unethical behaviour.

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11.1.1 Special Auditing Techniques

Techniques of auditing refer to specific art and skill used for obtaining the evidence required by the auditor. The techniques are given below are in addition to conventional audit procedures such as posting, casting and vouching.

1. ***Confirmation:*** Confirmation refers to a reply to the inquiry put forth to corroborate the information contained in the records.
2. ***Surprise Checks:*** An element of surprise while conducting an audit improves its effectiveness. Elements of surprise in an audit may be with regard to time of audit or item of audit.
3. ***Inquiry:*** Inquiry involves seeking appropriate information from knowledgeable sources, both inside and outside the organization.
4. ***Cut-off Procedures:*** These are procedures employed to ensure the separation of transaction at end of one year from those at the commencement if next year.
5. ***Analytical Review Procedure:*** This is a technique designed to obtain evidence as to completeness, validity and accuracy of data produced by accounting system.
6. ***Observation:*** Observation consists of witnessing a process being performed by others.

11.1.2 Types of Special Audit

Following are the various types of Special Audit:

1. ***Statistical Sampling:*** Statistical Sampling in auditing stands for the technique of forming an opinion about a group of items on the basis of an examination of a few of the items. It may be recalled that test checking technique is one of the accepted auditing techniques, which most of the professional bodies of the world, including the ICAI have recommended for use by the members of a proper consideration of facts and applicability. These techniques may be considered as a refined application of the test check technique which has all the advantages of the latter with the shortcomings removed. The greatest merit of this technique lies in its being based on the statistical theory of probability. It is however not as simplistic as the test checks.

   On the basis of the audit carried out, an auditor is required to give a report containing his opinion, about truth and fairness of the accounting statements. In expressing his opinion the auditor never guarantees absolute accuracy of the accounting statements; but he takes a risk of being challenged about the validity of his opinion. Even after a complete checking, he cannot be sure that the accounts and the resulting accounting statements are absolutely free from error, manipulation, fraud or mistake. However, the opinion that he expresses, represents his overall assessment of the truth and fairness of the accounting statement based on his satisfaction that he has applied all professional skill at his command to see that no material error or fraud exists to distort the true and fair view of the accounting statements.

   When he checks only a part of the total accounting data in lieu of checking of all the data, it is obvious that the degree of satisfaction obtainable from the latter would not be available; however, a small loss of the degree of satisfaction will be more than compensated by the considerable savings in time and costs for having checked only a fraction of the total data. It is again true that bigger the sample, the greater would be the satisfaction, but from a practical consideration the minimum requisite sample size, if determined statistically

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will be adequate to express an opinion about the overall truth and fairness of the total data within a reasonable range of precision and with reasonable confidence.

Notes It is important to recognize that certain testing procedures do not come within the definition of sampling. Tests performed on 100% of the items within a population do not involve sampling.

2. ***Audit Risk:*** Audit risk is the risk that an auditor may give an inappropriate opinion on financial information that is materially misstated.

Example: An auditor may give an unqualified opinion on financial statements without knowing that they are materially misstated. Such risk may exist at overall level or while verifying various transactions and balance-sheet items.

(i) *Audit risk at the financial statement level* - Audit risk is considered at the financial statement level during the audit planning process. At this time, the auditor should undertake an overall audit risk assessment based on his knowledge of the client's business, industry, management, control environment and operations. Such an assessment provides preliminary information about the general approach to the engagement, the auditor's staffing needs and the framework within which materiality and audit risk assessments can be made at the individual account balance or class of transactions level. As part of this overall risk assessment, the auditor should consider whether there is potential for pervasive problems, for example, liquidity or going concern problems.

(ii) *Audit risk at the account balance and class of transactions level* - The majority of audit procedures are directed to, and carried out at the account balance and class of transactions level. Accordingly, audit risk should be considered by the auditor at this level taking into account the results of the overall audit risk assessment made at the financial statement level. To assess inherent risk, the auditor uses professional judgement to evaluate numerous factors, examples of which are:

At the financial statement level:

(a) the integrity of management;

(b) management experience, knowledge and changes during the period;

Example: The in-experience of management may affect the preparation of the financial statements of the entity;

(c) unusual pressures on management;

Example: Circumstances that might predispose management to mis-state the financial statements, such as an entity in an industry experiencing a large number of business failures or an entity that lacks sufficient capital to continue operations;

(d) the nature of the entity's business;

Example: Its technological obsolescence of products and services, complex capital structure, significance of related parties, and the number of locations and geographical spread of its production facilities;

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(e) Factors affecting the industry in which the entity operates.

Example: Economic and competitive conditions, and changes in technology, accounting practices common to the industry and, if available, financial trends and ratios;

At the Account balance and class of transaction level:

(a) financial statement of accounts likely to be susceptible to misstatement (e.g. a financial statement of account which required adjustment in the previous period);

(b) the complexity of underlying transactions which might require the use of the work of an expert;

(c) the amount of judgment involved in determining account balances;

(d) susceptibility of assets to loss or misappropriation;

(e) the completion of unusual and complex transactions, particularly at or near year end; and

(f) Transactions not subjected to the normal processing mode.

3. ***Materiality in Auditing:*** The concise Oxford Dictionary defines the term "material" as "important or essential. Whatever is important or essential in a given auditing situation would automatically be material. It is a relative term and what may be material in one set of circumstances may not be so in another. The concept of materiality is fundamental to the process of aggregation, classification and presentation of accounting information. Questions of materiality arise in various circumstances. The Statement on Auditing Practices issued by the Institute of Chartered Accountants of India states that the recommendations contained therein apply primarily to items which are material and significant in relation to the affairs of a company.

Items of little or no significance may be dealt with as may be found expedient, as it is neither desirable nor necessary that members should devote their time and energies in the pursuit of matters of a trivial nature. However, freedom to deal expediently with non-material items should not extend to a group of items whose cumulative effect on the accounts may be material or significant.

Caution The auditor has to keep this in view while examining the truth and fairness of the statements of account.

The auditor has to satisfy himself that the statements exhibit a true and fair state of affairs having regard to all material aspects. At various places of Part II of Schedule VI to the Companies Act reference is made to materiality and the same is also a matter of importance in relation to items in the balance sheet.

Materiality in Auditing requires that the auditor should consider all material aspects, either individual or in aggregate which are relatively important for true and fair view of financial statements. In this context, the auditor should consider whether the effect of aggregate uncorrected misstatements on the financial information is material. Qualitative considerations also influence an auditor in reaching a conclusion as to whether the misstatements are material.

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4. ***Auditing of Fixed Assets:*** The Guidance Note on Audit of Fixed Assets issued by the ICAI recommends that the verification of fixed assets consists of examination of related records and physical verification. The auditor should normally verify the records with reference to the documentary evidence and by evaluation of internal controls.

   The verification of records would include verifying the opening balances of the existing fixed assets from records such as the Schedule of fixed assets; ledger or register balances to acquisition of new fixed assets should be verified with reference to supporting documents such as orders, invoices, receiving reports and title deeds. Self-constructed fixed assets and capital work-in-progress should be verified with reference to the supporting documents such as contractors' bills, work orders and independent confirmation of the work performed from other parties. When fixed assets have been written off or fully depreciated in the year of acquisition, the auditor should examine whether these were recorded in the fixed assets register before being written off or depreciated. In respect of retirement of fixed assets, the auditor should examine whether retirements were properly authorised, whether depreciation accounts have been properly adjusted, whether the sale proceeds, if any, have been accounted for and the resulting gains or losses, if material, have been properly adjusted and disclosed in the profit and loss account. In case the asset has impaired the auditor must ensure that the asset has met the criteria as specified in AS 28, "impairment of Assets".

   The ownership of assets like land the buildings should be verified by examining title deeds. In case the title deeds are held by other persons such as bankers or solicitors, independent conformation should be obtained directly by the auditor through a request signed by the client.

Caselet

Audits as a Tool for Standardization and Improvement: A Case Study from India

Colgate-Palmolive is the world's number one seller of toothbrushes and its single largest volume market is the subcontinent of India, where its market share there is in excess of 70%. Indian law classifies the toothbrush as a "light industry" product and imposes limitations on the volume that can be produced at any one facility. Although this measure is designed to aid employment by spreading business among a number of smaller manufacturers, it ensures that Colgate-India, which is entirely dependent upon contract manufacturers for its toothbrush production, has a large number of suppliers to manage and control.

To assist Colgate-India in managing its 20+ suppliers and to support their operating at acceptable quality and manufacturing levels, a special audit standard was created. Audit criteria were based on minimum requirements for product quality, quality control and GMP (Good Manufacturing Practice), especially as they pertain to fundamentals in cleanliness, sanitation and hygiene. Although the author does not, as a rule, favour scoring audits it was useful to provide a scoring system for this particular audit standard to establish a baseline for compliance and to measure improvement for follow-up.

Supplier quality engineers from India were trained in the US at Colgate's centre-of-excellence facility in Puerto Rico. In July, 195 two engineers from Colgate's corporate engineering group went to India, and together with the afore-mentioned CP-India personnel, they audited twelve key suppliers to the new standard. A corporate person led

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each audit team and scores were reached by consensus. The results showed a range of capabilities, but a number of common deficiencies were noted across the supply base. Specific improvement initiatives were identified for each supplier in particular, and for all suppliers in general. Follow-up audits by a CP-India team and subsequent visits by US personnel have shown quantified improvement and greater uniformity in approach and execution across the supply base.

Source: http://asq.org/qic/display-item/index.html?item=11028

Self Assessment

Fill in the blanks:

1. ……. is considered at the financial statement level during the audit planning process.
2. Audit risk is the risk that an …… may give an inappropriate opinion on financial information that is materially misstated.
3. …… Sampling in auditing stands for the technique of forming an opinion about a group of items on the basis of an examination of a few of the items.
4. The …… of assets like land the buildings should be verified by examining title deeds.
5. The auditor has to satisfy himself that the ……. exhibit a true and fair state of affairs having regard to all material aspects.
6. …….. special audit report is commissioned from outside the company.
7. A ……. company that owns subsidiaries in foreign countries may commission a special audit of these subsidiaries so as to determine their viability.
8. A qualified ……. special audit report is issued when an auditor discovers anomalies in the financial statements of an organization.

11.2 Concept of Efficiency Audit

The Auditor General's mandate for auditing the efficiency of government operations originates from section 7 (2) (d) of the *Auditor General Act*. It states ''...The Auditor General ... shall call attention to anything that he considers to be of significance and of a nature that should be brought to the attention of the House of Commons, including any cases in which he has observed that ... money has been expended without due regard to ... efficiency." This mandate is interpreted to include examining an entity's management systems, practices, and results to determine whether they demonstrate due regard to efficiency. It also includes assessing the level of efficiency achieved. This Guide is intended to help Office of the Auditor General (OAG) auditors fulfil that mandate. Some key points are the following:

- There are profound differences between the private and public sectors, as well as similarities. The forces of the marketplace do not always apply to government operations. The cost, quantity, and quality of government products and services usually are not determined by the forces of supply and demand, or by the profit motive and competitiveness present in the private sector. The similarities derive from an obligation to provide goods and services to clients. Public servants, however, have an additional responsibility to comply with government-wide management policies; multiple (and at times conflicting) program objectives, and service levels that in some cases may be defined by legislation. These factors need to be taken into consideration in assessing efficiency.

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- Potential efficiency issues can be found in all government programs, activities, or operations related to the delivery of goods or services to internal or external clients, as well as in regulatory, enforcement, and revenue collection operations. Efficiency issues are most likely to be found in labour or capital-intensive operations that consume significant amounts of resources. Materiality, risk significance, sensitivity, and the potential for improvement are some of the factors considered in selecting efficiency issues for examination.
- The concept of efficiency applies to all types of operations, even though some may have outputs that are not uniform and are consequently more difficult to measure against consistent standards. In operations with difficult-to-measure outputs, the assessment of efficiency focuses on controls, operational processes, and work methods used to achieve efficiency.

Caution In determining the scope of an audit of efficiency, auditors should consider all key factors influencing the relationship between goods and services produced and the resources used to produce them.

- A results-oriented audit approach should be followed wherever possible, because it can usually accomplish the audit objectives at least cost. Results in this context mean efficiency achievements compared against standards. This approach can be used only where results are measurable. In using a results-oriented audit approach, it may nevertheless be necessary to examine some critical systems to verify the efficiency information generated by the audited organization or to seek causes for any revealed inefficiencies.
- The auditor may assess, among other aspects of efficiency management, the adequacy of efforts to improve efficiency. These include continuing efforts to achieve higher productivity, improved quality of outputs, or reduced cost of resource inputs, as appropriate.
- The *Auditor General Act* refers to "due regard" to efficiency. This should not be interpreted to mean that efficiency should be the overriding management priority in every case. In determining what is "due regard" in a particular case, the auditor has to take into account all management considerations, such as policy requirements, the relative importance of effectiveness and safety, and agreements with staff unions.
- In concentrating on the government's efforts to achieve efficiency in its operations, auditors should not lose sight of the possible impact of those efforts on other levels of government or the private sector. The national economy may not benefit as a whole if efficiency is gained in one sector at the cost of another.

11.2.1 What is Efficiency?

In essence, efficiency indicates how well an organization uses its resources to produce goods and services. Thus, it focuses on resources (inputs), goods and services (outputs), and the rate (productivity) at which inputs is used to produce or deliver the outputs. To understand fully the meaning of "efficiency", it is necessary to understand the following terms: inputs, outputs (including quantity and quality), productivity, and level of service.

- Inputs are resources (e.g., human, financial, equipment, materiel, facilities, information, energy and land) used to produce outputs.
- Outputs are goods and services produced to meet client needs. Outputs are defined in terms of quantity and quality and are delivered within parameters relating to level of service.

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- **Quantity** refers to the amount, volume, or number of outputs produced. For example, number of passports issued, number of income tax returns processed, number of applicants selected as immigrants, and area of facilities maintained.
- **Quality** refers to various attributes and characteristics of outputs such as reliability, accuracy, timeliness, service courtesy, safety, and comfort.
- Productivity is the ratio of the amount of **acceptable** goods and services produced (outputs) to the amount of resources (inputs) used to produce them. Productivity is expressed in the form of a ratio such as cost or time per unit of output.
- Level of service refers to the "richness" of service in terms of such characteristics as accessibility, options, frequency, and response time. Level-of-service standards are sometimes defined by statute, regulations, or policies. Such standards may influence quality as well as the cost of service.

Staff and work processes, among other factors, determine the rate at which resources are consumed in producing goods or services. Thus, staff and work processes affect the productivity of an operation.

Efficiency is a relative concept. It is measured by comparing achieved productivity with a desired norm, target, or standard. Output quantity and quality achieved and the level of service provided are also compared to targets or standards to determine to what extent they may have caused changes in efficiency.

Notes Efficiency is improved when more outputs of a given quality are produced with the same or fewer resource inputs, or when the same amount of output is produced with fewer resources.

11.2.2 How does Efficiency relate to Economy and Effectiveness?

Efficiency is only one dimension of the performance of a government program or operation. Auditors should be equally aware of other dimensions of performance, including economy and effectiveness.

Due regard to economy requires that resources of appropriate quantity and quality be obtained at least cost. Because efficiency derives from the relationship between resource inputs and outputs, the concepts of efficiency and economy are inextricably linked. Economic acquisition of resources contributes to efficiency by minimizing the cost of inputs used.

Effectiveness questions overlap with and extend beyond efficiency into program effects and impacts (outcomes). Efficiency is closely linked to effectiveness because it is an important factor in determining the least-cost method of achieving desired outcomes.

11.2.3 Auditing Operations with Non-uniform Outputs

Government operations cover a wide variety of work ranging from repetitive clerical tasks to complex intellectual analyses, and from manual tasks to automated operations using expensive equipment and technology. Efficiency of some operations with dissimilar outputs can be difficult to measure.

Examples of such operations include planning, policy development, research, advisory support functions, administrative overhead, and project management.

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Measurable operations have many features in common with difficult-to-measure operations. For example, both types of operations have to be planned, budgeted, operated, monitored, and controlled. Usually, all operations have clients who receive a service or product. The main difference is in the difficulty of measuring and assessing efficiency based on output/input ratios.

The manager's obligation to be prudent in the use of resources is pertinent to all operations, including those where efficiency is difficult to measure. All audit-worthy operations, regardless of the difficulty of **measuring** their efficiency, should be examined to determine whether management has demonstrated **due regard** to efficiency.

Where the efficiency of an operation is difficult to measure, auditors are expected to verify whether the controls, operational processes, and work methods are appropriate for minimizing resource inputs in the delivery of required goods and services or maximizing output with given resources. The following are a few examples of activities that auditors can consider as evidence of management's due regard to efficiency:

- Carrying out periodic reviews to eliminate redundant operations and intermediate or internal outputs that do not contribute to the organization's final outputs (e.g., administrative and overhead functions, useless reports).
- Using project management information covering milestones reached versus those planned, actual dates versus target dates, and resources used versus those budgeted.
- Comparing the total and component costs of operations (including overhead) with costs in other similar organizations.
- Reducing layers of control, speeding up decision making, and creating more shared services.
- Rationalizing products and services to better serve the needs of internal and external clients, and discontinuing outputs that are no longer needed.
- Reducing operational costs by contracting out work, when justified.
- Improving the quality and level of service to satisfy user demand without increasing costs.
- Developing better systems and work methods, including appropriate use of technology.
- Improving staff productivity through such things as better equipment, training and development, improved working conditions, incentives, and recognition of good performance.
- Identifying new opportunities to apply best practices based on appropriate comparisons with other departments, other jurisdictions, or the private sector.

11.2.4 Measuring Efficiency

Efficiency information is necessary for management to determine whether the level of efficiency achieved meets an acceptable standard. It is also necessary for comparing efficiency levels before and after corrective action.

Efficiency and associated factors usually can be measured and monitored best using a family of indicators focusing, for example, on various aspects of quantity, quality, and level of service. The purpose of using a family of indicators is to understand how related operational factors influence the efficiency of an operation. The related factors can then be controlled to improve efficiency.

Notes

Measuring Inputs: Inputs (e.g., labour, materiel, or capital) can be measured in either physical or monetary terms. Labour inputs, for example, can be measured in units of time or dollars. Materiel and capital resources are generally measured in dollars.

Measuring Outputs: Outputs of some operations are uniform. These outputs can be readily counted and the amount of resources consumed can also be measured to calculate the efficiency of producing them. If outputs are not uniform, it is not appropriate to count them as standard units of production requiring equal amounts of resources for calculating efficiency.

Standards for Efficiency: Standards provide a reference point or benchmark to measure and assess efficiency. Different kinds of standards can be used as benchmarks so long as they represent a reasonable level of expected efficiency.

- ***Engineered Standards:*** These are developed with well-established work measurement techniques. Therefore, engineered standards provide a reliable basis for measuring and assessing efficiency levels.
- ***Historical Standards:*** Productivity ratios, representing efficiency achieved in the past, can be used as a base to assess current efficiency levels.
- ***Organizational Comparisons (benchmarking):*** Comparing against standards based on the achievements of other organizations that are doing similar work and are considered leaders in the field, or comparing with the generally accepted industry or business standards are other ways of assessing an organization's efficiency.
- ***Capacity Utilization:*** The efficiency of staff, equipment, and facilities, etc., is strongly influenced by the extent to which such resources are used productively in relation to the time available for use. Utilization is expressed as the percentage of the available capacity that is actually used.

11.2.5 Benefits of Auditing Efficiency

Auditing efficiency can directly or indirectly help departments and agencies to identify opportunities to provide more or better services at the same or lower cost. More specifically, such audits can:

- help managers and staff to be more sensitive to their obligation of due regard to efficiency;
- underline the importance of measuring efficiency and of using that information for managing operations and providing accountability;
- identify means for improving efficiency, even in operations where efficiency is difficult to measure;
- demonstrate the scope for lowering the cost of delivering programs without reducing the quantity or quality of outputs or the level of service;
- Identify needed improvements in existing controls, operational systems, and work processes for better use of resources.

