Auditing and Corporate Governance

DEACC215

Edited by:
Dr. Nancy

LOVELY PROFESSIONAL UNIVERSITY

Auditing and Corporate Governance

Edited By
Dr. Nancy

Title: AUDITING AND CORPORATE GOVERNANCE

Author's Name: Dr. Arpit Sidhu

Published By : Lovely Professional University

Publisher Address: Lovely Professional University, Jalandhar Delhi GT road, Phagwara - 144411

Printer Detail: Lovely Professional University

Edition Detail: (I)

ISBN: 978-81-19929-31-3

Content

Unit 01: An Introduction to Auditing

CONTENTS

Objectives

After studying this unit, you will be able to:

- explain the fundamental nature of a joint stock company as a type of business organization and the various types of companies based on the liability of their members;
- identify the categories of shares issued by a corporation;
- explain the accounting treatment of shares issued at par, at premium, and at discount, including oversubscription

Introduction

The evolution of modern accountancy and the expansion of the auditing profession in India and globally can be attributed to the significant growth of industry and commerce that followed the Industrial Revolution. In the past, when business enterprises were small and managed by their proprietors, there was no pressing need for complicated accounting procedures. However, as companies grew in size, and shareholders invested capital in joint stock companies without playing an active role in management, it became necessary for managers to present annual accounts to the shareholders.

Unfortunately, the directors of failing companies had a vested interest in concealing the lack of success of their firms from shareholders, which resulted in fraudulent accounting practices and subsequent scandals. As a solution, governments mandated that accounts be reported by third-party auditors rather than solely relying on the directors. This led to the emergence and development of auditing.

As enterprises have grown in size and their accounting procedures have become increasingly complex, the demands on auditors' skills have increased. As a result, it is crucial that only qualified accountants who are members of recognized professional bodies audit accounts.

1.1 Origin

The word 'audit' is derived from the Latin word 'audire', which means 'to hear'. The origin of 'audit' can be traced back to early times of civilization, but auditing as its existing form was established only in the middle of the 19th century.

In early times, the method of accounting was so crude and the number of transactions was so smallthat every individual was in a position to check all the transactions recorded by himself or by hisemployees. Whenever the owner of the business suspected frauds or misappropriation of funds, he used to appoint an official to check the accounts. Such a person would meet the concerned employees and hear whatever they had to say in connection with the accounts. The person appointed to examine the accounts came to be known as the 'auditor'.

1.2 Early History of Audit

Throughout history, the importance of accountability in the financial affairs of states, empires, and businesses has been recognized. The ancient Egyptians, Greeks, and Romans utilized systems of checks and counter checks to ensure the integrity of their public accounts. However, the duties of auditors were limited in ancient times.

In the late 15th century, with the Renaissance in Italy, trade and commerce experienced a greatimpetus. To meet the demand, a system of accounts capable of recording all kinds of business transactions was developed. Luca Pacioli published the principles of double-entry bookkeeping in 1494, which described the duties and responsibilities of an auditor in detail. Since then, the duties and responsibilities of an auditor have expanded greatly.

The Industrial Revolution was another landmark in the history of trade and commerce. Large-scale production required significant capital investment, which individuals were unable to provide due to their limited finances. This led to the creation of the company as a business organization, which allowed for the issuance of shares with limited liability. Shareholders delegated management to the board of directors, who submitted accounts to shareholders periodically.

With the growth of companies, professional accountants became more prevalent as auditors. In 1880, the Institute of Chartered Accountants of England and Wales was established, and by the early 1990s, professional accountants had become prominent as auditors. The objectives of audit changed during this time, with the primary objective becoming the verification and attestation of financial statements. The detection of errors and frauds became incidental to this objective.

In India, developments in the United Kingdom had a significant effect on company legislation. The Joint Stock Companies Act of 1857 contained provisions for voluntary annual audits, and the Companies Act of 1913 made the audit of company accounts compulsory. The Chartered Accountants Act of 1949 established the Institute of Chartered Accountants of India, which regulates the profession of chartered accountants throughout India. India produced its own Companies Act in 1956, which was replaced by a new Act in 2013 that contains provisions regarding the qualifications and disqualifications of auditors, their method of appointment, and their powers and duties.

1.3 Evolution of Auditing

Before the year 1500 CE, accounting was mainly concerned with the government's activities. The only form of auditing available at that time was the keeping of separate records by two different scribes. The primary objective of maintaining such records was to detect fraud and prevent defalcations within the treasuries. The goal was also to minimize the erroneous recording of transactions and ensure the honesty of those responsible for the custody of resources. However, internal controls were non-existent, although it was recognized that standardized accounting systems could reduce the possibility of fraud.