Did u know? Auditing Efficiency increases the quantity or improves the quality of outputs and level of service without increasing spending.

Self Assessment

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Fill in the blanks:

9. There are profound differences between the private and ..... sectors, as well as similarities.
10. In determining the scope of an audit of ....., auditors should consider all key factors influencing the relationship between goods and services produced and the resources used to produce them.
11. A results-oriented audit ..... should be followed wherever possible, because it can usually accomplish the audit objectives at least cost.
12. ..... and capital resources are generally measured in dollars.
13. Efficiency information is necessary for ..... to determine whether the level of efficiency achieved meets an acceptable standard.
14. Auditing efficiency can directly or indirectly help departments and agencies to identify ..... to provide more or better services at the same or lower cost.
15. ..... is expressed as the percentage of the available capacity that is actually used.

Task Study on how to Measure the Efficiency?

Case Study

Government of Canada Building, Edmonton, Alberta

The Department of Public Works provides accommodation for federal public servants. In 1970, DPW examined the option of integrating a new office building with a proposed development by the City of Edmonton. Discussions with the City and the Province of Alberta continued until 1983, when DPW was given approval to acquire a parcel of land to construct a building that would accommodate the majority of Edmonton-based federal public servants, create a "central federal presence", and meet the redevelopment needs of both the Province of Alberta and the City of Edmonton. In 1984, DPW was given approval to sign a lease purchase agreement with a developer. The cost of the project was reported to Treasury Board in terms of net present value at $152.2 million in 1984.

In its 1985-86 Estimates report to Parliament on the cost of the project, DPW did not include several significant facts, notably that a management agreement worth $34 million over a 10-year period was an integral part of the agreement with the developers and that the cost of land was $33.7 million. The Department has stated that its reporting format had the agreement of the Office of the Comptroller General and the Treasury Board.

DPW had requested a number of developers to submit design and construction proposals based on performance specifications. From the initial respondents, a short list of five was invited to present fully developed proposals. DPW had Treasury Board approval to make payments of up to $30,000 to developers whose bids proved unsuccessful. In the end, DPW

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paid $50,000 to each of the two unsuccessful bidders who had submitted proposals - in effect making, without appropriate authority, two ex gratia payments of $20,000 each.

We concluded that DPW had examined the requirements for office space at various times during the planning phase between 1970 and 1984, culminating in a study in 1983. We are satisfied that the needs analysis was adequately done. Two options were possible for meeting the accommodation needs of the federal government: either continue to rent space in various buildings in the city, or build a new building. Given the direction to create a "central federal presence", the rental option was of interest only as a financial alternative. We concluded that DPW had properly analyzed the options of renting or building. We examined the pricing and availability analysis presented to the Treasury Board in seeking Effective Project Approval to sign a lease purchase agreement with the developer. The Department indicated that the lease purchase option was, in 1984 net present value terms, $13.1 million more expensive (including developer's charges and higher costs of borrowing). The Treasury Board directed the Department to proceed with the lease purchase option. In our 1986 Report we identified a similar occurrence in the acquisition of the Guy Favreau Complex in Montreal. We noted then that, in analyzing the options, the Department had used the Real Estate Investment Analysis System (REIAS), which sometimes requires manual calculation to undertake cost analysis of all options. When this is not done, as was the case again here, the Department is unable to present the full range of possible costs that may follow from any one option. The Department acknowledges that a sensitivity analysis should be done as part of the overall assessment of risk.

In sum, the government acquired a building that cost about $80 million to construct, but for which it has paid and will continue to pay a higher sum. We calculated that in current year dollars the additional cost will be approximately $100 million (or $13.1 million in 1984 net present value). Even though Treasury Board was advised of the higher cost, the Department was directed to acquire the building on the basis of lease purchase which, we calculate, will cost almost 20 percent more than the alternative of Crown construction. We noted that, in conducting regular progress inspections and reporting on deficiencies, DPW had brought to the notice of the developers construction practices which, if left unresolved, would reduce fire resistance. At the time of our audit, several of these matters had not been resolved. The reported instances also reflect construction practices that affect the load bearing capacity of some floor slabs, which the Department advises us, will require remedial work. Although the Department noted and reported major deficiencies during construction, it was not always advised of corrective action by the contractor. Corrective action to remedy some of these deficiencies has been taken and is continuing, but no assurance has been given that all of them will be corrected to the Department's satisfaction.

Based on our examination, and on previous audits of lease purchase projects reported by the Auditor General, it is our opinion that lease purchase is the most costly method for the Department of Public Works to acquire buildings.

Question:

Pen down your views to the above case study.

Source: http://www.oag-bvg.gc.ca/internet/English/parl_oag_198811_19_e_4246.html

11.3 Summary

- A special audit report is the report issued by an auditor after inspecting the financial records of a company following a directive for the audit to be performed before the usual annual audit.

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- The government may order a special audit conducted on a corporation if there is evidence that its financial affairs are not being run in accordance with proper accounting practice.
- Statistical Sampling in auditing stands for the technique of forming an opinion about a group of items on the basis of an examination of a few of the items.
- It may be recalled that test checking technique is one of the accepted auditing techniques, which most of the professional bodies of the world, including the ICAI have recommended for use by the members of a proper consideration of facts and applicability.
- Techniques of auditing refer to specific art and skill used for obtaining the evidence required by the auditor.
- The concept of efficiency applies to all types of operations, even though some may have outputs that are not uniform and are consequently more difficult to measure against consistent standards.
- In operations with difficult-to-measure outputs, the assessment of efficiency focuses on controls, operational processes, and work methods used to achieve efficiency.
- Efficiency information is necessary for management to determine whether the level of efficiency achieved meets an acceptable standard. It is also necessary for comparing efficiency levels before and after corrective action.
- Efficiency and associated factors usually can be measured and monitored best using a family of indicators focusing.
- Efficiency is only one dimension of the performance of a government program or operation.

11.4 Keywords

Adverse Opinion: An adverse special audit report is issued when an auditor discovers outright distortions that make the financial statements of a company unreliable.

Disclaimer of Opinion: A disclaimer of opinion special audit report is issued when an auditor is unable to conduct an audit of a particular organization.

Efficiency: Efficiency indicates how well an organization uses its resources to produce goods and services.

Internal Audit: This is a special audit report that is commissioned by a company's management. It may be initiated by the company's executive management or the board of directors.

Qualified Opinion: A qualified opinion special audit report is issued when an auditor discovers anomalies in the financial statements of an organization.

Quality: Quality refers to various attributes and characteristics of outputs such as reliability, accuracy, timeliness, service courtesy, safety, and comfort.

Quantity: Quantity refers to the amount, volume, or number of outputs produced.

Special Audit Report: A special audit report is the report issued by an auditor after inspecting the financial records of a company following a directive for the audit to be performed before the usual annual audit.

Statistical Sampling: Statistical Sampling in auditing stands for the technique of forming an opinion about a group of items on the basis of an examination of a few of the items.

Notes

11.5 Review Questions

1. What do you mean by efficiency?
2. Discuss the techniques of Special Audit.
3. Define the following terms:
   (a) Internal Audit
   (b) External Audit
   (c) Special Audit
   (d) Adverse Opinion
4. Explain the types of Special Audit.
5. What is the difference between internal and external audit?
6. How does efficiency relate to economy and effectiveness?
7. What are the benefits of Auditing efficiency?
8. How to measure the audit efficiency?
9. What do you mean by Statistical sampling?
10. "Efficiency information is necessary for management to determine whether the level of efficiency achieved meets an acceptable standard." Elaborate this statement.

Answers: Self Assessment

1.	Audit Risk	2.	Auditor
3.	Statistical	4.	Ownership
5.	Statements	6.	External
7.	Multinational	8.	Opinion
9.	Public	10.	Efficiency
11.	Approach	12.	Material
13.	Management	14.	Opportunities
15.	Utilization		

11.6 Further Readings

Books

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Notes

Unit 12: Special Features of Audit

CONTENTS

Objectives

After studying this unit, you will be able to:

- Discuss the special features of audit of public sector undertakings
- Understand Objective and Scope of Public Enterprises Audit
- Elaborate the process of auditing of banks
- Classify the non-banking financial companies and explain their audit procedure
- Explain the audit of insurance companies and audit empanelment requirements
- Discuss the audit of cooperative societies, their special features and special provisions related to them

Notes

Introduction

Audit is classified into various types, viz., audit under statute, audit of accounts of private firm, audit of accounts of private individuals, audit of trust accounts. An auditor can adopt any one of the modes to conduct his audit of an organisation, viz. continuous audit or periodical audit or interim audit. Besides being a Chartered Accountant an auditor should possess certain other qualities, such as knowledge of relevant laws, intelligence, tactfulness, vigilance, honesty and integrity courage, impartiality, broadmindedness, patience, perseverance, maintaining secrecy of his client, commonsense etc. In this unit we will discuss the Special features of audit of banks, insurance companies, co-operative societies and non-banking financial companies.

12.1 Special Features of Audit of Public Sector Undertakings

The public sector undertakings differ from private sector undertakings in many ways and it is necessary to keep them in mind before actually undertaking the audit of such undertakings. The auditor should keep in mind the distinction between the audit of private sector undertakings and that of public sector undertakings. This is quite necessary, as the professional accountants are required to audit the accounts of both the types of undertakings.

The auditor of a private sector undertaking is, in general, required to undertake the verification audit and has to give his opinion as to whether the profit and loss account and the balance sheet exhibit true and fair state of affairs of the undertakings. He has nothing to do with the impropriety of the actions of the management. He is not required to question the points of inefficiency of the management.

Different Forms

These undertakings have been set up mainly in three forms, viz., departmental commercial undertakings, statutory corporations and government companies. All these three forms differ substantially from the point of view of their establishment, operations and operational autonomy.

Governing Acts and Provisions

A majority of these undertakings have been set up as government companies under the Companies Act, 1956 just like any other company in the private sector. These companies are governed by the provisions of the Companies Act. A few undertakings have been set up as departmental undertakings and their operational autonomy is quite limited as they are under the direct control of the government. Statutory corporations are governed by the special statute and Act.

The public enterprises in India have been assigned a key role in the socio-economic development of the country. These enterprises are industries supplying basic inputs to industry and agriculture, such as coal, oil, steel, minerals and metals, cement, chemicals and fertilizers and heavy equipment. Public utilities like the railways, postal and telecom services, electricity generation and supply, road transport, etc. constitute another class of public enterprises. Thus in India the public sector has achieved a dominant role in the national economy.

Public sector enterprises are organised through any one of the following modes:

- Departmentally managed undertakings which form part and parcel of Government activities;

Example: Indian Railways, Postal Services, Security Printing Press , Canteen Stores Department;

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- Government companies and deemed Government companies set up under the Companies Act 1956, where Government or Government-owned and controlled institutions own 51 percent or more of the paid up capital;
- Corporations set up under the specific Acts of legislature e.g., Life Insurance Corporation, Unit Trust of India, etc.

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-

(a) to examine the reports and accounts of public undertakings.

(b) to examine the reports of the Comptroller & Auditor General on public undertakings.

(c) 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.

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.

12.1.1 Objective and Scope of Public Enterprises Audit

Under the Act of 1971, the scope and extent of audit is determined by the Comptroller and Auditor General. Audit of public enterprises in India is not restricted to financial and compliance audit; it extends also to efficiency, economy and effectiveness with which these operate and fulfil their objectives and goals. Another aspect of audit relates to questions of propriety; this audit is directed towards an examination of management decisions in sales, purchases, contracts, etc. to see whether these have been taken in the best interests of the undertaking and conform to accepted principles of financial propriety.

In examining the decisions of a management, the auditor examines that these were taken by the competent authority after examination of all aspects (economic, technological, public interest) on the basis of all the relevant information available at that time and taking into consideration the different alternatives available to management and that the decisions were consistent with the aims and objectives of the enterprise. Audit is an instrument of accountability. But an equally important purpose of audit of public enterprises in India is to help the Government and the enterprise managements improve their efficiency and effectiveness.

This is achieved by bringing out financial and operational deficiencies, inadequacies or ineffectiveness of systems, shortfalls in performance, etc. and by analysing the causes of shortfall from acceptable standards of performance. Financial performance is linked with physical performance and issues of efficient and economic operations and management of resources are highlighted. There is an increasing emphasis on audit being an instrument of improvement. But the Comptroller and Auditor General do not make specific recommendations for improvement though the areas and needs for improvement are highlighted in his reports. In the broader context, Government audit encompasses two main elements, viz., (a) Fiscal Accountability: It includes audit of provisions of funds, sanctions, compliances and propriety; and (b) Managerial Accountability: It includes audit of efficiency, economy and effectiveness (This is often referred to as efficiency-cum-performance audit).

Notes

12.1.2 Comprehensive Audit of Public Enterprises

The areas covered by comprehensive audit are those of investment decisions, project formulation and management, organisation, delegation of powers and management information systems, organisational effectiveness, capacity utilisation, management of equipment, plant and machinery, production performance, use of materials, productivity of labour, idle capacity, costs and prices, development of complementary ancillary small scale industries, materials management, sales and credit control, budgetary and internal control systems, etc. The areas covered in comprehensive audit will naturally vary from enterprise to enterprise depending on the nature of the enterprise, its objectives and operations.

Some of the issues examined in comprehensive audit are:

(a) How does the overall capital cost of the project compare with the approved planned costs? Were there any substantial increases and, if so, what are these and whether there is evidence of extravagance or unnecessary expenditure?

(b) Has the accepted production or operational outputs been achieved? Has there been under-utilisation of installed capacity or shortfall in performance and, if so, what has caused it?

(c) Has the planned rate of return been achieved?

(d) Are the systems of project formulation and execution sound? Are there inadequacies? What has been the effect on the gestation period and capital cost?

(e) Are cost control measures adequate and are there inefficiencies, wastages in raw materials consumption, etc.?

(f) Are the purchase policies adequate? Or have they led to piling up of inventory resulting in redundancy in stores and spares?

(g) Does the enterprise have research and development programmes? What has been the performance in adopting new processes, technologies, improving profits and in reducing costs through technological progress?

(h) If the enterprise has an adequate system of repairs and maintenance?

(i) Are procedures effective and economical?

(j) Is there any poor or insufficient or inefficient project planning?

(k) Has there been undue waste, unproductive time for men and machines, wasteful utilisation or even non-utilisation of resources? If so, why?

The efficiency and effectiveness audit of public enterprises is conducted on the basis of certain standards and criteria. Profit is not the key criterion on performance; management's performance in the economical and efficient use of public funds and in the achievement of objectives is more relevant. Public enterprises have been set up with certain socio-economic purposes and for fulfilment of certain objectives. The objectives vary from enterprise to enterprise. Audit appraisal analyses the performance of an enterprise to bring out the extent to which the objectives for which the enterprise was set up have been served. Admittedly this is a complex task but basic to effectiveness appraisal.

The feasibility/detailed project reports give the basis of investment, capacity, costs, time schedules, gestation period, etc. and are built up of capacities, parameters and norms of consumption, yields, productivity, costs, rate of return, etc. These provide yardsticks by which the performance is measured. Some of the parameters may change due to external or internal factors subsequent to the setting up of the enterprise/project. In conducting efficiency audit due account is taken of the changes effected. Then enterprises are required to have their long and

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short term capital and operational plans and these provide another set of reference points for assessment of performance. Rated capacity of the unit provides an acceptable benchmark against which physical performance is evaluated.

However, utilisation of the rated capacity is assessed along with norms for consumption of raw materials and utilities, yields and rejections as well as requirements for proper maintenance and servicing of equipment. Cost efficiency is another important basis in appraising performance. Standard or target costs are determined on the basis of norms of capacity utilisation, consumption, productivity, yield etc. given in the detailed project reports, moderated in many cases by expert studies to take care of later constraints and changes. The Bureau of Public Enterprises has issued guidelines to be followed by the public sector enterprises in respect of general management, financial management, materials management, production management, construction management, etc. and these guidelines provide another basis for appraising enterprise performance and its systems. Another source of criteria is industrial engineering and other technical studies by internal and external experts and the standards given in these. Then there are standards of financial propriety. This is a broad indication of the criteria and sources of criteria for conducting efficiency and effectiveness audit of public enterprises.

Notes A basic task in audit is to carefully identify the acceptable criteria for assessing the efficiency and effectiveness of an enterprise so that the appraisal by audit is valid and meaningful.

The starting point of a comprehensive appraisal of a public enterprise, which covers aspects of economy, efficiency and effectiveness, is the preparation of an audit programme based on the study of decisions relating to the setting up of the enterprise, its objectives, the areas of operation, organisation, financial and operational details available in the annual reports and accounts, capital and operational budgets, deliberations of the board of directors, material in the earlier audit inspection reports on the enterprise and other relevant available papers. These audit programmes (or guidelines) identify the areas/aspects which require further detailed audit analysis and criteria, the data required for such analysis and the sources of such data, the extent of the audit analysis including the test checks to be applied and the Instructions to the audit parties assigned to the work.

Self Assessment

Fill in the blanks:

1. Under the Act of 1971, the scope and extent of audit is determined by the …….. .
2. Audit is an instrument of …… .
3. …… includes audit of provisions of funds, sanctions, compliances and propriety.
4. …… includes audit of efficiency, economy and effectiveness.

12.2 Audit of Banks

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. A banking company requires maintaining the books of account in accordance

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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.

12.2.1 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 008-09 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.

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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.

12.2.2 Audit of Accounts

Sub-section (1) of section 30 of the Act requires that the balance sheet and profit and loss account of a banking company should be audited by a person duly qualified under any law for the time being in force to be an auditor of companies. Similar provisions are contained in the enactments governing nationalised banks [section 10 of the Banking Companies (Acquisition and Transfer of Undertakings) Act of 1970/1980], State Bank of India [section 41 of the State Bank of India Act, 1955], subsidiaries of State Bank of India [section 41 of the State Bank of India (Subsidiary Banks) Act, 1959], and regional rural banks [section 19 of the Regional Rural Banks Act, 1976]. It is important to note that section 41 of the State Bank of India Act, 1955, specifically provides that the affairs of the bank shall be audited by "two or more auditors".

Qualifications of Auditor: According to section 226 of the Companies Act, 1956, a chartered accountant, a firm of chartered accountants, or a restricted state auditor can be appointed as auditor of a company. However, the following persons cannot be appointed as auditor of a company:

(a) a body corporate;

(b) an officer or employee of the company;

(c) a person who is a partner, or who is in 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 holding any security means an instrument which carries voting rights of the company (this disqualification is applicable from the expiry of a period of one year from the date of commencement of the Companies (Amendment) Act, 2000.

It may be noted that in case of indebtedness in excess of the specified limit as mentioned at (d) above, the chartered accountant concerned (or the firm of chartered accountants) becomes disqualified to audit any branch of the bank; the disqualification is not confined to appointment as auditor of the particular branch to which the debt is owed.

In the context of banks, the expression indebtedness would cover, inter alia, the amounts outstanding in respect of credit cards issued by a bank. Thus, where the credit card outstanding exceeds the prescribed limit of ₹ 1,000, the chartered accountant in whose name the card is issued as well as the firm of which he is a partner would be disqualified for appointment as auditor of the issuing bank.

Notes

Appointment of Auditor: As per the provisions of the relevant enactments, the auditor of a banking company is to be appointed at the annual general meeting of the shareholders, whereas the auditor of a nationalised bank is to be appointed by the bank concerned acting through its Board of Directors. In either case, approval of the Reserve Bank is required before the appointment is made. The auditors of the State Bank of India are to be appointed by the Reserve Bank of India in consultation with the Central Government. The auditors of the subsidiaries of the State Bank of India are to be appointed by the State Bank of India. The auditors of regional rural banks are to be appointed by the bank concerned with the approval of the Central Government.

As mentioned earlier, the State Bank of India Act, 1955, specifically provides for appointment of two or more auditors. Besides, nationalised banks and subsidiaries of State Bank of India also generally appoint two or more firms as joint auditors.