The Industrial Revolution (1750–1850) marked a period of significant economic growth in Great Britain, leading to the passing of management from owners to professional managers. This resulted in an increased demand for auditors who were independent of management and could detect not only clerical errors but also management fraud. As a result, auditors began periodically reporting on the work they had performed to the entity's owners, and the concept of the 'independent auditor's report' emerged. During this time, the concept of 'testing' also evolved, where auditors selected a few random cases to examine, as it was not economically feasible to physically examine all transactions. However, the use of testing is recognized as one of the limitations of modern-day audits.

From 1905 to 1930, British and American audit objectives progressed independently. In the United States, the audit objective gradually changed from the detection of fraud to reporting on 'the actual condition of an entity,' and there was considerable use of testing. In Great Britain, however, the primary objective remained the detection of fraud and error, and detailed checking remained prominent. Although auditors recognized the benefits of internal control procedures, this recognition had little, if any, effect on the nature, timing, and extent of auditors' procedures.

From 1933 to 1940, auditors accepted somewhat 'softer' audit objectives, and the standard auditor's report on the financial statements reflected this change. In the United States, auditors reported on whether financial statements 'present fairly' the state of affairs of an entity, while in Great Britain, the more precise 'present a true and fair view' was still used. By 1940, testing became the rule, and detailed checking became the exception. There was also a general recognition that the adequacy of 'internal checks' could reduce the extent of testing by auditors. Since then, the relevance of effective internal controls has been increasingly recognized by auditors as an important factor in the determination of the nature, timing, and extent of audit procedures.

Since 1960, the auditing profession worldwide has experienced a significant increase in wage costs. This, combined with the increasing complexity of business and the proliferation of computerized information systems, led to an increased demand for more efficient and effective methods of auditing. During the period 1960-1980, an assessment of the reliability of internal control became the accepted method of determining the nature, timing, and extent of many audit procedures. This led to the extensive use of what was called 'system-based auditing.' Statistical methods were also introduced to determine the extent of testing, although their use was not widespread. Around 1972, the concept of audit risk was recognized in the professional literature.

Since 1980, increasing fee pressure has accentuated the need for audit to be both effective and efficient. As a result, there has been increasing recognition of the importance of the audit risk concepts in audit practice. Audit firms have adopted a 'risk-based approach' in auditing, which involves a particular way of determining the nature, timing, and extent of audit procedures based on an explicit evaluation of the risk of the financial statements containing a material misstatement. Although the objectives of an audit have remained unchanged since about 1940, there is pressure fromthe public to widen audit objectives to embrace, for example, the detection of fraud continues.

1.4 Meaning of Auditing

The term "Audit" has its roots in the Latin word "audire" which means "to hear". In earlier times, whenever business owners suspected fraudulent activities within their organization, they appointed certain individuals to check their accounts. These appointed persons would summon the accountant and "hear" what they had to say in connection with the accounts.

The dictionary defines "Audit" as an official examination of accounts. Naturally, the individual who conducts this examination must possess the necessary knowledge and expertise to examine the accounts, know what to examine, and to whom the examination report and observations must be submitted. In summary, auditing is a process in which competent and independent individuals collect and evaluate evidence to form an opinion and communicate their opinion to interested parties through an audit report.

From the above, it is clear that the auditing process involves three essential components:

A) the books of accounts,

B) the auditor, and

C) the techniques and procedures of audit.

Montgomery, a leading American accountant, defines auditing as a systematic examination of the books and records of a business or organization to check, verify, and report upon the results thereof. The Institute of Chartered Accountants of India (ICAI) has defined auditing as an independent examination of financial information of any entity, profit-oriented or not, and irrespective of its size or legal form when conducted with a view to express an opinion thereon.

From the above definitions, it is evident that an auditor's role extends beyond ensuring the arithmetical accuracy of the books of accounts. The auditor is also responsible for ascertaining the correctness of the transactions entered in the books of original entry. To perform this function, the auditor must inspect, compare, check, review, scrutinize the vouchers supporting the transactions in the books of accounts and examine the correspondence, minute books of shareholders' and directors' meetings, memorandum of association and articles of associations, and other relevant documents.

1.5 Nature of Auditing

Accounting is an essential function of any organization that involves recording economic events and their impact on the financial position of the organization. At the end of a particular accounting period, the financial statements are prepared to provide information on the financial result and position of the organization. The primary objective of accounting is to ensure that the financial position and financial results of an organization are known by stakeholders such as management, shareholders, creditors, investors, loan-providing financial institutions, and the public.