Remuneration of Auditor: The remuneration of auditor of a banking company is to be fixed in accordance with the provisions of section 224 of the Companies Act, 1956 (i.e., by the company in general meeting or in such manner as the company in general meeting may determine). The remuneration of auditors of nationalised banks and State Bank of India is to be fixed by the Reserve Bank of India in consultation with the Central Government. The remuneration of auditors of subsidiaries of State Bank of India is to be fixed by the latter. In the case of regional rural banks, the auditors' remuneration is to be determined by the bank concerned with the approval of the Central Government.

Powers of Auditor: The auditor of a banking company or of a nationalised bank, State Bank of India, a subsidiary of State Bank of India, or a regional rural bank has the same powers as those of a company auditor in the matter of access to the books, accounts, documents and vouchers. He is also entitled to require from the officers of the bank such information and explanations as he may think necessary for the performance of his duties. In the case of a banking company, he is entitled to receive notice relating to any general meeting. He is also entitled to attend any general meeting and to be heard there at on any part of the business, which concerns him as auditor.

It is important to note that under section 10 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980, the auditor of a nationalised bank may employ accountants or other persons at the expense of the bank to assist him in audit of accounts. Similar provisions exist in section 41 of the State Bank of India Act, 1955 and the State Bank of India (Subsidiary Banks) Act, 1959. These provisions are aimed at facilitating the work of auditors of these banks by empowering them to appoint the auditors of branches and are particularly important in the context of the fact that the above enactments do not contain any specific provisions for audit of branches of these banks. This is unlike banking companies where audit of branches is required under section 228 of the Companies Act, 1956. It may be noted that the Regional Rural Banks Act, 1976, does not contain any provisions relating to audit of branches. Accordingly, in the case of such banks, audit of branches is also carried out by the auditors appointed for the bank as a whole.

Auditor's Report: In the case of a nationalised bank, the auditor is required to make a report to the Central Government in which he has to state the following:

(a) whether, in his opinion, the balance sheet 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 the affairs of the bank, and in case he had called for any explanation or information, whether it has been given and whether it is satisfactory;

(b) whether or not the transactions of the bank, which have come to his notice, have been within the powers of that bank;

Notes

(c) whether or not the returns received from the offices and branches of the bank have been found adequate for the purpose of his audit;

(d) whether the profit and loss account shows a true balance of profit or loss for the period covered by such account; and any other matter which he considers should be brought to the notice of the Central Government.

Did u know? The report of auditors of State Bank of India is also to be made to the Central Government and is almost identical to the auditor's report in the case of a nationalised bank.

The auditor's report in the case of subsidiaries of State Bank of India is identical to the auditor's report in the case of a nationalised bank, except that all references to Central Government have to be construed instead as references to the State Bank of India. Similar is the position in the case of regional rural banks, except that the references are instead to the bank concerned.

In addition to matters on which he is required to report to the shareholders under the Companies Act, 1956, the auditor of a banking company is required to state in his report:

(a) Whether or not the information and explanations required by him have been found to be satisfactory;

(b) whether or not the transactions of the company which have come to his notice have been within the powers of the company;

(c) whether or not the returns received from the branch offices of the company have been found adequate for the purpose of his audit;

(d) whether the profit and loss account shows a true balance of profit or loss for the period covered by such account; and

(e) any other matter which he considers should be brought to the notice of the shareholders of the company.

It may be noted that in the case of a banking company, by virtue of the provisions of clause (d) of sub-section (3) of section 227 of the Companies Act, 1956, the auditor has to specifically report whether, in his opinion, the profit and loss account and balance sheet of the banking company comply with the accounting standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956.

Long Form Audit Report: Besides the audit report as per the statutory requirements discussed above, the terms of appointment of auditors of public sector banks, private sector banks and foreign banks [as well as their branches, require the auditors to also furnish a long form audit report (LFAR)]. The matters which the banks require their auditors to deal with in the long form audit report have been specified by the Reserve Bank of India.

Conducting an Audit

The audit of banks or of their branches involves the following stages:

(a) Preliminary Work.

(b) Evaluation of Internal Control System.

(c) Preparation of Audit Programme for Substantive Testing and its Execution.

(d) Preparation and Submission of Audit Report.

Notes

Preliminary Work

(i) The auditor should acquire knowledge of the regulatory environment in which the bank operates. Thus, the auditor should familiarise himself with the relevant provisions of applicable law(s) and ascertain the scope of his duties and responsibilities in accordance with such law(s). He should be well-acquainted with the provisions of the Banking Regulation Act, 1949, as well as any other applicable law(s) e.g. Companies Act, 1956 in the case of audit of a banking company particularly in so far as they relate to preparation and presentation of financial statements and their audit.

(ii) The auditor should also acquire knowledge of the economic environment in which the bank operates. Similarly the auditor needs to acquire good working knowledge of the services offered by the bank. In acquiring such knowledge, the auditor needs to be aware of the many variations in the basic deposit, loan and treasury services that are offered and continue to be developed by banks in response to market conditions. To do so, the auditor needs to understand the nature of services rendered through instruments such as letters of credit, acceptances, forward contracts, and other similar instruments.

The auditor should also obtain an understanding of the accounting system of the bank and the terminology used by the bank to describe various types of transactions and operations. Most banks have well-designed accounting and procedures manual which can serve as an important source of information on these aspects. Banks are extensively using information technology for its operations. The advent of technology has added a risk parameter to the auditor's process of risk assessment.

Evaluation of Internal Control System

AAS-6, 'Risk Assessment and Internal Control', states that auditor's procedure should be addressed to keep the audit risk at an acceptably low level and also require the auditor to assess the components of the audit risk. Internal control evaluation is an important element of audit process. In the case of audit of banks, it assumes even greater importance due to the enormous volume of transactions entered into by banks. Evaluation of design and operation of internal control system enables the bank auditors to perform more effective audits. The auditor should, therefore, study and evaluate the design and operation of internal controls. This would assist him in determining the nature, timing and extent of substantive procedures in various areas, depending upon whether the internal controls are adequate and observed in practice.

Preparation of Audit Programme for Substantive Testing and its Execution

Having familiarized himself the requirements of audit, the auditor should prepare an audit programme for substantive testing which should adequately cover the scope of his work. In framing the audit programme, due weightage should be given by the auditor to areas where, in his view, there are weaknesses in the internal controls. The audit programme for the statutory auditors would be different from that of the branch auditor. At the branch level, basic banking operations are to be covered by the audit. On the other hand, the statutory auditors at the head office level have to deal with consolidation of branch returns (both audited and unaudited), verification of investments, items normally deal with at the head office (like provision for gratuity, inter-office accounts, etc.). The scope of the work of the statutory auditors would also involve dealing with various accounting aspects and disclosure requirements arising out of the branch returns.

Caution The auditor should ensure that the work is executed in accordance with the audit programme by persons having the requisite skills and competence.

Notes

Preparation and Submission of Audit Report

The branch auditor forwards his report to the statutory auditors who have to deal with the same in such manner as they consider necessary. It is desirable that the branch auditors' reports are adequately detailed in unambiguous terms. As far as possible, the financial impact of all qualifications or adverse comments on the branch accounts should be clearly brought out in the branch audit report. It would assist the statutory auditors if a standard pattern of reporting, say, head-wise, commencing with assets, then liabilities and thereafter items related to income and expenditure, is followed. Similarly, for statutory auditors of a bank, the form and content of the audit report should be determined by the auditor taking into account his terms of engagement and applicably statutory, regulatory and professional requirements.

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 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.

Contd....

Notes

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.
3. The Cash Flow Statement gives a true and fair view of the cash flows for the year ended on that date.

Source: http://smartinvestor.business-standard.com/company/audrpt-6061-Indian_Bank.htm

Self Assessment

Fill in the blanks:

5. A banking company requires maintaining the books of account in accordance with section 209 of the Companies Act .....
6. The financial position of a bank is depended on the condition of assets, loan, investment, cash balanced and those of its .....

12.3 Audit of Non-Banking Financial Companies

Non-Banking Financial Companies (NBFCs) have been the subject of focussed attention during the nineties. In particular, the rapid growth of NBFCs, especially in the nineties, has led to a gradual blurring of dividing lines between banks and NBFCs, with the exception of the exclusive privilege that commercial banks exercise in the issuance of cheques. Owing to certain disquieting developments in the NBFC sector, the RBI Act was amended in 1997, providing for a comprehensive regulatory framework for NBFCs. The RBI (Amendment) Act, 1997 provides for compulsory registration with the Reserve Bank of all NBFCs, irrespective of their holding of public deposits, for commencing and carrying on business, minimum entry point norms, maintenance of a portion of deposits in liquid assets, creation of Reserve Fund and transfer of 20 per cent of profit after tax annually to the Fund. The Amendment Act also conferred powers on Reserve Bank to issue directions to companies and its auditors, prohibit deposit acceptance and alienation of assets by companies and effect winding up of companies.

Notes

Accordingly, the Reserve Bank issued directions to companies on acceptance of public deposits, prudential norms like capital adequacy, income recognition, asset classification, provision for bad and doubtful debts, exposure norms and other measures to monitor the financial solvency and reporting by NBFCs. Directions were also issued to auditors to report non-compliance with the RBI Act and regulations to the Reserve Bank, Board of directors and shareholders.

12.3.1 Classification of NBFCs

NBFCs normally fall into following categories:

1. ***Non-Banking Financial Company:*** In terms of the Section 45-I(f) read with Section 45-I(c) of the RBI Act, 1934, as amended in 1997, NBFC is one whose principal business is that of receiving deposits or that of a financial institution, such as lending, investment in securities, hire purchase finance or equipment leasing. Such companies may also be categorised as under:

   (a) Equipment leasing company engaged in equipment leasing or financing of such activity.

   (b) Hire purchase finance company engaged in hire-purchase transaction or financing of such transactions.

   (c) Investment company engaged in acquisition of securities and trading in such securities to earn a profit.

   (d) Loan company engaged in providing finance by making loans or advances, or otherwise for any activity other than its own; excludes EL/HP/Housing Finance Companies (HFCs).

   (e) Residuary Non-Banking Company (RNBC) which receives deposits under any scheme or arrangement, by whatever name called, in one lump-sum or in instalments by way of contributions or subscriptions or by sale of units or certificates or other instruments, or in any manner. These companies do not belong to any of the categories as stated above.

2. ***Mutual Benefit Financial Company (MBFC) i.e. Nidhi Company:*** Any company which is notified by the Central government under Section 620A of the Companies Act 1956 (1 of 1956).

3. ***Mutual Benefit Company (MBC), i.e., Potential Nidhi Company:*** A company notified under section 620A of the Companies Act, 1956 and by the Central Government, having minimum Net Owned Funds and Preferential Share Capital of ₹ 10 lakh, has applied to the RBI for Certificate of Registration and also to Ministry of Company Affairs (MCA) for declaration as Nidhi company and has not contravened directions/regulations of Reserve Bank/MCA.

4. ***Miscellaneous Non-Banking Company (MNBC), i.e., Chit Fund Company:*** Managing, conducting or supervising as a promoter, foreman or agent of any transaction or arrangement by which the company enters into an agreement with a specified number of subscribers that every one of them shall subscribe a certain sum in instalments over a definite period and that every one of such subscribers shall in turn, as determined by lot or by auction or by tender or in such manner as may be provided for in the arrangement, be entitled to the prize amount.

Notes

12.3.2 Audit Procedure

The following are the necessary steps involved:

1. ***Ascertaining the Business of the company:*** The first step in carrying out the audit of a NBFC is to scan through the Memorandum and Articles of Association of the company, so as to acquaint oneself with the type of business that the company proposes to engage itself in. Normally, the Memorandum of Association of any company would be very wide in scope thereby permitting it to undertake a host of business activities, but companies generally lend to specialise in and focus on a few select activities.

> *Notes* An auditor should therefore make a careful study of the business policy of the company so as to ascertain its principal business activities.

For this purpose, an auditor may also scan through the minutes of the Board/Committee Meetings and hold discussions with the top level management to ascertain the corporate business plan/strategy which would give him a clear picture as to the principal objects of the company. An auditor should then independently corroborate his findings with the actual business done by the company, as reflected by the company's financial results.

The task of ascertaining the principal business activity of any NBFC is of paramount importance (more so with the recent amendments made to the RBI Act) since the very classification of a company as a NBFC and its further classification into a loan company or an investment company or an equipment leasing/hire purchase finance company would all depend upon its principal business activity. Based on the classification of a company into a loan Company/Investment company etc., it will be accordingly required to comply with the provisions relating to limits on acceptance of public deposits as contained in the NBFC Public Deposit Directions.

2. ***Evaluation of Internal Control System:*** The responsibility of maintaining an adequate accounting system incorporating various internal controls to the extent appropriate to the size and nature of its business vests with the management. A sound internal control system would enable an organisation to plug loopholes in its workings, particularly in the detection of frauds and would also aid in timely decision making.

> *Notes* An auditor should gain an understanding of the accounting system and related internal controls adopted by the NBFC to determine the nature, timing and extent of his audit procedures.

An auditor should also ascertain whether the internal controls put in place by the NBFC are adequate and are being effectively followed.

In particular, an auditor should review the effectiveness of the system of recovery prevalent at the NBFC. He should ascertain whether the NBFC has an effective system of periodical review of advances in place which would facilitate effective monitoring and follow up. The absence of a periodical review system could result in non-detection of sticky advances at its very inception which would ultimately result in the NBFC having an alarmingly high level of NPAs.

3. ***Registration with the RBI:*** Section 45-IA inserted by the RBI Act, w.e.f. 9th January, 1997, has made it incumbent on the part of all NBFCs to comply with registration requirements

Notes

and have minimum net owned funds of ₹ 25 lakhs for commencing/carrying on its business. An auditor should obtain a copy of the certificate of registration granted by the RBI or in case the certificate of registration has not been granted, a copy of the application form filed with the RBI for registration. It may particularly be noted that NBFCs incorporated after 9th January, 1997 are not entitled to commence business without first obtaining a registration certificate from the RBI. An auditor should therefore verify whether the dual conditions relating to registration with the RBI and maintenance of minimum net owned funds have been duly complied with by the concerned NBFC.

4. ***NBFC Public Deposit Directions:*** The auditors must ascertain whether the company is a loan company or an investment company or a hire purchase finance company or an equipment leasing company as per the classification, if any, assigned to the NBFC by the RBI. In case, the NBFC has not been classified by the RBI, the classification of a company will have to be determined after a careful consideration of various factors such as particulars of earlier registration granted, if any, particulars furnished in the application form for registration, company's Memorandum of Association and its financial results.

5. ***NBFC Prudential Norms Directions:***

   - Check compliance with prudential norms encompassing income recognition, income from investments, accounting standards, accounting for investments, asset classification, provisioning for bad and doubtful debts, capital adequacy norms, prohibition on granting of loans by a NBFC against its own shares, prohibition on loans and investments for failure to repay public deposits and norms for concentration of credit/investments.
   - An auditor should ensure that the Board of Directors of every NDFC granting/ intending to grant demand/call loans shall frame a policy for the company and shall implement too.
   - An auditor should assess on the basis of examinations conducted by him whether the NBFC has complied with the prudential norms. In particular, he should verify that advances and other credit facilities have been properly classified as standard/ sub standard/doubtful/loss and that proper provision has been made in accordance with the Directions.
   - In respect of Non-Performing Assets, an auditor should check whether the unrealised income in respect of such assets has not been taken to the Profit & Loss Account on an accrual basis. Income from NPAs should be accounted for on realisation basis only.
   - Check whether all accounts which have been classified as NPAs in the previous year also continue to be shown as such in the current year also. If the same is not treated as a NPA in the current year, the auditor should specifically examine such accounts to ascertain whether the account has become regular and the same can be treated as performing as per the Directions.

Self Assessment

Fill in the blanks:

7. 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.

8. The consent given by an audit firm will be treated as…… .

Notes

9. The auditors of the State Bank of India are to be appointed by the …….. in consultation with the Central Government.

10. Internal control evaluation is an important element of……. .

12.4 Audit of Insurance 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.

12.4.1 Audit of Accounts

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 companies), policyholders, re-insurers 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.

Under section 12 of the Insurance Act, 1938, the financial statements of every insurer are required to be audited annually by an auditor. Section 2(4) of the Insurance Act, 1938 defines the term 'auditor' as a person qualified under the Chartered Accountants Act, 1949 to act as an auditor of a company. The auditor, for audit of financial statements, has the powers to exercise the rights

Notes

vested in, and discharge the duties and be subject to the liabilities and penalties imposed on auditors of companies under the Companies Act, 1956.

The provisions of Section 12 of the Insurance Act, 1938 apply only in a case where the financial statements of the insurer are not subject to audit under the Companies Act, 1956. A company carrying on general insurance business is subject to audit requirements laid down under the Companies Act, 1956.

The financial statements under section 12 include Balance Sheet, Profit and Loss Account and Revenue Account. Section 12 of the Insurance Act, 1938 does not cover the requirement for audit of the Receipts and Payments Account of an insurer. It may be noted that the Insurance Regulatory and Development Authority Act, 1999 inserted a new sub-section (1A) in Section 11 of the Insurance Act, 1938. The sub-section has an overriding effect over sub-section (1) of section 11 that prescribed the financial statements to be prepared by an insurer. The new sub-section requires that after the commencements of IRDA Act, 1999, every insurer, in respect of insurance business transacted by him and in respect of his shareholders funds, should prepare, at the end of each financial year, a Balance Sheet, a Profit and Loss Account, a separate Account of Receipts and Payments and a Revenue Account in accordance with the regulations made by the IRDA. Since Receipts and Payments Account has been made a part of financial statements of an insurer, it is implied that the Receipts and Payment Account is also required to be audited.

The Authority, in exercise of the powers conferred by the Insurance Act, 1938, issued the IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2000. These Regulations require the auditor of an insurance company to report whether the Receipts and Payments Account of the insurer is in agreement with the books of account and returns. The auditor is also required to express an opinion as to whether the Receipts and Payments Account has been prepared in accordance with the provisions of the relevant statutes and whether the Receipts and Payments Account gives a true and fair view of the receipts and payments of the insurer for the period under audit. This also implies that the auditor is required to audit the Receipts and Payments Account of the insurer.

Appointment of Auditors: The appointment of statutory auditors in the General Insurance Corporation of India, and its subsidiaries and the divisions is made by the Comptroller and Auditor General of India, as in the case of other public sector undertakings. The appointment of auditors of the agencies abroad is made by the Board of Directors of each company.

Rights and Duties of Branch Auditors: It is a practice that the divisional offices prepares a trial balance in a manner that it provides information required to be included in the various formats of financial statements prescribed in the Insurance Act. Each trial balance, in which are incorporated the figures relating to the branches of the divisions, is required to be audited and the report thereon is furnished to the statutory auditors. The divisions of the companies carrying on general insurance business are treated for the purposes of the Companies Act, 1956 as their branches. It follows that the branch auditors appointed to conduct the audit of the divisions have the same rights and obligations under the statute as those of the, statutory auditors to whom they are expected to submit their report.

Auditors' Report: The Authority has prescribed the matters to be dealt with by the Auditors' Report vide Regulation 3 under Schedule C of IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2000.

Tax Audit: It is necessary for general insurance companies to get their accounts audited under Section 44AB of the said Act. For this purpose, the tax auditor(s) may be appointed by the company itself by means of a resolution of the Board of Directors or by the Chairman/Managing Director if so authorised in this behalf. The company is expected to fix separate remuneration for the auditor(s) appointed for this purpose. The Form of tax audit report applicable would be

Form 3C and the prescribed particulars would have to be given in Form 3CD, in accordance with Rule 6G of the Income Tax Rules, 1962, pursuant to Section 44AB of the Income Tax Act, 1961. It is recommended that, wherever applicable, a common audit programme be framed for statutory audit and for certification of the prescribed particulars under the aforesaid rules for tax audit.

12.4.2 Audit Procedures

The important part of the business operations of general insurance companies comprises the issuance of policies for risks assumed and to indemnify the insured for losses to the extent covered by such policies. In financial terms, these operations get translated into the receipt and recording of premiums and the recording and settlement of claims. Both premiums and claims have a significant impact on the insurance companies' revenues, it would be an important part of the duty of the auditor to satisfy himself that the financial transactions involving both these operations have been fairly and properly recorded in the relevant books of account.

Caution The auditor should also ensure that the legal requirements as to the disclosure of these items are complied with in the financial statements.

The auditor's primary objective in audit of investments is to satisfy himself as to their existence and valuation. Examination of compliance with statutory and regulatory requirements is also an important objective in audit of investments insofar as non-compliance may have a direct and material affect on the financial statements. The auditor should verify the investment scrips physically at the close of business on the date the balance sheet. In exceptional cases where physical verification of investment scrips on the balance sheet date is not possible, the auditor should carry out the physical verification on a date as near to the balance sheet date as possible. In such a case, he should take into consideration any adjustments for subsequent transactions of purchase, sale, etc. He should take particular care to see that only genuine investments are produced before him, and that securities held by the insurance company on behalf of others (e.g., those held as security against loans) are not shown to him as the insurance company's own investments.

Notes To ensure this, the auditor should – require that all investment scrips in the possession of the insurance company – whether belonging to it or to borrowers should be produced before him simultaneously.

The auditor should keep them under his control until he completes his checking. Normally, the investments of an insurance company are held by the insurance company itself or a depository (in the case of dematerialised securities other than government securities).

Investments are normally dealt with at the Head Office and not at the branches. However, sometimes, for realisation of interest, etc. and other similar purposes, investments of an insurance company may be held at Branch Offices also. In such cases, the auditor should examine the record maintained at the Head Office to record details of investments held at other locations and request the respective branch auditors to physically verify such investments as a part of their audit. The auditor should obtain a written confirmation to this effect from the branch auditors. In case the verification has been done on a date other than the balance sheet date, a statement showing the reconciliation of the investments held at the time of physical verification with the investments held as on the balance sheet date should also be obtained from the branch auditors. The branch auditors should report whether adequate records are maintained by the branch for the securities held by it on behalf of the Head Office.

Notes

Investments should not normally be held by any other person (as laid down in the City Equitable Fire Insurance Co. case). If any investments are so held, proper enquiry should be made to ensure that there is some justification for it, e.g., shares may be held by brokers for the purpose of transfer or splitting-up, etc. Shares may also be lodged with the companies concerned for transfer etc. When investments are held by any other person on behalf of the insurance company, the auditor should obtain a certificate from him. The certificate should state the reason for holding the investment (e.g., in safe custody or as security).

In respect of scripless dealings in investments through the OTC Exchange of India, the auditor should verify the interim and other acknowledgements issued by dealers as well as the year-end confirmation certificates of the depository organisation. The auditor should also examine whether securities lodged for transfer are received back within a reasonable period. Similarly, he should examine whether share certificates, etc. are received within a reasonable period, of the lodging of the allotment advice. In case there is an unusual delay in registration of transfers, etc., the auditor should see that adequate follow-up action has been taken. He may, in appropriate cases, also enquire from the issuers, or their registrars, about the delays. In cases where the issuer/ registrar has refused to register the transfer of securities in the name of the insurance company, the auditor should verify the validity of the title of the insurance company over such securities.

The auditor should examine whether the portfolio of the insurance company consists of any securities whose maturity dates have already expired. It is possible that income on such investments may also not have been received. In case the amount of such investments or the income accrued thereon is material, the auditor should seek an explanation from the management on this aspect. He should also consider whether any provision for loss on this account is required. Similarly, where income on any security is long overdue, the auditor should consider whether provision is required in respect of such income accrued earlier. Investments in securities now-a-days constitute a substantial part of total assets of many insurance companies. Method of valuation of investments followed by an insurance company may, therefore, have a significant effect on its Balance Sheet and Profit and Loss Account. The auditor should examine whether the method of accounting followed by the insurance company in respect of investments, including their year-end valuation, is appropriate.

The auditor should examine the manner of accounting for investments in the context of the guidelines of the Insurance Regulatory and Development Authority and the accounting policy followed by the insurance company in respect of' investments. The auditor should examine the appropriateness of accounting policies followed by the insurance company. In case any of the accounting policies is not appropriate, the auditor should consider the effect of adoption of such policy on the financial statements and, consequently, on his audit report. A change in the method of valuation of investments constitutes a change in accounting policy and adequate disclosure regarding the fact of the change along with its financial effect should be made in the balance sheet. The auditor should examine whether income from investments is properly accounted for. This aspect assumes special importance in cases where the insurance company has opted for receipt of income through the Electronic Clearing Service. There may be cases where the certificates of tax deduction at source (TDS) received along with the interest on investments are found missing. This increases the incidence of tax on the insurance company. The auditor should see that there is a proper system for recording and maintenance of TDS certificates received by the insurance company.

Task How audit procedure for banks is different from insurance company?

Notes

12.4.3 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, reinsures, tax authorities can hardly be overemphasized.

Self Assessment

Fill in the blanks:

11. Co-operative Society shall not make a loan to any person other than a .....
12. ..... main role is preparation of financial statements and auditor's report of insurance companies.
13. ..... is the actual claims paid less adjustments for reinsurance recoveries on them and provisions for claims outstanding as on the date of financial reporting.
14. 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.

12.5 Audit of Co-operative Societies

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.

Notes

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, Labour 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 modelled 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.

12.5.1 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 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 (4A) 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.

12.5.2 Salient Features Concerning Accounts

Following are the salient features concerning accounts:

(i) ***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.

(ii) ***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.

(iii) ***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).

(iv) ***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 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.

12.5.3 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

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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-sections (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.

The following points should be kept in mind in connection with the audit of a co-operative society:

1. ***Qualifications of Auditors:*** Apart from a chartered accountant within the meaning of the Chartered Accountants Act, 1949, some of the State Co-operative Acts have permitted persons holding a government diploma in co-operative accounts or in co-operation and accountancy as also a person who has served as an auditor in the co-operative department of a government to act as an auditor.
2. ***Appointment of the Auditor:*** An auditor of a co-operative society is appointed by the Registrar of Co-operative Societies and the auditor so appointed conducts the audit on behalf of the Registrar and submits his report to him as also to the society. The audit fees are paid by the society on the basis of statutory scale of fees prescribed by the Registrar, according to the category of the society audited.

Example: The audit fees of co-operative credit society and Urban Co-operative Banks are to be calculated with reference to working capital at the prescribed rates. 'Working Capital' here means funds at the disposal of the society inclusive of paid up share capital, funds built up out of profits and monies raised by borrowing and by other means.

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3. ***Books, Accounts and other records of Co-operative Societies:*** Under section 43(h) of the Co-operative Societies Act, a state government can frame rules prescribing the books and accounts to be kept by a co-operative society.

Example: In Maharashtra the co-operative societies are required to maintain cash book, general ledger, personal ledger, stock register, property register, etc. It is very much clear that requirement under State Acts resembles the provisions made under Section 209 of the Companies Act, 1956.

4. ***Restrictions on shareholdings:*** According to Section 5 of the Co-operative Societies Act, 1912, in the case of a society where the liability of a member of the society is limited, no member of a society other than a registered society can hold such portion of the share capital of the society as would exceed a maximum of twenty percent of the total number of shares or of the value of shareholding to ₹ 1,000. The auditor of a co-operative society will be concerned with this provision so as to watch any breach relating to holding of shares. One should also watch whether any provision in the bye-laws of the society is not contrary to this statutory position. The State Acts may provide limits as to the shareholding, other than that provided in the Central Act.

5. ***Restrictions on loans:*** A registered society shall not make a loan to any person other than a member. With the special sanction of the Registrar, a registered society may make a loan to another registered society (Section 29).The State Government may further put such restrictions as it thinks fit on the loaning powers of the society to its members or to other societies in the interest of the society concerned and its members.

6. ***Restrictions on borrowings:*** A registered society may accept loans and deposits from its members and others subject to the restrictions and limits of the bye-laws of the society. The auditor will have to examine the bye-laws in this respect (Section 30).

7. ***Investment of funds:*** According to Section 32 of the Central Act the modes of investment of funds of a society may be stated as follows. A society may invest its funds in any one or more of the following:

   (i) In the Central or State Co-operative Bank.

   (ii) In any of the securities specified in Section 20 of the Indian Trusts Act, 1882.

   (iii) In the shares, securities, bonds or debentures of any other society with limited liability.

   (iv) In any co-operative bank, other than a Central or State co-operative bank, as approved by the Registrar on specified terms and conditions.

   (v) In any other moneys permitted by the Central or State Government.

   The principal provision relating to the investments of funds of a co-operative society, the Central as well as State Acts does not mention anything about the investment of reserve fund outside the business specifically.

8. ***Appropriation of profits:*** Section 33 of the Central Act states that 25% of the profits should be transferred to Reserve Fund, before distribution as dividends or bonus to members. However, having regard to the financial position of the society, the Registrar may reduce the percentage of transfer, but in any case not less than 10%. Generally in case of newly started salary earners' credit societies this liberal view is taken.

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9. ***Contributions to Charitable Purposes:*** According to Section 34, a registered society may, with the sanction of the Registrar, contribute an amount not exceeding 10% of the net profits remaining after the compulsory transfer to the reserve fund for any charitable purpose as defined in section 2 of the Charitable Endowments Act, 1890.

10. ***Investment of Reserve Fund outside the business or utilisation as working capital:*** Some of the State Acts provide that a society may use the Reserve Fund:

    (i) in the business of a society, as working capital (subject to the rules made in this behalf).

    (ii) may invest as per provisions of the Act.

    (iii) may be used for some public purposes likely to promote the object of the society. The auditor should ensure strict compliance with the State Act and Rules in this regard.

11. ***Contribution to Education Fund:*** Some of the State Acts provide that every society shall contribute annually towards the Education Fund of the State Federal Society, at the appropriate rate as per the class of the society. Contribution to Education Fund is a charge on profits and not an appropriation.

Special features of Co-operative Audit

The general processes of auditing involved in audit work such as checking of posting, ascertainment of arithmetical accuracy, vouching, verification of assets and liabilities and final scrutiny of Balance Sheet are well known to the students, and the same are to be applied in co-operative audit as well. It need not be discussed in detail. However, the special features of co-operative audit, to be borne in mind in general while conducting the audit are as follows:

(i) ***Examination of overdue debts:*** Overdue debts for a period from six months to five years and more than five years will have to be classified and shall have to be reported by an auditor. Overdue debts have far reaching consequences on the working of a credit society. It affects its working capital position. A further analysis of these overdue debts from the viewpoint of chances of recovery will have to be made, and they will have to be classified as good or bad. The auditor will have to ascertain whether proper provisions for doubtful debts are made and whether the same is satisfactory. The percentage of overdue debts to the working capital and loans advanced will have to be compared with last year, so as to see whether the trend is increasing or decreasing whether due and proper actions for recovery are taken, the position regarding cases in co-operative courts, District Courts etc. and the results thereof.

(ii) ***Overdue Interest:*** Overdue interest should be excluded from interest outstanding and accrued due while calculating profit. Overdue interest is interest accrued or accruing in accounts, the amount of which the principal is overdue. In practice an overdue interest reserve is created and the credit of overdue interest credited to interest account is reduced.

(iii) ***Certification of Bad Debts:*** A peculiar feature regarding the writing off of the bad debts as per Maharashtra State Co-operative Rules, 1961, is very interesting to note. As per Rule No. 49, bad debts can be written off only when they are certified as bad by the auditor. Bad debts and irrecoverable losses before being written off against Bad Debts Funds, Reserve Fund etc. should be certified as bad debts or irrecoverable losses by the auditor where the law so requires. Where no such requirement exists the managing committee of the society must authorise the write-off.

Self Assessment

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Fill in the blanks:

15. 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 .....
16. With sanction of ....., Co-operative societies may also borrow from credit agencies subject to the limits and conditions prescribed.
17. While the main object of a ..... is to earn profit, the object of a ..... is to render service to its members.
18. Proper classification of assets and provisioning of cooperative institutions are based on .....

Case Study

AngloGold Ashanti - Mine Closure Stretches Environmental Legislation

AngloGold Ashanti is an active participant in the development of a water management strategy in the Klerksdorp, Orkney, Stilfontein and Hartebeesfontein (KOSH) area, after it found itself, along with other mining companies, in the middle of uncharted legal territory.

This followed a dispute over responsibility for pumping of underground water after DRDGOLD placed its North West Operations (NWO), comprising Hartebeesfontein and Buffelsfontein mines, into provisional liquidation on 22 March 2005. Prior to this, dewatering of mines in the area was conducted by each mining company at their own mine shafts – DRDGOLD Limited, Harmony Gold Mining Company and AngloGold Ashanti – and Stilfontein Gold Mining Company, which, though closed, contracted the dewatering at its Margaret shaft to Hartebeesfontein.

Pumping is necessary to prevent the flow of underground water from mines at a higher location within the mining area to lower-lying mines and to keep the mines at the higher location dry for their own operating purposes. The designs of higher lying and shallower mines, like Hartebeesfontein, Buffelsfontein and Margaret, took account of the challenges posed by large volumes of water, unlike the deeper shafts owned by AngloGold Ashanti and Harmony, which do not encounter such volumes. Indeed Margaret shaft pumps a total of 37 mega litres a day (Ml/d), the equivalent of 740 swimming pools, while five other shafts in the area pump much lesser amounts each – 20.50 Ml/d in total. Once DRDGOLD abrogated its responsibilities to continue pumping natural underground water, the ensuing debate highlighted a crucial area, namely, on whose shoulders the pumping responsibility should lie when one mine closes down before another. The South African statutory law, in the opinion of AngloGold Ashanti, is clear in this regard, the mine in whose area the underground water occurs has the obligation to manage such water.

When DRDGOLD left responsibility for pumping with its liquidators, mines operated by AngloGold Ashanti and Harmony, lying as they do on the down dip of DRDGOLD's North West Operations, were at risk of flooding with a number of possible impacts: cessation of operations, loss of a valuable resource, and resultant job losses affecting the social and economic fabric of the area.

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AngloGold Ashanti's immediate response, on 13 April 2005, was to launch an urgent interim interdict to request the court to order DRDGOLD to continue to dewater at its operations, in terms of legislation contained in the National Water Act, the National Environmental Act, the Mine Health and Safety Act and the Mineral and Petroleum Resources Development Act, which says that each mining company is responsible for its own environmental impacts and safety and that it may not pass pollution and safety problems on to another mining company – in other words "the polluter pays" principle. Mining companies, in any event, are compelled to make financial provision and fulfil certain environmental obligations before obtaining a closure certificate from the Department of Minerals and Energy (DME). AngloGold Ashanti also asked the court to direct the state to fulfil its statutory duties.

As a result of the launching of the urgent interdict, the Department of Water and Forestry Affairs (DWAF), in the meantime, issued a directive to mining companies to formulate a proposal on how to handle the KOSH water issue. AngloGold Ashanti submitted a document suggesting a way forward. The proposal suggests that over the next 18 years (covering the life of mines in the area), water should continue to be pumped to surface at Stilfontein Margaret shaft before being piped to the local water service provider, Midvale Water Company or other water services provider where it is to be blended with Vaal River water, treated and used for domestic, industrial and mining purposes.

AngloGold Ashanti has also suggested that a water company (with the mining companies and government as members), similar to Midvale, be formed to manage the current crisis now and into the future. This should create a revenue stream to pay for pumping costs over the next 18 years and will make more widespread use of the water being pumped at Margaret shaft, now being discharged to the surface environmental and water resources. On the question of sustainability, as raised by government, the proposal further advises continued pumping for a 10-year period following mine closure, until voids fill up. It is also envisaged that, since the quality of water may not be accurately established at this time, a pre-treatment plant be erected at Margaret shaft before water is transferred to Midvale Water Company. With regard to water pollution, a monitoring measure is currently under investigation by DWAF, which is considering installing a Water Discharge Charge system, whereby companies will be charged for volumes and contaminants discharged into the natural watercourse.

At a two-day workshop held in October 2005, all mining companies and stakeholders agreed on the establishment of a water company, which will ultimately benefit the community, mining companies and government. Foreseeable challenges, besides raising the R60 million needed to set up the company, are how DWAF and the DME will legally appropriate Margaret shaft from Stilfontein in view of the fact that the company has no directors – they resigned en masse earlier in the year when they faced contempt of court proceedings for failing to comply with the DWAF directives; and the speed with which DWAF will be able to furnish a water license permit for the new company.

While AngloGold Ashanti is confident that the new water company will get off the ground in the foreseeable future, it would like to see government intervention in certain areas before a crisis on the scale of the KOSH area presents itself. Chief of these is ensuring that closure strategies are in place long before all mining operations cease, and that these strategies adopt a holistic view of the needs of affected areas.

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Hydrogeology in the South African Region

Hydrogeology – the study of the interaction of groundwater with surface water bodies, soil and rock formations and waste rock bodies – forms part of AngloGold Ashanti's integrated water management plan as prescribed by South African legislation.

Hydrogeology falls under the Water Management section of the South African Environmental Management Department. A number of hydrogeology projects have been undertaken over the past four years. They include isotope analyses to determine the origin and speciation of water bodies; studies to predict the influx of water into gold mines within the KOSH (Klerksdorp, Orkney, Stilfontein and Hartebeesfontein) area and to quantify the future influx of water into the Stilfontein area in the event of mine closure; and an assessment of the impact of dewatering of mines on neighbouring groundwater users, both in terms of quantity and water quality.

The main objectives of hydrogeology in the South Africa region are to establish the following:

- Identification of pollution sources and potential pollution sources (e.g. Tailings dams, dirty water separation dams, storm water dams);
- Risk assessment and classification of pollution sources;
- Mitigating the paths of pollution sources to prevent their ingress into unpolluted water;
- Identification of receivers of pollution (e.g. Rivers and other natural water sources) and mitigation options; and
- Impacts of mine dewatering.

Data obtained from the integrated ground and surface water monitoring network has enabled the compilation of a number of formal monitoring reports in the South Africa region. This has allowed for the construction of a detailed groundwater model and predictive simulations to identify potential groundwater risk. Groundwater contaminant flow transport models were constructed to quantify possible pollution impacts over a period of, for example, 20 years. The transport models were ranked according to their salt load allocation (the higher the salt load, the more polluted the water) and the distance over which the pollution travels.

From an identification of groundwater risk, AngloGold Ashanti has been able to pinpoint potential problem areas, and to implement mitigation strategies. These include:

- Responsible management of explosives which contain a high nitrate composition and therefore the potential to pollute groundwater;
- Implementation of production boreholes to intercept groundwater pollution plumes and thus reduce the contaminant flow into unpolluted water sources;
- Rehabilitation of soils and continuous monitoring of dam water level overflows to prevent seepage;
- Maximisation of the re-use of water;
- Installation of under-drains to intercept polluted water in shallow groundwater tables;
- Regular assessment of evaporation dams, to check salt levels, and of clean water dams, to prevent the ingress of potential pollution sources;

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- Lining of dirty water dams to prevent seepage; and
- Rehabilitation of pyrite stockpiling areas, which are a potential pollution source.

These measures are intended to substantially reduce the risk of groundwater pollution, ensuring company compliance with national water management policy, while at the same time minimising AngloGold Ashanti's potential liability.

Question:

Analyse the case and write down the case fact.

Source: http://www.anglogold.com/subwebs/informationforinvestors/reporttosociety05/values_bus_principles/environment/e_cs_sa_5_8.htm

12.6 Summary

- The public sector undertakings differ from private sector undertakings in many ways.
- These undertakings have been set up mainly in three forms, viz., departmental commercial undertakings, statutory corporations and government companies.
- A majority of these undertakings have been set up as government companies under the Companies Act, 1956 just like any other company in the private sector.
- The objective of the Financial Committees is not to focus only on the individual irregularity, but on the defects in the system which leads to such irregularity, and the need for correction of such systems and procedures.
- Under the Act of 1971, the scope and extent of audit is determined by the Comptroller and Auditor General.
- The areas covered in comprehensive audit vary from enterprise to enterprise depending on the nature of the enterprise, its objectives and operations.
- Audit appraisal analyses the performance of an enterprise to bring out the extent to which the objectives for which the enterprise was set up have been served.
- A basic task in audit is to carefully identify the acceptable criteria for assessing the efficiency and effectiveness of an enterprise so that the appraisal by audit is valid and meaningful.
- Sub-section (1) of section 30 of the Act requires that the balance sheet and profit and loss account of a banking company should be audited by a person duly qualified under any law for the time being in force to be an auditor of companies.
- The auditor of a banking company is to be appointed at the annual general meeting of the shareholders, whereas the auditor of a nationalised bank is to be appointed by the bank concerned acting through its Board of Directors.
- Under section 12 of the Insurance Act, 1938, the financial statements of every insurer are required to be audited annually by an auditor.
- The auditor's primary objective in audit of investments is to satisfy himself as to their existence and valuation.
- 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.