Auditors are appointed to ensure the authenticity and reliability of the books of accounts and the supporting documents that are used to record economic events. The auditors submit a report to the owners of the organization, stating whether the books of accounts give a true and fair view of the state of affairs of the organization. If there are any inconsistencies, the auditors will report accordingly.

Auditing is a technique of accounting control that ensures the books of accounts and documents are maintained accurately. Accounting errors or frauds can distort the true financial position of an organization. Therefore, auditors go through the entries recorded in the books of accounts and relevant supporting documents to ensure that the financial statements prepared on the basis of the books of accounts are true and fair.

Employees engaged in maintaining the books of accounts become more cautious in their duties because they know that if there are any irregularities, the auditor will report against them. Hence, accounting work is under the control of auditing work, making auditing an essential technique of accounting control.

1.6 Essential Features of Auditing

The following are the essential features of auditing:

1. **Accounting control:** Audit is an instrument of accounting control. The truth and fairness of the accounting information is controlled and checked by auditing activities.
2. **Safeguard:** Audit acts as a safeguard on behalf of the proprietor/s (whether an individual or a group of persons) against extravagance, carelessness or fraud on the parts of the proprietors' agents or servants in the realization and utilization of his/their money and other assets.
3. **Assurance:** Audit assures on the proprietors' behalf that the accounts maintained truly represents

1. facts and expenditure has been incurred with due regularity and propriety.

4. **Assessment:** Audit assesses the adequacy of the accounting system in order to ascertain its effectiveness in maintaining accounting records of an organization.
5. **Review:** Audit carries out a review of the financial statements to know whether the accounting

2. records are in agreement with those statements.
6. **Reporting tool:** Audit is a tool for reporting on the financial statements as required by the terms of the auditors' appointment and in compliance with the relevant statutory obligations.
7. **Practical subject:** Auditing is a practical subject. It is something that people do. How it is done today is a result of long history of marginal changes and responses to new commercial and legal developments over the centuries with the most rapid progress made in the last few years.

1.7 Why is there a Need for an Audit?

The problem that has always existed when the managers are required to report to the owners is the credibility of the report.
The report may—

a) contain error
b) not disclose fraud
c) be inadvertently misleading
d) be deliberately misleading
e) fail to disclose relevant information
f) fail to conform to regulations.

The solution to this problem of credibility in reports and accounts lies in appointing an independent person called an auditor to investigate the fact and report on his findings.

A further point is that modern companies can be very large with multinational activities. The preparation of the accounts of such groups is a very complex operation involving the bringing together and summarizing of accounts of subsidiaries with different conventions, legal systems and accounting and control systems. The examination of such accounts by independent experts trained in the assessment of financial information is of benefit to those who control and operate such organizations as well as to owners and outsiders.

Many financial statements must conform to statutory and other requirements. The most notable is

that all company accounts have to conform to the requirements of the Companies Act. In addition, all accounts should conform to the requirements of Accounting Standards. It is essential that an audit should be carried out on financial statements to ensure that they conform to these requirements.

1.8 Objective of an Audit

The original objective of an audit was principally to see whether the personnel involved in accountinghad properly accounted for the receipts and payments of cash. In other words, the objective of audit wasto find out whether cash had been embezzled and if so, who embezzled it and what amount was involved.

Thus, it was only an audit of cash book. But, at present, the main objective of audit is to find out, aftergoing through the books of accounts, whether the balance sheet and profit and loss account are properlydrawn up accordingly and whether they represent a true and fair view of the state of the affairs of theconcern. This is possible when he verifies the accounts and the statements. While performing his duties,an auditor has also to discover errors and frauds.

The ICAI in its Standard on Auditing (SA) titled 'Overall Objective of an Independent Auditor andthe Conduct of an Audit in accordance with Standards on Auditing' (SA-200) enumerates the followingas the objectives of an independent auditing of the financial statements:

(a) Enhance degree of confidence of the users of financial statements:

The purpose of an audit is toenhance the degree of confidence of intended users in the financial statements. This is achieved by theexpression of an opinion by the auditor on whether the financial statements are prepared, in all materialrespects, in accordance with an applicable financial reporting framework.

(b) Ensure that the financial statements are free from material misstatements:

Standards onAuditing require the auditor to obtain reasonable assurance about whether the financial statements as awhole are free from material misstatement. Reasonable assurance is a high level of assurance, which isobtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk to anacceptably low level.

The auditor should be an independent person who is appointed to investigate the organization, itsrecords and financial statements prepared from them and thus form an opinion on the accuracy and correctnessof the financial statements. The primary aim of an audit is to enable the auditor to conform thatthe accounts show a 'true and fair view'.