Notes

12.7 Keywords

Audit: An unbiased examination and evaluation of the financial statements of an organization.

Banking: 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 (section 5(i)(b)).

Banking Company: Banking company means any company which transacts the business of banking (section 5(i)(c)).

Compliance Audit: Audit undertaken to confirm whether a firm is following the terms of an agreement (such as a bond indenture), or the rules and regulations applicable to an activity or practice prescribed by an external agency or authority.

Fiscal Accountability: Maintaining the documentation necessary to support the financial auditability of an item throughout its life cycle.

Insurance Premium: 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.

Insurance Regulatory & Development Authority: 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.

Managerial Accountability: It refers to a system of supervisory control, peer reviews and reporting requirements, the agents being accountable to principals.

Mutual Benefit Financial Company: A company structure in which the company's owners are also its clients.

Non-Performing Assets: A debt obligation where the borrower has not paid any previously agreed upon interest and principal repayments to the designated lender for an extended period of time.

Non-Banking Financial Companies: NBFCs are the heterogeneous group of institutions (other than commercial and co-operative banks) performing financial intermediation in a variety of ways, like accepting deposits, making loans and advances, leasing, hire purchase, etc.

12.8 Review Questions

1. Write short note on "Unexpired Risks Reserve".
2. Write a short note on Comprehensive Audit of Public Enterprises.
3. The audit of accounts of banks is carried out in four stages. Mention and explain them.
4. Discuss in detail the audit procedure of NBFCs.
5. What are the special features of a co-operative audit?
6. State the procedure for verification of Agents' Balances in the course of Audit of GIC.
7. 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.
8. 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?

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9. 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?

10. "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.	Comptroller and Auditor General	2.	Accountability
3.	Fiscal Accountability	4.	Managerial Accountability
5.	1956	6.	Liabilities and fund
7.	1 lac crore	8.	Irrevocable
9.	Reserve Bank of India	10.	Audit process
11.	Member	12.	IRDA
13.	Incurred Claims	14.	URR
15.	KCS Act and Rules	16.	State Government
17.	Joint Stock Company; Co-operative Society		
18.	IRAC Norms		

12.9 Further Readings

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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

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

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Unit 13: Tax and Cost Audit

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Objectives

After studying this unit, you will be able to:

- Discuss the audit of Public Trusts
- Explain the Audit report under the VAT law
- Describe the Concept of Cost Audit
- Identify the Functions of Cost Auditor

Introduction

For ensuring compliance sometimes audit become a necessity. Therefore, various statutes, including legislations governing direct and indirect tax provisions have incorporated audit provisions in some or the other form. Under direct taxes, the Central Board of Direct taxes has posed onerous responsibility on the auditor via Income-tax Act, 1961 which has various provisions requiring compulsory audit. In the field of indirect taxes, audit is mostly done by departmental officers. However, with the growing importance of the indirect taxes in the economy, the Government is realizing the need of audit by independent bodies especially equipped to do the same. Introduction of audit provisions in the newly introduced Value Added Tax (VAT) legislations is a step towards this direction.

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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.

13.1 Audit(s) Under the Income Tax Act, 1961

The Income-tax Act, 1961 (hereinafter referred to as the Act) contains several provisions for audit of accounts of public charitable trusts, non-corporate assesses and other assesses to meet the specific objectives of the Act. Under the Act, several sections such as 12A, 35D, 35E, 44AB, 80-IA, 142 (2A), etc., require audit of accounts for tax purposes. We shall discuss the requirements of some of these provisions from the audit angle.

Who can audit the Accounts under the Income-tax Act: Normally, in all the sections referred to above, subject to the exceptions specifically provided, the audit is to be conducted by an 'accountant', as defined in the Explanation below Section 288(2) of the Act. The Explanation to Section 288(2) defines 'accountant' as a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949 and any other person who is entitled to be appointed as an auditor of a company under Section 226(2) of the Companies Act, 1956. It is clear that any chartered accountant, whether in practice or not, is also covered by the definition of the term Accountant. It may, therefore, *prima facie* appear that even a non-practising member of the Institute may be covered by the definition of 'accountant'. However, Section 7 of the Chartered Accountants Act, 1949 requires every member who practices as a Chartered Accountant to hold a certificate of practice.

Notes If a member wants to render his services which amount to "practice", must hold a certificate of practice.

Further, it may be noted that by the virtue of a resolution of the Council, with effect from 1st April 2005, a member in part-time practice (namely holding a certificate of practice and also engaging himself in any other business and/or occupation) is not entitled to perform attest functions including tax audit. Therefore, although it is not directly inherent in the definition of "accountant" given by Section 288, it is nevertheless a necessary requirement that the member concerned must hold a certificate of practice.

13.1.1 Audit of Public Trusts

Section 12A of the Act deals with the conditions as to registration of trust etc. According to this section, exemption from Income tax would be available under sections 11 and 12 of the Income tax Act in relation to the income of any trust or institution provided the following conditions are satisfied:

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(A) The person in receipt of the income has made an application for registration of the trust or institution in the prescribed form and in the prescribed manner to the Commissioner before the expiry of one year from the date of the creation of the trust or establishment of the institution. The Commissioner can, however, in his discretion admit an application for registration after the expiry of the period aforesaid.

(B) Where the total income of the trust or institution as computed under this Act, without giving effect to the provisions of Sections 11 and 12 exceeds the maximum amount which is not chargeable to income tax in any previous year i.e. ₹ 1,00,000 for the A.Y. 2007-08, the accounts of the trust or institution for that year have been audited by an accountant as defined in the explanation below sub-section (2) of Section 288 and the person in receipt of the income furnishes along with the return of Income for the relevant assessment year, the report of such audit in the prescribed form duly signed and verified by such accountant and setting forth such particulars as may be prescribed. Rule 17B of the Income tax Rules, 1962 provides that the report of audit of accounts of a trust or institution which is required to be furnished under Clause (b) of Section 12A should be in Form No. 10B. The audit programme is outlined in the following paragraphs:

(a) *Preliminary:*

(i) Obtain a resolution from the trust specifying the appointment as also indicating the scope of audit. In particular, the resolution should specify the duties of the auditor in relation to the items specified in the annexure to the prescribed Form No. 10B.

(ii) Obtain a letter of appointment from the trust. Although the audit may have been conducted in the past by a person appointed as an auditor for the purpose of Section 12A, having regard to the spirit of the requirement contained in clause (8) of Part-I of Schedule I to the Chartered Accountants Act, 1949, it is suggested that the auditor appointed for the purpose of Section 12A, should, before accepting the audit, communicate with such previous auditor.

(iii) Obtain a certificate as to the opening balances of assets and liabilities and the fund.

(iv) Obtain a list of books of accounts which are maintained by the trust.

(v) Obtain a certificate from the trust as to the system of accounting and internal control.

(vi) Obtain from the trust a list of the institutions/activities run/carried out by the trust.

(vii) Obtain from the trust a certified true copy of the Deed of Trust or any other scheme containing the objects and conditions of the trust as operative from time to time.

(b) *Routine Checking:*

(i) Check the books of account and other records having regard to the system of accounting and internal control.

(ii) Vouch the transactions of the trust to satisfy that:

(a) The transaction falls within the ambit of the trust;

(b) The transaction is properly authorized by the trustees or other delegated authority as may be permissible in law;

Notes

(c) All incomes due to the trust have been properly accounted for on the basis of the system of accounting followed by the trust;

(d) All expenses and outgoings appertaining to the trust have been recorded on the basis of the system of accounting followed by the trust; and

(e) Amounts shown as applied towards the object of the trust are covered by the objects of the trust as specified in the document governing the trust.

(iii) Obtain a trial balance on the closing date certified by the trustees.

(iv) Obtain the Balance Sheet and Profit & Loss Account of the trust authenticated by the trustees and check the same with the trial balance with which they should agree.

(c) *Accounting Principles:* The auditor should follow, i.e., generally accepted accounting principles and ascertain the accuracy, truth and fairness of the Balance Sheet and Profit & Loss Account.

In particular, the auditor will scrutinize that:

(i) all assets of the trust are verified;

(ii) The assets of the trust have been properly valued and depreciation duly provided for;

(iii) All liabilities of the trust are properly accounted for;

(iv) The investments of the trust are properly classified and indicated and market values shown; and

(v) Outstandings due to the trust are properly accounted for and their recoverability examined and provision made for irrecoverables.

(d) *Annexure to the Audit Report:*

(i) Obtain from the trustees, a certified list of persons covered by Section 13(3).

(ii) Obtain from the trustees, a statement enlisting the various items specified in the Annexure to Form No. 10B and giving the information against each item together with explanatory or supporting schedules.

(iii) Verify the information supplied by the trustees in the statements specified above in the light of available material. Where a list of persons specified in Section 13(3) is not available, indicate against Sections II and III of the items specified in the annexure the appropriate qualifying remarks.

The audit report is required to be furnished to the relevant year. Failure to furnish the report will disentitle the trust or institution to the benefit of Sections 11 and 12. The Auditor can accept as correct the list of persons covered by Section 13(3) as given by the managing trustees.

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Source: http://costaudit.org/

13.1.2 Audit of Accounts in Connection with the claim for Deduction under Sections 35D and 35E

The conditions under which certain specified preliminary expenditure incurred before the commencement of business and once the business is commenced on expanding an industrial undertaking or in connection with setting up a new industrial unit can be amortised are stated in Section 35D of the Act. The manner in which deductions are allowed in respect of expenditure on any prospecting operations relating to certain specified minerals listed in the Seventh Schedule to the Act are stated in Section 35E of the Act. In respect of assessees other than a company or a co-operative society, these deductions are admissible only if the accounts for, the year or years in which the above specified expenditure is incurred are audited by an "accountant" as defined in explanation below sub-section (2) of section 288 of the Income-tax Act, 1961 and the report of such audit is furnished by the assessee along with the return of income. Rule 6AB of the Income-tax Rules 1962 provides that the report of audit required to be furnished by the above-mentioned assessees under sections 35D and 35E should be in Form No.3B. While doing the audit the auditor is expected to follow general principles of auditing as mentioned in Auditing and Assurance Standards.

13.1.3 Tax Audit under section 44AB

Section 44AB provides for the compulsory audit of accounts of certain persons carrying on business or profession. Section 44AB reads as under:

Audit of accounts of certain persons carrying on business or profession – Every person -

(a) Carrying on business shall, if his total sales turnover or gross receipts, as the case may be, in business exceed or exceeds forty lakhs rupees in any previous year.

(b) Carrying on profession shall, if his gross receipts, in profession exceed ten lakhs rupees in any previous year,

(c) Carrying on the business shall, if the profits and gains from the business are deemed to be the profits and gains of such person under section 44AD or section 44AE or section 44AF or section 44BB or section 44BBB as the case may be, and he has claimed his income to be lower than the profits or gains so deemed to be the profits and gains of his business, as the case may be, in any previous year, get his accounts of such previous year audited by an

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accountant before the specified date and furnish by that date the report of such audit in the prescribed form duly signed and verified by such accountant and setting forth such particulars as may be prescribed:

Provided that this section shall not apply to the person, who derives income of the nature referred to in section 44B or section 4BBA on and from the lst day of April, 1985 or, as the case may be, the date on which the relevant section came into force, whichever is later:

Provided further that in a case where such person is required by or under any other law to get his accounts audited, it shall be sufficient compliance with the provisions of this section if such person gets the accounts of such business or profession audited under such law before the specified date and furnishes by that date the report of the audit as required under such other law and a further report by an accountant in the form prescribed under this section.

Explanation: For the purposes of this section–

(i) "Accountant" shall have the same meaning as in the explanation below sub-section (2) of Section 288;

(ii) "Specified Date", in relation to the accounts of the assessee of the previous year relevant to an assessment year, means the 31st day of October of the assessment year.

Notes The ICAI has issued a Guidance note on the audit of Fringe Benefits (With Supplementary Guidance Note on tax audit under section 44AB of the Income-tax Act, 1961). The said Guidance Note has to be read along with the "Guidance Note on Tax Audit under section 44AB of the Income-tax Act, 1961". The Guidance given in both the Guidance Note has been integrated in the following text.

The above section stipulates that every person carrying on business is required to get his accounts audited before the "specified date" by a chartered accountant, if the total sales turnover or gross receipts in the business in any previous year exceed ₹ 40 lakhs. A person carrying on a profession will also have to get his accounts audited before the "specified date" by a chartered accountant if his gross receipts in profession in any previous year exceed ₹ 10 lakhs.

Did u know? Clause (c) of Section 44AB, inserted by the Finance Act, 1997 w.e.f. assessment year 1998-99, provides that in the case of an assessee carrying on a business of the nature specified in section 44AD, 44AE, 44AF, 44BB or 44BBB, tax audit will be required if he claims his income to be lower than the presumptive income deemed under those sections.

Therefore, such assessees will be required to have a tax audit even if their sales, turnover or gross receipts do not exceed ₹ 40 lakhs.

Under the provisions of sections 44AD and 44AF, an assessee can opt to be assessed on presumptive basis, so long as the gross receipts/total turnover from any of the business(es) do not exceed ₹ 40 lakhs. Once the total turnover/gross receipts from any such business(es) exceed ₹ 40 lakhs, a tax audit will be required under clause (a) of Section 44AB. The provisions of sections 44AA and 44AB shall not apply in so far as they relate to the business of civil construction, etc. as referred to in Section 44AD(1), the business of plying, hiring or leasing goods carriages as referred to in section 44AE(1), retail business as referred to in section 44AF(1), the business of exploration, etc. of mineral oil as referred to in section 44BB(1) and the business of civil construction, etc. in certain turnkey power projects as referred to in section 44BBB(1). In computing the monetary limits under sections 44AA and 44AB, the turnover/gross receipts or as the case may be the income from the said business shall be excluded.

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If a person is carrying on business(es), coming within the scope of sections 44AD, 44AE, 44AF, 44BB or 44BBB but he exercises his option given under these sections to get his accounts audited under Section 44AB, tax audit requirements would apply, in respect of such business(es) even if the turnover of such business(es) does not exceed ₹ 40 lakhs. In the case of a person carrying on businesses covered by sections 44AD, 44AE, 44AF, 44BB or 44BBB and opting for presumptive taxation, tax audit requirement would not apply in respect of such businesses, If such person is carrying on other business(es) not covered by presumptive taxation, tax audit requirements would apply in respect thereof if the turnover of such business(es), other than the business covered by presumptive taxation thereof, exceed ₹ 40 lakhs.

13.1.4 Approach to Tax Audit under VAT

The audit approach of the tax auditor under the value added tax system will be more or less similar to the approach, which is adopted by the auditor while conducting the tax audit under the provisions of section 44AB of the Income-tax Act, 1961. However, the reporting requirements vary to a considerable extent.

While the auditor has to apply the basic principles of audit he has to keep in mind that the requirements of VAT audit are different and accordingly he should design his audit programme.

While designing the audit program the auditor has to ensure that the program includes the performance of such audit checks as would generate the information which would enable him to ensure the following and also to draw his audit reports.

(i) The turnover of sales/purchases of goods has been properly determined keeping in view not only the generally accepted accounting policies but the definition of turnover of sales in the relevant VAT law. The sales turnover arrived at by applying the generally accepted accounting policies may not be the same as required under the VAT law.

Example: The sale proceeds of a fixed asset will not form a part of turnover or sales as per the generally accepted accounting policies but will form a part of turnover or sales for the purpose of VAT law.

Similarly the price of goods returned is deducted from the turnover or sales even if the returns are from the sales effected in the previous years, while under VAT law, the goods returned are to be deducted only if they are made within the prescribed time, say six months from the date of sale. Thus, the results of the audit procedure adopted by the auditor should be such as will give him a reasonable assurance regarding the figures of sales reported in the returns. Not only that, he should also be able to get the exact quantum of the sales under reported or over reported duly classified for different tax rates and its impact on overall tax liability. The sales as per the financial statements may include the turnover or sales effected by all the branches, but for the purposes of VAT law the turnover or sales of only those branches will be included which are included in one registration certificate.

(ii) The turnover of purchases should be tested by applying audit checks as will enable the auditor to get the purchases eligible for grant of input tax credit segregated from other purchases. Further, the purchases on which the input tax credit is available in full and the purchases on which it is available partially should also be ascertained correctly.

Caution The auditor should get the exact amount of input tax credit available; compare the same with the credit claimed in the returns and report on the excess/short claim of the credit in the returns filed.

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(iii) The auditor is also required to comment on the timely filing of the returns under the VAT law. For this purpose the auditor is expected to list out the due dates of filing of returns and find out the reasons for delay in filing the returns if any.

(iv) The auditor is also required to give his report on the composition scheme. He should apply such compliance tests as will be enable him to ascertain that the auditee is eligible for composition, it has paid the requisite composition fee and all the procedural formalities in relation thereto have been complied with.

(v) The auditor has to give his report on the TDS. Therefore, such tests are to be applied as will enable him to report on the applicability of TDS provisions, the accuracy of the amount deducted and paid, timely issue of TDS certificate and filing of TDS returns.

(vi) The auditor is also expected to check the consolidation of the returns filed for all the periods covered in the year under audit, both under the State-Level VAT law and the Central Sales-tax Act, 1956. These returns are to be compared with the books of account and the documentary evidences available. The auditor is expected to apply such substantive steps as would enable him to judge whether all the transactions relating to sale and purchase are entered in the books of account and have been taken into consideration while filing the returns. In case of any inconsistency a proper reconciliation of book figures and the returned figures should be made and also the correct quantification of tax liability is to be done.

The above are only the major areas which are to be tested by the auditor while conducting the tax audit under VAT laws. The auditor has to take a judgement of his own regarding the adequacy and appropriateness of the audit checks to be applied and the areas where the tests are to be applied, so as to give him all the information needed to form a view not only on the authenticity of the books of account, correctness of the returns filed but also in the quantification of tax liability.

13.1.5 Audit Report under the VAT Law

All State-Level VAT laws have been framed by following a common VAT law Module suggested by the Central Government. Further the Empowered Committee which pioneered the concept of model VAT law based on certain common principles also insisted that the basic framework of all the VAT laws in the various States should be common. It is felt that there should be a common design for VAT Audit Report also so that the auditor should not find it difficult to conduct the audit and the reports can be made more meaningful and comprehensible to all. The Institute of Chartered Accountants of India has already taken a major initiative in this direction and has already developed a standard format of the audit report. The standard format of audit report was also submitted to the Empowered Committee. States can take the benefit of the same and incorporate the format of the audit report suggested by the ICAI in their VAT laws.

At the end of the audit the auditor has to arrive at his conclusion on the matters to be reported in the audit report. The format of the audit report is generally prescribed under the relevant VAT law and the auditor has to fill in all the columns of the audit report that are applicable. While performing the audit under VAT law the auditor is expected to conduct the audit presuming himself to be the tax assessor. His audit report will therefore have to be comprehensive commenting on each and every aspect which goes to the root of quantification of tax liability. The auditor is expected to give his opinion on the adequacy of accounting records, correctness and completeness and arithmetical consistency of returns filed. Further he has to State the basis of his opinion on the accounts, financial statements and the documents verified by him to arrive

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at the above conclusion. The auditor is also expected to give the summary of additional tax liability/additional refund arising on his verification of the returns together with the books of account. While the auditor is giving a general opinion on the truth and fairness of books and account he can make a qualified opinion or an unqualified opinion. He can also resort to disclaimer where he finds that the accounting records were insufficient to enable him to frame either an unqualified opinion or a qualified opinion.

So far as the comment on the variation of tax liability is concerned the auditor has to quantify exactly the amount by which the liability increases or decreases. He has also to State the transactions against which there is variation in tax liability. Therefore, either he has to State that the tax liability shown in the return is correct or is incorrect and to what extent. Thus, an amount of certification of tax liability is involved therein which casts greater responsibility on the auditor.

Several State VAT Legislations have provided for audit of accounts by chartered accountants. Such audit becomes necessary whenever the turnover of the assessee exceeds the prescribed limit under the relevant State VAT Legislations. In this context the ICAI has developed a model State VAT Audit report. Maharashtra VAT legislation has also prescribed a form of audit report and also the details to be furnished along with the audit report. The audit report and the prescribed details are largely similar to the Model VAT Audit report developed by the ICAI. The objective of furnishing such details is to help the VAT authorities to determine the correct turnover and also to satisfy themselves whether the VAT has been remitted properly to the credit of the State Government. Wherever applicable such particulars have to be verified by the Chartered Accountants. Such verification ensures that the input VAT credit has been claimed by the assessee in a proper manner.

Self Assessment

Fill in the blanks:

1. A member in part-time practice is not entitled to perform …….. functions including tax audit.
2. While doing the audit the auditor is expected to follow general principles of auditing as mentioned in Auditing and …… Standards.
3. While the auditor has to apply the basic principles of audit he has to keep in mind that the requirements of …… audit are different and accordingly he should design his audit programme.
4. The results of the audit procedure adopted by the auditor should be such as will give him a reasonable assurance regarding the …….. of sales reported in the returns.
5. The auditor is also required to comment on the timely …….. of the returns under the VAT law.
6. The auditor has to take a judgement of his own regarding the ……. and …….. of the audit checks to be applied.
7. While performing the audit under VAT law the auditor is expected to conduct the audit presuming himself to be the tax ……...
8. The auditor is also expected to give the …….. of additional tax liability/additional refund arising on his verification of the returns together with the books of account.

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13.2 Concept of Cost Audit

According to the Institute of Cost and Management Accountants of England, cost audit represents the verification of cost accounts and a check on the adherence to cost accounting plan. Cost audit, therefore, comprises:

(a) Verification of the cost accounting records such as the accuracy of the cost accounts, cost reports, cost statements, cost data and costing techniques, and

(b) Examination of these records to ensure that they adhere to the cost accounting principles, plans, procedures and objectives.

It, therefore, means that the cost auditors attention and approach should be to see that the cost accounting plan is in consonance with the objectives set by the organization and the system of accounting is geared towards the attainment of the objectives. A cost accounting system designed to exercise control over cost may be different from the one if the objective is to fix price. The cost auditor should examine whether the methods laid down for ascertaining expenses as direct or indirect are cases in point. The cost auditor should also establish the correctness or otherwise of the figures by the processes of vouching verification, reconciliation etc.

The origin of the concept of cost audit could be traced to the Second World War period when the practice of assigning cost plus contracts started. However, probably India is the only country in the "free" world where cost audit is statutorily prescribed. The management will be in a position to know what price is to be fixed for a product, whether the wastages are avoidable, whether to re--organize purchase or sales or inventory systems to make the work more efficient and so on. Existence of such a system of audit will also be of great use for maintaining internal control and internal check and can be an advantageous even to the statutory financial auditor. Cost audit, apart from having all the normal ingredients of audit namely vouching, verification etc. has within its compass elements of efficiency audit.

Notes Cost audit can offer valuable assistance to the management in its decision making process since it ensures reliable cost accounting data and information.

13.2.1 Types of Cost Audit

Cost audit is basically carried out at the instance of the management for obvious advantages. Apart from this, different other circumstances also sometimes occasion audit of cost accounts. The different types of cost audit that we come across may be the following:

Cost Audit on behalf of the Management: The principal object of this audit is to see that the cost data placed before the management are verified and reliable and they are prepared in such detail as will serve the purpose of the management in taking appropriate decisions. The detailed objectives include:

(a) Establishing the accuracy of the costing data, as for example, cost of material used, allocation of wages into direct and indirect and on different products, functions and cost centres.

(b) Ensuring that the objectives of cost accounting are being achieved through appropriate collection, segregation, analysis and compilation of data.

(c) Ascertaining abnormal losses and gains along with the relevant causes, expressed in financial terms in a manner that the person responsible for such loss or gain is identified.

(d) Determination of the unit cost of production in a precise but practicable manner.

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(e) Establishing proper overhead rates for absorption of overheads by various units of costs so that the cost is properly ascertained and there is no significant over or under recovery of expenses.

(f) Fixation of contract price and the determination of the additional or supplementary charge that can be raised against customers for alterations, etc.

(g) Improving the quality of cost accounting system by obtaining the audit observations and suggestions of cost auditor.

Cost Audit on behalf of a Customer: In case of cost plus contracts, often the buyer or the contractee insists on a cost audit to satisfy himself about the correct ascertainment of cost. More often than not, the provision, for a cost audit in such a circumstance is put in the relevant contract with the stipulation that the supplier or the contractor will extend all co-operation to the cost auditor. The cost of production arrived at for this purpose may differ from the cost of production ascertained for internal purposes.

Cost Audit on behalf of Government: Sometimes, government is approached with requests for subsidies, protection, etc. Before taking a decision the government may prefer to have the cost of production of the product determined on the basis of cost audit to satisfy itself whether the need is genuine or the industry seeking assistance is generally efficiently run. The government, of its own also may initiate cost audit, in public interest to establish the fair price of any product.

Cost Audit by Trade Association: Where activities of a trade association include maintenance of a price of the products manufactured by the member units or where there is pooling or contribution arrangements, the trade association may require the accuracy of costing information submitted by the member-units checked. The trade association may seek full information on the costing system, level of efficiency, utilization of capacity, etc.

Statutory Cost Audit: This is covered by the provisions of Section 233B of the Companies Act.

Apart from the aforesaid types of cost audit, the undernoted circumstances may warrant the introduction of cost audit:

(a) ***Price fixation:*** The need for fixation of retention prices in the case of materials of national importance, like steel, cement etc. may be useful in knowing the true cost of production.

(b) ***Cost variation within the industry:*** Where the cost of production varies significantly from unit to unit in the same industry, cost audit may be necessary to find the reasons for such differences.

(c) ***Inefficient management:*** Where a factory is run inefficiently and uneconomically, institution of cost audit may be necessary. It may be particularly useful for the Government before it takes over any unit.

(d) ***Tax assessment:*** Where a duty or tax is levied on products based on cost of production, the levying authorities may ask for cost audit to determine the correct cost of production.

(e) ***Trade disputes:*** Cost audit may be useful in settling trade disputes about claim for higher wages, bonus, etc.

13.2.2 Advantages of Cost Audit

Cost audit will prove to be useful to the management, society, shareholders and the government. The advantages are as under:

Notes

To Management

(i) Management will get reliable data for its day-to-day operations like price fixing, control, decision-making, etc.

(ii) A close and continuous check on all wastages will be kept through a proper system of reporting to management.

(iii) Inefficiencies in the working of the company will be brought to light to facilitate corrective action.

(iv) Management by exception becomes possible through allocation of responsibilities to in-dividual managers.

(v) The system of budgetary control and standard costing will be greatly facilitated.

(vi) A reliable check on the valuation of closing stock and work-in-progress can be established.

(vii) It helps in the detection of errors and fraud.

To Society

(i) Cost audit is often introduced for the purpose of fixation of prices. The prices so fixed are based on the correct costing data and so the consumers are saved from exploitation.

(ii) Since price increase by some industries is not allowed without proper justification as to increase in cost of production, inflation through price hikes can be controlled and con-sumers can maintain their standard of living.

To Shareholder

Cost audit ensures that proper records are kept as to purchases and utilization of materials and expenses incurred on wages, etc. It also makes sure that the valuation of closing stocks and work- in-progress is on a fair basis. Thus the shareholders are assured of a fair return on their investment.

To Government

(i) Where the Government enters into a cost-plus contract, cost audit helps government to fix the price of the contract at a reasonable level.

(ii) Cost audit helps in the fixation of ceiling prices of essential commodities and thus undue profiteering is checked.

(iii) Cost audit enables the government to focus its attention on inefficient units.

(iv) Cost audit enables the government to decide in favour of giving protection to certain industries.

(v) Cost audit facilitates settlement of trade disputes brought to the government.

(vi) Cost audit and consequent management action can create a healthy competition among the various units in an industry. This imposes an automatic check on inflation.

13.2.3 Functions of Cost Auditor

The Institute of Cost and Works Accountants of India has detailed the principal functions of a cost auditor by way of comparison with the functions of the auditor of financial accounts. The principal functions of cost auditor, according to the aforesaid Institute are the following:

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(i) ***Inventory***

(a) Is the size of the inventory adequate or excess compared with the production programme?

(b) Is the provision most economical?

(c) Does it ensure optimum order size?

(d) Does it take into account the storage cost on the one hand, and carrying cost on the other?

(e) Does it take note of lead time of the various items or groups of items?

(f) Does the receipt and issue system cause any bottle-neck in production?

(g) Does it involve too many forms and too much paper work?

(h) Is there any room for reduction of inventory cost consistent with production needs?

(i) Is the inventory as per the priced store ledger and as certified by the management physically correct?

(j) Is the same amount of attention and care given to monies translated into material things like raw materials, stores and supplies of all kinds as given to liquid cash?

(k) Does the issue of raw materials make the production in accordance with the standard or schedule or otherwise, or covered by authorised schedule?

(l) Is the expenditure of consumable stores within the standard? If not, why not?

(ii) ***Opening and Closing Stocks:*** The cost auditor will see the following:

(a) that the opening stock is not unduly large compared with the volume of production during the year;

(b) that the opening stock against various jobs really represents the actual physical stock in the production shop and is not merely an accounting figure;

(c) that the responsibility of the shop foreman in-charge of the stock held in the production shop is clear and properly documented; that he maintains proper record of actual consumption vis-a-vis the actual withdrawal from the stock.

Valuation and correct indication of closing stock in the Trading and Profit and Loss Account and in Balance Sheet is equally important. The Cost Auditor will examine and certify:

(a) that the physical verification is correctly carried out;

(b) that the valuation is correct with reference to the actual cost of production and recognised policy for valuation;

(c) that volume of closing stock is commensurate with the volume of production and that it does not reflect any failure or bottleneck in sales budget or production budget;

(d) that the volume of unmoved stores is not abnormal in comparison with the normal rate of yearly consumption. The Cost Auditor will recommend disposal of such unmoved stores with consequent release of capital unnecessarily locked up to the advantage of the financial resources of the concern.

(iii) ***Store Issue Procedure in Stocks:*** The Cost Auditor will see:

(a) that withdrawal of materials or stores to production shop is scientific or covered by authorised schedule and permits receipt to be located;

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(b) that there is no possibility of loss or pilferage of stock lying in the production section;

(c) that surplus materials and scraps arising in production shops are returned to stores correctly and without delay for which necessary credit is given to unit cost of production. If transferred to other jobs, proper transfer voucher has been prepared and copies sent to the accounts, stores, etc.

(iv) ***Work-in Progress:*** The Cost Auditor will see the following:

(a) that work-in-progress has been physically verified and that it agrees with the balance in the incomplete cost card;

(b) that valuation of the work-in-progress is correct with reference to stage of completion of each job or process and the value job cost cards or process cost sheet;

(c) that there is no over-valuation or under-valuation of opening work-in-progress or closing work-in-progress, thereby artificially pushing up and down net profits or net assets as the case may be;

(d) that the volume and value of work-in-progress is not disproportionate compared with the finished out-turn.

(v) ***Labour***

(a) Proper utilization of labour and increase in productivity are now receiving attention, Several productivity teams have emphasized importance of higher productivity. It is, therefore, essential to assess the performance efficiency of labour and compare it with standard performance, so that labour utilization could be progressively improved. The labour force in Indian industries is generally very high compared to similar types of industries in other developed countries. Our aim should be to reach that level, though not immediately but over some time. A study of this nature would give an idea where the inefficiency lies so that timely and adequate steps could be taken to ensure maximum utilization of labour to reduce labour cost.

(b) Cost of labour is allocated to different jobs with reference to time or job cards.

(vi) ***Capacity Utilisation:*** The cost auditor will see:

(a) that the idle capacity in any production shop or of transport facilities for distribution is not excessive;

(b) that production volume and overall machine time utilised are commensurate. In other words, the machine hours utilised have given the optimum output.

(vii) ***Overheads and Indirect Expenditure:*** The cost auditor will see and certify:

(a) that allocation of indirect expenditure over production, sales, and distribution is logical and correct;

(b) that compared with the value of production in a production shop, overhead charges are not excessive;

(c) that actual indirect expenditure does not exceed budgets or standard expenditure significantly and that any variations are satisfactorily explained and accounted for;

(d) that the relation of indirect expenditure in keeping with the load on individual production shop is appropriate;

(e) correctness of appropriate allocation of overhead expenditure (both production and sales) will be certified by the cost auditor;

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(f) that allocation of overheads between finished products and unfinished products is in accordance with correct principles.

Presently we shall discuss in detail the aspects to be dealt with in the cost auditor's report pursuant to the Cost Audit (Report) Rules, 1968 as amended in 1996 and again in 2001. These rules came into force from October 1, 2002. The aforesaid Rules have been issued pursuant to Section 233B(4) of the Companies Act which requires the cost auditor to make a report on the cost accounts and cost records maintained by the company.

It may be noted that the requirement of the statutory cost audit in our Companies Act is something special, because statutes in most of the other countries do not contain a similar requirement. In most of the countries the concept of cost audit as such is also non-existent and the objectives, whatever they may be, are achieved by properly designing the scope and depth of internal audit.

Task Pick up an audit report of a well known company through internet and see if it is made as per VAT law.

The object with which the statutory requirement of cost audit has been included in the Companies Act can only be ascertained by a study of the cost audit report requirements. They include control over cost, wastage and losses, efficiency in the utilisation of human, material, and other resources, determination of appropriate selling price, proper maintenance of cost records appropriate use of the costing system, etc.

For determining the scope and extent of cost audit, the cost auditor will necessarily have regard to the relevant costing records required to be maintained pursuant to Section 209(l)(d) of the Companies Act, in respect of products manufactured by certain types of industries and the cost sheets prescribed. The records are broadly based on the elements of cost and, therefore, there is a great deal of similarity between the various records prescribed for various products. The cost sheets, however, vary from product to product, having regard to the nature of the product and the production process involved. The cost auditor will also have to pay special attention to the reporting requirements laid down under the Cost Audit (Report) Rules.

Self Assessment

Fill in the blanks:

9. A cost accounting system designed to exercise control over cost may be different from the one if the ……. is to fix price.
10. The cost auditor should examine whether the methods laid down for ascertaining expenses as …… or ……. are cases in point.
11. Cost audit, apart from having all the normal …… of audit namely vouching, verification etc. has within its compass elements of efficiency audit.
12. The principal object of cost audit is to see that the cost data placed before the management are …… and reliable.
13. Cost audit is often introduced for the purpose of …….. of prices.
14. In most of the countries the concept of cost audit as such is also non-existent and the objectives, whatever they may be, are achieved by properly designing the scope and …… of internal audit.
15. The records are broadly based on the elements of .....

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Case Study

Vodafone Tax case - A Case Study for Investments in India

India Inc has been surging ahead audaciously with the support of its Information Technology developments with its repertoire of resources. Global players have been eying the Indian market, owing to immense opportunities that the continent provides; both in terms of expansion and profit. Investment patterns in India have shown positive growth over the years with significant process on the de-regulation front. India has been greatly involved with the G-8 and G-20, including signing of the Double Taxations Avoidance Agreements/Treaties (DTAA) with various tax-haven countries. This has boosted the image of India as a 'lookout destination' for investment and an emerging hub for economical activities. World Report 2010 ranked India as the 9th most attractive investment destination, while Bloomberg Global Poll conducted in September 2010 put India in the third position, above the United States of America (USA).

However, the very same image is said to have taken a beating with the recent Vodafone Tax case, which has been revolving in courts since 2009. With clear signs of the court ruling in favour of the tax authorities, many global companies are said to be rethinking their investment plans in India, keeping in mind the impact of the judgment on the taxation front. The Doing Business Report 2011 of World Bank has ranked India at 134, below neighbouring countries like Pakistan and Bhutan. This is a result of procedural difficulties for start-up companies and investment companies, in India and abroad.

Tax regulations play a major role in cross border transactions and investments in a country. Tax havens, open borders and DTAA countries are major destinations for investment through Foreign Direct Investment (FDI) or other routes. The Vodafone tax case throws an interesting question on the taxability of a non resident company acquiring shares of a resident company through an indirect route. This is a landmark case, as it is for the first time that the tax departments have sought to tax a company through a mechanism of tracing the source of acquisition. While we have heard about lifting the 'corporate veil', this instance has set a rare example wherein the Indian tax authorities have gone to length to interpret the existing tax laws, to bring a global company like Vodafone to its tax ambit.

Facts

Vodafone International Holdings BV, based in Netherlands and controlled by Vodafone UK, obtained the controlling interest and share of CGP Investments Holdings Ltd (CGP) located in Cayman Island for a value of $11.01 billion from Hutchinson Telecommunications International Ltd. (HTIL), which had stake in Hutchinson Essar Ltd (HEL) that handled the company's mobile operations in India. HEL had its stake in CGP Holdings, from which Vodafone bought 52 per cent of HEL's stake in 2007, thereby vesting controlling interest over them. The Bombay High Court, on September 8, ruled that where the underlying assets of the transaction between two or more offshore entities lies in India, it is subject to capital gains tax under relevant income tax laws in India. The Court invoked the nexus rule wherein a state can tax by connecting a person sought to be taxed with the jurisdiction, which seeks to tax. The treatment of the company as an Assessee in Default (AID) under Section 201(1)[1] of the Income Tax Act and reading Sections 5(2)[2], 9(1)[3] and 195[4], the court came to the conclusion that Vodafone was liable to deduct tax at source (TDS). Vodafone has now appealed before the Supreme Court to revisit the judgment, which makes them liable for a record amount of ₹ 12,000 crores going to the tax authorities' kitty.

Contd....

Notes

Impact

Vodafone raises pertinent questions on the issue of taxation of non-resident entities. The judgment will have direct impact on transactions of major acquisitions like SABMiller-Foster and Sanofi Aventis-Shanta Biotech. Similar transactions that existed earlier are Sesa Goa, AT&T and General Electric. British firm Cairn Energy has already agreed to pay tax in India as well as the UK on selling its stake in Cairn India to Vedanta Resources from $6.65 billion to $8.48 billion. Depending upon the size of the stake sale, the tax liability could range between $868 million and $1.1 billion. The judgment would definitely throw a cautious note to major investors and M&As in India; however, it does not have that great an impact to curtail the investment flow to an emerging destination like India. The judicial propriety of the case is still to be settled when the matter comes for final stages in the Supreme Court. Going by the events in the lower courts, the Supreme Court is unlikely to disturb the Bombay High Court ruling.

The global community is keenly watching the current trends happening in the Indian subcontinent, especially since it has become an emerging player at the socio-economic and political levels. United Nations Conference on Trade and Development (UNCTAD) has reported that India is set to dislodge the US by December 2012 to become the second best destination for FDIs, the major component of which is M&As. India is also set to revamp its taxations norms with significant changes at the regulatory level. The proposed Direct Tax Code contains key provisions, which will have a major impact on investments in India[5]. India has improved its rankings in the WB 'Doing Business' Report on the number of regulatory changes taken in the existing year. This shows that the country is set to make a global footprint by branding itself as a 'Must Invest' destination.

The Vodafone tax case has given India the opportunity to create a model for other countries, which follow source-based taxation principles[6]. It is an opportune time to bask in the glory of India, which is said to have had one third share of the world market in ancient times, as pointed out by economist Amartya Sen in his book The Argumentative Indian. Let's hope that we can revive the 'Real India' soon.

Notes:

1. Section 201 of the Act broadly provides that any person (referred to in Section 200 of the Act), and in cases referred to in Section 194, the principal officer and the relevant company, who does not deduct the whole or any part of the tax, or after deducting fails to pay the tax as required by or under the Act, he or it shall, without prejudice to any other consequences which he or it may incur, be deemed to be an 'assessee in default' in respect of the tax.
2. Section 5(2) enunciates that the income of a non-resident from whatever source derived is included in the total income if (i) it is received in India; (ii) deemed to be received in India; (iii) accrues in India; (iv) deemed to accrue in India; (v) arises in India; or (vi) deemed to arise in India.
3. Section 9(1) explains the circumstances in which income is deemed to accrue or arise in India and includes all income accruing or arising in India, whether directly or indirectly (a) through or from any business connection in India; or (b) through or from any property in India; or (c) through or from any asset or source of income in India; or (d) through the transfer of a capital asset situated in India.
4. Section 195 provides for deduction for tax at source upon a payment to a non-resident or foreign company

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5. The proposed DTC says that if 50 per cent of the value of the shares being transferred is derived from assets situated in India, it is deemed to be taxable in India.

6. Countries like India have been following resident-based taxation mechanism, wherein whoever is the resident of India is taxed. Source-based taxation provides for a taxation regime which goes into the source of the asset which is liable for tax.

Question:

Discuss the facts of the case study.

Source: http://www.mindtext.org/view/89/ Vodafone_Tax_case__A_Case_Study_for_Investments_in_India/

13.3 Summary

- For ensuring compliance sometimes audit become a necessity. Therefore, various statutes, including legislations governing direct and indirect tax provisions have incorporated audit provisions in some or the other form.
- The Explanation to Section 288(2) defines 'accountant' as a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949 and any other person who is entitled to be appointed as an auditor of a company under Section 226(2) of the Companies Act, 1956.
- It may be noted that by the virtue of a resolution of the Council, with effect from 1st April 2005, a member in part-time practice (namely holding a certificate of practice and also engaging himself in any other business/ and or occupation) is not entitled to perform attest functions including tax audit.
- The audit report is required to be furnished to the relevant year. Failure to furnish the report will disentitle the trust or institution to the benefit of Sections 11 and 12.
- The conditions under which certain specified preliminary expenditure incurred before the commencement of business and once the business is commenced on expanding an industrial undertaking or in connection with setting up a new industrial unit can be amortised are stated in Section 35D of the Act.
- The manner in which deductions are allowed in respect of expenditure on any prospecting operations relating to certain specified minerals listed in the Seventh Schedule to the Act are stated in Section 35E of the Act.
- In respect of assessees other than a company or a co-operative society, these deductions are admissible only if the accounts for, the year or years in which the above specified expenditure is incurred are audited by an "accountant" as defined in explanation below sub-section (2) of section 288 of the Income-tax Act, 1961 and the report of such audit is furnished by the assessee along with the return of income. Rule 6AB of the Income-tax Rules 1962 provides that the report of audit required to be furnished by the above-mentioned assessees under sections 35D and 35E should be in Form No.3B.
- Under the provisions of sections 44AD and 44AF, an assessee can opt to be assessed on presumptive basis, so long as the gross receipts/total turnover from any of the business(es) do not exceed ₹ 40 lakhs. Once the total turnover/gross receipts from any such business(es) exceed ₹ 40 lakhs, a tax audit will be required under clause (a) of Section 44AB.

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- While the auditor has to apply the basic principles of audit he has to keep in mind that the requirements of VAT audit are different and accordingly he should design his audit programme.
- While performing the audit under VAT law the auditor is expected to conduct the audit presuming himself to be the tax assessor. His audit report will therefore have to be comprehensive commenting on each and every aspect which goes to the root of quantification of tax liability. The auditor is expected to give his opinion on the adequacy of accounting records, correctness and completeness and arithmetical consistency of returns filed.
- The origin of the concept of cost audit could be traced to the Second World War period when the practice of assigning cost plus contracts started. However, probably India is the only country in the "free" world where cost audit is statutorily prescribed.
- Cost audit can offer valuable assistance to the management in its decision making process since it ensures reliable cost accounting data and information. The management will be in a position to know what price is to be fixed for a product, whether the wastages are avoidable, whether to re-organize purchase or sales or inventory systems to make the work more efficient and so on.
- The object with which the statutory requirement of cost audit has been included in the Companies Act can only be ascertained by a study of the cost audit report requirements. They include control over cost, wastage and losses, efficiency in the utilisation of human, material, and other resources, determination of appropriate selling price, proper maintenance of cost records appropriate use of the costing system, etc.

13.4 Keywords

Assessee: Income Tax Act 1961 (Act no. 43) defines 'assessee' as a person by whom any tax or any other sum of money is payable.

Cost Records: All ledgers, supporting records, schedules, reports, invoices, vouchers, and other records and documents reflecting the cost of projects, jobs, production centres, processes, operations, products, or services, or the cost of any of the component parts thereof.

Deed of Trust: A written instrument legally conveying property to a trustee often used to secure an obligation such as a mortgage or promissory note.

Tax Audit: Type of forensic audit, performed by the government appointed auditors, to determine if the appropriate taxes were paid in full by the entity being audited.

Tax deducted at source (TDS): A method of tax collection on income assessments in India.

Closing stock: A business's remaining stock at the end of an accounting period.

Turnover: In accounting, it is defined as the number of times an asset is replaced during a financial period.

Value Added Tax (VAT): An indirect tax on consumption levied at each discrete point in the chain of production and distribution, from raw material to end use.

13.5 Review Questions

1. What is cost audit? Explain in brief.
2. What do you mean by audit of public trusts?

Notes

3. How is routine checking done in public trusts?
4. Explain audit of tax under section 44AB.
5. What is the Approach to tax audit under VAT?
6. How audit report is prepared under the VAT law?
7. What is the format of the audit report that is prescribed under the relevant VAT law?
8. Discuss the origin of the concept of 'Cost Audit'.
9. Explain various types of cost audit.
10. What are the advantages of cost audit to management?
11. What are the benefits of cost audit to government?
12. Explain the functions of a cost auditor.

Answers: Self Assessment

1.	Attest	2.	Assurance
3.	VAT	4.	Figures
5.	Filing	6.	Adequacy, appropriateness
7.	Assessor	8.	Summary
9.	Objective	10.	Direct, indirect
11.	Ingredients	12.	Verified
13.	Fixation	14.	Depth
15.	Cost		

13.6 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

http://www.scribd.com/doc/53416937/Functions-of-a-Cost-Auditor-Mythhen-Cma

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http://icmap.com.pk/downloads/Past-Publications/costauditHandbook.pdf

http://220.227.161.86/19372sm_aape_finalnew_cp16.pdf

http://www.ssmrae.com/admin/images/2a7df059f1450305a58638f0a1eb266d.pdf

Notes

Unit 14: Professional Ethics and Current Issues

CONTENTS

Objectives

After studying this unit, you will be able to:

- Discuss the professional ethics in auditing
- Explain the regulations in auditing
- Describe the current issues in auditing

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

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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.

14.1 Professional Ethics in Auditing

The professional bodies require strict adherence to the ethical codes and have considerable enforcement mechanisms. Necessarily, ethical codes should be obeyed in the spirit as well as the letter but often are not. There is a probability that external regulation may replace self-regulation. The accounting and auditing profession has undergone many changes in recent years. There are now three tiers:

1. Very big firms.
2. Medium sized firms.
3. Myriad small firms.

Big firms are merging to become bigger. Big firms use big audit firms to audit their accounts. Therefore, there is also a need for audit firms to merge. In the past, all audit firms were required to be partnerships. However, it is now possible for an audit firm to be a company.

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 labour 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 cooperation 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 behaviour of individuals and organizations in the conduct of auditing. It describes the minimum requirements for conduct, and behavioural expectations rather than specific activities.

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

Recent high-profile corporate collapses, such as Enron and WorldCom, have brought into question the status and credibility of the accounting profession, especially auditors, "with allegations of accountants' violations of public trust"

Auditing standards require the auditor to verify that the information provided in the operational and financial review is consistent with the audit report and the other information contained in the annual report.

Ethical auditing is a process which measures the internal and external consistency of an organisation's values base. The key points are that it is value-linked, and that it incorporates a stakeholder approach.

Its objectives are two-fold:

- It is intended for accountability and transparency towards stakeholders
- It is intended for internal control, to meet the ethical objectives of the organisation.

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The value of the ethical audit is that it enables the company to see itself through a variety of lenses: it captures the company's ethical profile. Companies recognise the importance of their financial profile for their investors, of their service profile for their customers, and of their profile as an employer for their current and potential employees. An ethical profile brings together all of the factors which affect a company's reputation, by examining the way in which it does business. By taking a picture of the value system at a given point in time, it can:

- clarify the actual values to which the company operates
- provide a baseline by which to measure future improvement learn how to meet any societal expectations which are not currently being met
- give stakeholders the opportunity to clarify their expectations of the company's behaviour
- identify specific problem areas within the company
- learn about the issues which motivate employees
- identify general areas of vulnerability, particularly related to lack of openness

In relation to the specific factors of the ethical environment, studies on codes of ethics have dominated the ethical accounting and auditing literature. Codes of ethics are important since they implicitly set limits for unethical behaviour and are intended to offer guidance in ambiguous situations.

Caselet

Conducting an Ethics Audit

In recent years, social workers have become more aware of ethical challenges and risks. Contemporary practitioners are familiar with a wide range of ethical issues related to client confidentiality and privacy, informed consent, self-determination, conflicts of interest, dual relationships, termination of services, and impaired professionals. Social work education, continuing education, and staff development now routinely include discussions of ethical dilemmas and ethics risk management.

Ethical standards in social work have matured. The profession has moved from relatively brief and simplistic ethical standards to more comprehensive and detailed guides. As a result, social workers are now expected to adhere to ambitious ethical standards set forth in pertinent codes of ethics, licensing, and other statutes and regulations. In light of these increasing demands, social workers should thoroughly examine their ethics-related practices, policies, and procedures to ensure compliance with prevailing standards.

One way to assess the adequacy of one's ethics-related practices, policies, and procedures is to conduct an ethics audit. An ethics audit should focus on what is currently considered to be essential or core ethical issues in social work. Social work's literature suggests two key knowledge areas that should form the foundation of the audit: (1) ethics-related risks in practice settings, based on empirical trend data gathered from actual ethics complaints (filed with state licensing boards and professional organizations, such as the National Association of Social Workers [NASW]), lawsuits filed against social workers that allege ethics-related negligence, and ethics committee and court findings and dispositions; and (2) current agency policies and procedures for handling ethical issues, dilemmas, and decisions. Based on these sources, social workers should audit their ethics-related policies, practices, and procedures related to a number of key risks: client rights; confidentiality and privacy; informed consent; service delivery; boundary issues and dual relationships;

Contd....

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conflicts of interest; documentation; defamation of character; client records; supervision; staff development and training; consultation; client referral; fraud; termination of services and client abandonment; practitioner impairment; evaluation and research; and ethical decision making.

Source: http://www.socialworktoday.com/archive/EoEJanFeb07.shtml

Self Assessment

Fill in the blanks:

1. ..... involves an intelligent scrutiny of the books of account of a company, with reference to documents, vouchers and other relevant records.
2. ..... is a process which measures the internal and external consistency of an organisation's values base.
3. In relation to the specific factors of the ethical environment, studies on codes of ethics have dominated the ..... and auditing literature.

14.2 Regulations in Auditing

Non-compliance means acts of omission or commission by the entity which is contrary to the prevailing laws or regulations. Non-compliance does not include personal misconduct by those charged with governance, management or employees of the entity. ISA 250 deals with the auditor's responsibility to consider laws and regulations in an audit of financial statements.

Caution The ISA 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.

This International Standard on Auditing (ISA) 250, "Consideration of Laws and Regulations in Audit of Financial Statements" was prepared by the International Auditing and Assurance Standards Board (IAASB), an independent standard-setting body within the International Federation of Accountants (IFAC). The objective of the IAASB is to serve the public interest by setting high quality auditing and assurance standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of practice throughout the world and strengthening public confidence in the global auditing and assurance profession.

The mission of IFAC is to serve the public interest, strengthen the worldwide accountancy profession and contribute to the development of strong international economies by establishing and promoting adherence to high quality professional standards, furthering the international convergence of such standards and speaking out on public interest issues where the profession's expertise is most relevant.

Scope of ISA

This International Standard on Auditing (ISA) deals with the auditor's responsibility to consider laws and regulations in an audit of financial statements. This ISA 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

Notes

14.2.1 Effect of Laws and Regulations

The effect on financial statements of laws and regulations varies considerably. Those laws and regulations to which an entity is subject constitute the legal and regulatory framework. The provisions of some laws or regulations have a direct effect on the financial statements in that they determine the reported amounts and disclosures in an entity's financial statements. 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. Some entities operate in heavily regulated industries such as banks and chemical companies. Others are subject only to the many laws and regulations that relate generally to the operating aspects of the business.

Notes Non-compliance with laws and regulations may result in fines, litigation or other consequences for the entity that may affect all the financial statements adversely.

14.2.2 Responsibility for Compliance with Laws and Regulations

It is the responsibility of management, with the oversight of those charged with governance, 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.

The requirements in this ISA are designed to assist the auditor in identifying material misstatement of the financial statements due to non-compliance with laws and regulations. However, the auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations.

The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement.

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

14.2.3 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.

Did u know? There are 35 Indian Standards (Ind AS) and are applicable to all companies.

Notes

In all 29 Accounting Standards have been prescribed. However their applicability is dependent on its size – Level I/II/III Company. The following text 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'.
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.

Self Assessment

Fill in the blanks:

4. ..... does not include personal misconduct by those charged with governance, management or employees of the entity.
5. The mission of .....is to serve the public interest, strengthen the worldwide accountancy profession and contribute to the development of strong international economies.
6. ..... 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.

Notes

7. The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from .....

8. The ..... are required to make qualification in their report in case any item is treated differently from the prescribed Accounting Standard.

14.3 Current Issues in Auditing

Auditing, like many other disciplines, is a fast changing discipline. There are a surprisingly large number of current issues. There will continue to be new issues and it is therefore important for a professional accountant/auditor to be continuously updating himself/herself, *inter alia*, by:

- Reading professional journals.
- Attending seminars, workshops and symposia.

14.3.1 Matters Influencing Auditing

There are several matters which influence auditing and give rise to current issues. These matters are:

1. ***Statute laws:*** Statute laws enacted by parliament are likely to have profound influence on auditing, e.g. Public Procurement Act 2004, Money Laundering Act.
2. Development of new accounting standards and guidance by international bodies like the International Accounting Standards Board (IASB) of IFAC.
3. The issue of corporate governance which has become an international concern. This requires auditors to be more vigilant in their audit assignments.
4. Scandals such as the collapses of Enron, WorldCom, BCCI and Maxwell shortly after clean audit reports have led to doubts about the competence end integrity of audit firms which were involved.
5. Development of new opportunities for auditing type of work. These include environmental and social auditing, VFM auditing and assurance reporting of various types.
6. The economics of auditing have led to changes in practice. The business risk approach is now a new development. Auditors now spend too much time on their computers doing analyses and too little time talking to people and getting to grips with real things and real documents.
7. We now live in a much more litigious society and auditors have to practice more defensive auditing to avoid being sued. This may get in the way of desirable innovation.
8. The legal status of audit firms is now an issue. Should they be partnerships, limited liability companies or limited liability partnerships?
9. Global economy has led to auditing becoming more international. This needs harmonisation of auditing practices in all countries, e.g. by application of International Standards on Auditing (ISAs).
10. Use of computers in auditing.
11. E-commerce may become a dominant way of doing business. Auditors have to adopt themselves to this development.

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14.3.2 Auditing Profession

Auditing plays a unique role in our economy. By law, all companies whose securities are available to the general public through U.S. exchanges are required to have their financial statements audited by an independent registered public accounting firm. The goal has historically been to provide confidence to investors and bring standardisation and discipline to corporate accounting, thereby increasing the liquidity and economic potential of U.S. capital markets.

While there are legitimate debates about the meaning of financial statement audits, there are certain facts about the auditing profession that are hard to deny:

- Not only is auditing required by law, but recent regulations and legislation greatly increased its role in public companies. The political determination has been made that auditing is central to public confidence in our capital markets.
- The pressure for auditors to "do more" when conducting audits means that the auditor-client relationship is becoming more involved and continuous, with much more frequent interactions, rather than simply holding periodic discussions geared around financial statement reporting cycles.
- The auditing profession faces a number of significant legal challenges. It is subject to new regulation under the auspices of the Public Company Accounting Oversight Board (PCAOB). More important, the profession finds itself the target of a difficult litigation and regulatory enforcement environment, where business losses by a client can result in lawsuits, and a single indictment — even without a conviction — can result in the destruction of thousands of jobs.
- Because of the Sarbanes-Oxley Act and other requirements, auditing expenses have increased tremendously. At the same time, many clients believe that they are receiving less overall advice and support from their auditors. Audit firms feel that they are caught in a no-win situation between the demands of regulators, law enforcement, the plaintiffs' bar, and their clients.
- The process of developing accounting principles remains in flux, even as business transactions become ever more complex. In addition to the respective roles of FASB, the PCAOB, and the SEC, there are many emerging issues related to international harmonisation and the IASB.
- There remain significant misunderstandings about the meaning and nature of accrual accounting systems and the level of precision inherent in such systems. Changes of 1 or 2 cents per share in a company's earnings can have a great market impact—and create significant litigation risk—even if such changes indicate nothing about the health of a company's underlying business.
- The profession—through voluntary mergers as well as through the elimination of Andersen—is severely contracted, with only four major firms serving a large majority of the listed and actively traded public companies in the United States. While four appears to be a sustainable number, any further contraction in this industry would present a major challenge to the viability of the profession, with potential for a negative effect on public confidence in our markets.

Did u know? William McDonough, former chair of the PCAOB, said, "None of us [regulators] has a clue what to do if one of the Big Four failed." He also said that if one of the Big Four were to collapse, the best accountants could choose to quit the profession.

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14.3.3 Automating Audit Procedures

There are several benefits from automating audit procedures. These include:

- Automatic generation of audit plans, programs, schedules and procedures.
- Savings due to more efficient working.
- Better compliance with audit firm procedures.
- Freeing audit personnel to think rather than merely go through procedures.
- Creation of networks such that online supervision becomes possible.
- Rapid sharing of information.

14.3.4 E-Commerce

E-commerce is a system of conducting business over the internet by electronic rather than paper-based methods. In E-commerce, documents such as invoices are exchanged using a standard method known as Electronic Data Interchange (EDI). Electronic form filling and transmission becomes far quicker than manually completing a form and then posting it. Secure Electronic Transmission (SET) is an extension of EDI. Using SET, monies can be transferred primarily through credit card payments. E-commerce raises various risks for firms applying it and for auditors as well.

Some risks involved in E-commerce are:

1. ***Systems breakdown:*** It includes Systems breakdown which may have going-concern implications.
2. ***Computer viruses:*** Spread of computer viruses which can cause computer failure.
3. ***Failure of internet services:*** Failure of internet services may bring operations to a standstill.
4. ***Lack of confidentiality:*** Data which may be commercially sensitive may be obtained by hackers or by other means.
5. ***Integrity:*** Electronic data may lack integrity since it may be corrupted or be unauthorised or duplicated or lost.
6. ***Health and safety:*** Continuous exposure to computer screens may damage employees' health and lead to actions for damages.
7. ***Compliance with laws and regulations:*** There are/there will be some laws and regulations to be complied with.
8. ***Competition:*** Business competition is facilitated. For example, one can buy books more cheaply from web-based booksellers in the USA than in the UK. This has implications for many businesses that formerly had quasi-monopoly position.
9. ***Fraud:*** The complexity and anonymity of modern IT systems make fraud a possibility and its detection more unlikely.
10. ***Money laundering:*** Money laundering is facilitated by modern IT systems.
11. ***Lack of audit trail:*** The trail of paper tracing all transactions is gradually disappearing as the paperless office is coming in sight.
12. ***Lack of appropriate technical skills:*** E-commerce indeed presents a number of challenges to the auditor. These include:
    - The need for having a technical expert in E-commerce in the audit firm

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- Whether to accept or not to accept an audit engagement after considering the risk involved and the expertise the audit firm has
- The going concern problem needs more attention than usual
- The function of internal audit becomes especially important
- The focus of internal controls may be different
- Audit firms may be involved as advisors and consultants for setting clients' e-commerce systems

In many ways, the procedures required in carrying out audits on clients engaged in E-commerce are the same as those used on any other audit. A possible approach could be:

- Consider accepting or not accepting the audit engagement. If you have already accepted, consider whether or not you should continue with the engagement.
- Assign staff with appropriate technical expertise.
- Obtain a very detailed knowledge of the business (KOB) and especially of the risks facing the client.
- Evaluate the implications of the risks to the auditor.
- Examine and assess the overall control environment.
- Examine and assess the specific controls in force. In this case, auditing around the computer is often not desirable. Use the computer as an audit tool.
- Examine and assess the controls in place in connection with outsourced processing.
- Liaise with the internal auditor and assess the internal audit function.
- Pay special attention to going concern.

Caution Ensure that the client has some form of business continuity planning in the case of systems failure.

14.3.5 Financial Reporting and Websites

Many firms now put their financial statements on the web. This presents problems for the auditor as financial statements on the web may be altered. As a result, users may rely on wrong information. In such a situation, the letter of engagement should include:

- Acknowledgement by the auditor that the report may be published on the web.
- A statement that the responsibilities for the report published on the web rests with directors.
- A statement that the company should seek advice from the auditors before making any electronic publication.
- A statement that the auditors reserve the right to withhold consent to publish their report electronically if the financial statements or auditors' report are published inappropriately.
- A statement that the directors are responsible for the controls over, and security of, the web site.
- A statement that the examination of the controls over the maintenance and integrity of the web site is not part of the auditors' duties but can be added if required.

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Notes Generally, the auditors' procedures for electronically published financial statements should include checking the information by reviewing the process by which the financial statements published form the manually signed accounts.

14.3.6 Forensic Accounting

Forensic accounting/auditing can be defined as accounting/auditing skills to situations that have legal consequences.

Example: Forensic auditing is the investigation of a fraud or presumptive fraud with a view to gathering evidence that could be presented in a court of law.

It is the specialty practice area of accountancy that describes engagements that result from actual or anticipated disputes or litigation. "Forensic" means "suitable for use in a court of law", and it is to that standard and potential outcome that forensic accountants generally have to work. Forensic accountants, also referred to as forensic auditors or investigative auditors, often have to give expert evidence at the eventual trial. All of the larger accounting firms, as well as many medium-sized and boutique firms have specialist forensic accounting departments. Within these groups, there may be further sub-specialisations: some forensic accountants may, for example, just specialise in insurance claims, personal injury claims, fraud, construction, or royalty audits.

Forensic accountants may be involved in recovering proceeds of crime and in relation to confiscation proceedings concerning actual or assumed proceeds of crime or money laundering. In the United Kingdom, relevant legislation is contained in the Proceeds of Crime Act 2002. Some forensic accountants are also Certified Forensic Accounting Professionals, Certified Fraud Examiners, Certified Public Accountants, Chartered Accountants or ACCAs. Forensic accountants utilise an understanding of business information and financial reporting systems, accounting and auditing standards and procedures, evidence gathering and investigative techniques, and litigation processes and procedures to perform their work.

Forensic accountants are also increasingly playing more proactive risk reduction roles by designing and performing extended procedures as part of the statutory audit, acting as advisers to audit committees, fraud deterrence engagements, and assisting in investment analyst research. "While Forensic Accountants ("FAs") usually do not provide opinions, the work performed and reports issued will often provide answers to the how, where, what, why and who. The FAs have and are continuing to evolve in terms of utilizing technology to assist in engagements to identify anomalies and inconsistencies. It is important to remember that it is not the Forensic Accountants that determine fraud, but instead the court."

Since all professional accountants operate within a commercial legal environment, all professional accountants are, in a sense, forensic accountants. What distinguishes forensic accounting in common parlance, however, are the engagements. That is, when a professional accountant accepts an engagement where they anticipate that their finding or analysis may be subject to adversarial or judicial scrutiny or administrative review, the professional accountant seeks a level of evidentiary detail and analytical precision which will be sustainable within the legal framework of such scrutiny or review.

Forensic accounting is focused, therefore, upon both the evidence of economic transactions and reporting as contained within an accounting system, and the legal framework which allows such evidence to be suitable to the purpose(s) of establishing accountability and/or valuation. Forensic accountants specialise in those types of engagements where there is a need for such

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evidence. Engagements are wide-ranging, and include transaction reconstruction and measurement; bankruptcy, matrimonial divorce, and probate asset identification and valuation; falsifications and manipulations of accounts or inventories or in the presentation thereof; and accountability within the statutory audit and other environments; among many others.

Increasingly, as various parties perceive the value of such evidence, grounded as it is in "accounting facts," forensic accountants are called upon to play important pre-emptive roles (as of right, without cause), offering independent assurance in such diverse areas as audit committee advisory services, merger and underwriting due diligence, investment analyst research, and enterprise risk management.

Did u know? The validation and enhancement of the body of knowledge (the models and methodologies) relating to the evidentiary value of accounting data, within a strict legal framework, is the raison d'être of the Journal of Forensic Accounting.

Forensic accountants detect and interpret the evidences of both normal (non-fraudulent) and abnormal (fraudulent) phenomena introduced into the books and records of an accounting system (expansively defined) and the resultant effect upon the accounts, inventories, and the presentation thereof. It is imperative; therefore, that forensic accountants first understand what is normal, since even extremely high value abnormalities are introduced by such simple mechanisms as improper account classification or the presentation policy of routine transactions. Therefore, just as forensic dentists and forensic anthropologists are dentists or anthropologists first (that is, they are foremost professionals in the underlying discipline and are specialists in its forensic aspects), so too forensic accountants are accountants first.

On a day-to-day basis, this can mean that you are using your skills in a variety of situations. 'One of the areas that we are highly involved in is confiscation orders. 'If someone has been charged and convicted, for example, if they've been money laundering then the court has to find out what was actually the receipts of this crime and distinguish that from what was actually legitimate business.

'We have to go through everything to discover and establish what comes from a legitimate source of income. In that situation, we are often challenging the prosecution's case and saying it is less or more, so we'll work with the individuals in that type of case. Another area is if an accountant has missed something in relation to a corporation tax return, we analyse the accounts to see if what they did was correct.

The Role of Forensic Accountants

The main role of forensic accountants is to assist the courts, solicitors and clients understand the complex financial and accounting issues and presenting that information in a manner that all users can understand. An important addition to that is that the opinions or results are supported by evidence that will hold up under cross examination or scrutiny.

As forensic accountants, we help at a number of different levels in the litigation process including:

- ***Assisting in Initial Discovery:*** Helping solicitors ask for the right information the first time that will provide them with the greatest level of information. As a note, ask for top level information first and then, work down to source material. The level of information available will depend on the complexity of the business and the nature of the claim.
- ***Applying our Commercial Knowledge and Expertise:*** Financial statements and income tax returns tell a story of a business. As forensic accountants, we can translate that story and apply it to the other information in the business. When the stories do not match, finding

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the evidence and clues that will support or disprove the claim for damages is one of the important roles of forensic accountants.

- ***Providing Expert Evidence both Written and Oral:*** As forensic accountants, we are able to provide expert evidence in written form and where necessary, support the opinions and calculations in cross examination. Extensive experience in cross examination is vital, as the strategies used by counsel varies considerably from case to case.
- ***Independence:*** The expert evidence rules mean that an expert must give an objective, unbiased opinion. This provides a stronger argument for acceptance by the Court. Where reports are normally prepared by internal 'experts' on behalf of the either party, there can often be questions concerning the independence of these 'experts' as they are typically long-term employees of the body concerned.

14.3.7 IT Audit Basics

IT audit is a part of the overall audit process, which is one of the facilitators for good corporate governance. While there is no single universal definition of IS audit, Ron Weber has defined it (EDP auditing—as it was previously called) as "the process of collecting and evaluating evidence to determine whether a computer system (information system) safeguards assets, maintains data integrity, achieves organisational goals effectively and consumes resources efficiently."

Information Technology is the lifeblood of any large business. As in years past, computer systems do not merely record business transactions, but actually drive the key business processes of the enterprise. In such a scenario, senior management and business managers do have concerns about information systems. The purpose of IT audit is to review and provide feedback, assurances and suggestions. These concerns can be grouped under three broad heads:

1. ***Availability:*** Will the information systems on which the business is heavily dependent is available for the business at all times when required? Are the systems well protected against all types of losses?
2. ***Confidentiality:*** Will the information in the systems be disclosed only to those who have a need to see and use it and not to anyone else?
3. ***Integrity:*** Will the information provided by the systems always be accurate, reliable and timely? What ensures that no unauthorised modification can be made to the data or the software in the systems?

Elements of IT Audit

An information system is not just a computer. Today's information systems are complex and have many components that piece together to make a business solution. Assurances about an information system can be obtained only if all the components are evaluated and secured.

Notes The proverbial weakest link is the total strength of the chain.

The major elements of IS audit can be broadly classified:

1. ***Physical and Environmental Review:*** This includes physical security, power supply, air conditioning, humidity control and other environmental factors.
2. ***System Administration Review:*** This includes security review of the operating systems, database management systems, all system administration procedures and compliance.

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3. ***Application Software Review:*** The business application could be payroll, invoicing, a web-based customer order processing system or an enterprise resource planning system that actually runs the business. Review of such application software includes access control and authorisations, validations, error and exception handling, business process flows within the application software and complementary manual controls and procedures. Additionally, a review of the system development lifecycle should be completed.

4. ***Network Security Review:*** Review of internal and external connections to the system, perimeter security, firewall review, router access control lists, port scanning and intrusion detection are some typical areas of coverage.

5. ***Business Continuity Review:*** This includes existence and maintenance of fault tolerant and redundant hardware, backup procedures and storage, and documented and tested disaster recovery/business continuity plan.

6. ***Data Integrity Review:*** The purpose of this is scrutiny of live data to verify adequacy of controls and impact of weaknesses, as noticed from any of the above reviews. Such substantive testing can be done using generalised audit software (e.g., computer assisted audit techniques).

Self Assessment

Fill in the blanks:

9. ..... enacted by parliament is likely to have profound influence on auditing e.g. Public Procurement Act 2004, Money Laundering Act.

10. The ..... determination has been made that auditing is central to public confidence in our capital markets.

11. In E-commerce, documents such as invoices are exchanged using a standard method known as .....

12. ..... means "suitable for use in a court of law", and it is to that standard and potential outcome that forensic accountants generally have to work.

13. ..... can be defined as accounting/auditing skills to situations that have legal consequences.

14. The purpose of ..... audit is to review and provide feedback, assurances and suggestions.

15. Assurances about an ..... can be obtained only if all the components are evaluated and secured.

Case Study

South Africa - Fostering Environmental Regulations

The most important industries with regard to their contribution to the GDP, but also in terms of their political weight constitute a strong regulatory environment. South Africa has been built on its mineral wealth. The country owns some of the world's richest reserves of diamonds, gold, coal, iron ore, platinum, chrome, and several other minerals. The mining sector's relative importance to the GDP was overturned by manufacturing only in the 1950s and has afterwards been steadily decreasing. However,

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with a share of about 40% mining remains a major contributor to South Africa's export earnings (Malherbe 2000). The food & beverage sector in South Africa is of considerable relevance for the overall economy. It constitutes the third largest manufacturing sector by gross value of production.

The mining industry causes large-scale destructions of landscapes which include erosions, siltation, deforestation and desertification. The use of toxic chemicals entails the pollution of soils and rivers, while air pollution is generated by the dust from bulldozing and tailing dams. Toxic waste management and the rehabilitation schemes for old mines are crucial regulatory issues. Especially, in water-scarce South Africa, the industry's enormous consumption of water as well as the phenomenon of acid water drainage is further critical issues. These negative environmental effects combine with issues of social inequality. The South African mining industry has a bad record of low environmental and social standards, as its labour intensive economic strategy has been built on the supply of extremely cheap migrant labour, supported by the apartheid regime.

During the apartheid era, polluting industries such as mining were set-up near black townships and homelands. Also, migrant workers' settlements were located near the mines so that the poor and discriminated population has been particularly exposed to environmental pollution. With the industrialization and commoditisation of food production, which has taken place in South Africa over the past years, the impact of these production processes on natural resources has increased substantially. Such developments have led and will further contribute to a serious degradation and over-utilization of soil and water resources. If continued at current levels, water use in the agricultural sector will aggravate the problem of water-scarcity in the drought-prone regions of South Africa. The increased deployment of fertilizers and pesticides in high-intensity agriculture is expected to further impair the quality of water and soil resources. While these are impacts related more directly to the agricultural sector, food processing companies are increasingly forced to show responsibility for these impacts as well. Due to its dependency on the agricultural sector the food manufacturing sector is extremely vulnerable to changing climate conditions, droughts and water shortages.

Both sectors have a significant presence of large international companies; they have significantly different backgrounds and operate in a distinctive environment as regards the structure of each industry. The two sectors vary significantly with regard to the sector structure, the number of foreign MNCs versus South African expatriated companies, the strength of organised business interests, and the awareness of local and international civil society and public actors as regards negative environmental impacts per sector. These variations have provided for a number of theoretically deducted reasons for case selection. Here we will restrict ourselves to introducing two that have mainly guided our selection of cases. The food & beverage sector, by contrast, displays a considerable heterogeneity and variability in terms of firm size and type. The industry reflects the country's manifold agricultural activities, and is often characterised as typical for an emerging market economy.

After 1960, the development in the food sector could hence be characterised by a further concentration and fragmentation, two seemingly antagonistic trends, which were equally boosted by the liberalization of agricultural markets starting in the late 1980s. In some sub-sectors, this led to the emergence of new market actors, mostly smaller processors and thus an expansive growth of the number of companies.

Involvement in Public Regulation

In the aftermath of the WSSD 2002 in Johannesburg, South Africa has taken part in the Intergovernmental Forum on Mining and Sustainable Development, initiated by United

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Nations Conference on Trade and Development (UNCTAD) and United Nations Department of Economic and Social Affairs (UNDESA), UK's Department for International Development (DFID) and the Canadian Department of Foreign Affairs and International Trade (DFAIT), to encourage member states to implement the relevant mining clauses of the Johannesburg Plan of Implementation.

In the food and beverage industry companies have participated in consultative processes particularly on the issue of packaging. Interestingly these activities are closely related to previous self-governing advances around packaging e.g. on the issue of recycling of packaging material. Another area of fostering is the building of weak administrative capacities, especially at the provincial and local tier of state administration. In South Africa, companies are for example required by law to integrate their local policies within the framework of Integrated Development Plans of municipalities. This is not enforced and there are many examples of companies ignoring or circumventing ineffective state agencies.

Co-Regulation

The South African government is the driving agent to engage stakeholders, including business actors from all sectors, in environmental policy formulation and implementation. There are ample general and issue-specific multi-stakeholder forums which are proscribed in the national legislation or which are initiated by national or local government as a response to a particular problem pressure. Companies also engage in multi-stakeholder initiatives either at the transnational level, or initiated by companies within the local context of their operations. At the transnational level, a number of multi-stakeholder initiatives have emerged engaging in the development of transnational voluntary standards and codes of conducts.

The mining industry has faced extensive criticism for its negative impact on the environment, especially in developing countries. In order to counter increasing public pressure, the industry has come up with a number of initiatives, not only at the company level, but also in the form of collective business responses at the transnational level. In 1999 nine of the largest mining companies closed ranks to form the Global Mining Initiative (GMI), presenting the industry as committed to environmental principles and standards. In preparation of the WSSD in Johannesburg 2002, a comprehensive consultation and research program was initiated; the Mining/ Metals and Sustainable Development process (MMSD). For a period of two years, a comprehensive consultation and research effort was undertaken to come up with a state of the art of sustainability policies within the industry, amongst others in the Southern African region.

As a result, the ICMM was established and mandated to develop a common global reporting standard for the industry, the Sustainable Development Framework (SDF). At the national level, all larger mining companies are part of the South African Chamber of Mines, which acts as the major spokes body for the big mining companies' vis-à-vis the South African government. The national body of the mining industry, the South African Chamber of Mines, has traditionally been a powerful industry body, and represents about 90% of the industry.

According to the research, there are two dominant drivers in South African industrial environmental policy: governmental legislation and global and local proponents of environmental standards. The government has been the driving force behind South Africa's

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progressive environmental legislation in the first place. During the political transition, the country's environmental legislation has been pushed by an international epistemic community represented through international organisations and NGOs, which went along with initiatives in other policy fields used by the ANC government to re-integrate the internationally isolated country in the international community.

Question:

Analyse the case and write down the case facts.

Source: http://www.sfb-governance.de/publikationen/sfbgov_wp/wp9/wp9.pdf

14.4 Summary

- The professional bodies require strict adherence to the ethical codes and have considerable enforcement mechanisms. Necessarily, ethical codes should be obeyed in the spirit as well as the letter but often are not.
- Non-compliance means acts of omission or commission by the entity which is contrary to the prevailing laws or regulations.
- 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.
- Auditing, like many other disciplines, is a fast changing discipline. There are a surprisingly large number of current issues.
- E-commerce is a system of conducting business over the internet by electronic rather than paper-based methods. In E-commerce, documents such as invoices are exchanged using a standard method known as Electronic Data Interchange (EDI).
- Many firms now put their financial statements on the web. This presents problems for the auditor as financial statements on the web may be altered.
- Forensic accounting/auditing can be defined as accounting/auditing skills to situations that have legal consequences.
- Forensic accountants detect and interpret the evidences of both normal (non-fraudulent) and abnormal (fraudulent) phenomena introduced into the books and records of an accounting system (expansively defined) and the resultant effect upon the accounts, inventories, and the presentation thereof.
- An information system is not just a computer. Today's information systems are complex and have many components that piece together to make a business solution.
- IT audit is a part of the overall audit process, which is one of the facilitators for good corporate governance.

14.5 Keywords

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.

Audit Operation: 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.

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E-commerce: E-commerce is a system of conducting business over the internet by electronic rather than paper-based methods.

Electronic Data Interchange (EDI): In E-commerce, documents such as invoices are exchanged using a standard method known as Electronic Data Interchange (EDI).

Forensic Accounting: Forensic accounting/auditing can be defined as accounting/auditing skills to situations that have legal consequences.

International Standard on Auditing (ISA): The International Standard on Auditing (ISA) deals with the auditor's responsibility to consider laws and regulations in an audit of financial statements.

Non-compliance: 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.

Secure Electronic Transmission (SET): Secure Electronic Transmission (SET) is an extension of EDI. Using SET, monies can be transferred primarily through credit card payments. E-commerce raises various risks for firms applying it and for auditors as well.

14.6 Review Questions

1. Briefly explain about the professional ethics in auditing.
2. What is the term non-compliance with laws and regulation means?
3. What are Auditor's Duty while considering laws and regulation in an audit of financial statements?
4. Describe the regulations in auditing
5. What audit procedures are necessary to be applied by the auditor when non-compliance is identified or suspected?
6. Explain Forensic accounting.
7. What are IT Audit basics?
8. Explain the purpose and elements of IT Audit Basics.
9. What are the current issues in auditing?
10. Write down the matters which influence auditing and give rise to current issues.

Answers: Self Assessment

1. Audit operation
2. Ethical auditing
3. Ethical accounting
4. Non-compliance
5. IFAC
6. International Standard on Auditing (ISA)
7. Material misstatement
8. Statutory auditors
9. Statute laws
10. Political
11. Electronic Data Interchange (EDI)
12. Forensic
13. Forensic accounting/auditing
14. IT
15. Information system

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14.7 Further Readings

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