So, the primary objective of an audit is to promote efficiency and accuracy in accounting andto place before the shareholders and management accurate information of the financial conditionof the business, which may serve as an aid to overall administration of the business entity. For thefulfilment of the primary objectives of an audit, the following subsidiary objectives are to berealized—

(a) Detection of errors

(b) Detection of frauds

(c) Prevention of errors

(d) Prevention of frauds

Again, errors, which arise out of innocence and carelessness, are of three types—

(a) Clerical errors

(b) Compensating errors

(c) Errors of principles

Also, clerical errors may be of two types:

(a) Errors of omission

(b) Errors of commission

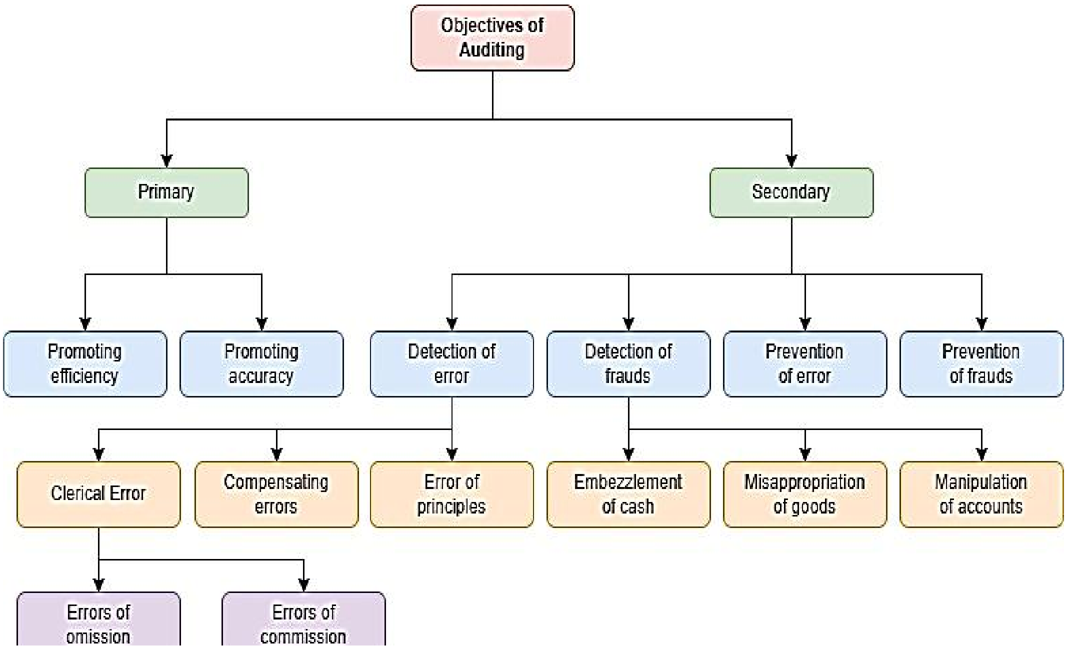
On the other hand, frauds, which arise out of some intention to gain something through some manipulatingdevices, are of three types:

(i) Misappropriation or Embezzlement of cash.

(ii) Misappropriationof goods, and

(iii) Manipulation of accounts.

The objectives of auditing can be presented in the following chart:



1.9 How the Objective is Achieved

The principal objective noted above might be expanded by including a reference as to how the objectiveis achieved. Auditors achieve their objective by gathering and evaluating audit evidence. The evidenceneeds to be such quantity and quality that an auditor is able to form an opinion on the financialstatements. Thus, it may be stated that the objective of audit of the financial statements of an entity isto gather and evaluate audit evidence of sufficient quantity and appropriate quality in order to form anopinion on the financial statements prepared by the management. The term 'quality' refers to therelevance and reliability of the evidence and 'entity' includes entities such as partnerships, trusts,government departments, and quasi-government organizations as well as corporate entities. Theobjective of audit of financial statements is the same, irrespective of the entity to which the financialstatements relate. The auditor will achieve the objectives of auditing by fulfilling the followingrequirements as prescribed in the SA-200 as follows:

(a) Ethical requirements: The auditor shall comply with relevant ethical requirements, includingthose pertaining to independence, relating to financial statement audit engagements.

(b) Professional skepticism: The auditor shall plan and perform an audit with professional scepticism recognizing that circumstance may exist that cause the financial statements to be materially misstated.

(c) Professional judgement: The auditor shall exercise professional judgement in planning andperforming an audit of financial statements.

(d) Sufficient appropriate audit evidence and audit risk: To obtain reasonable assurance, the auditorshall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level andthereby enable the auditor to draw reasonable conclusions on which to have the auditor's opinion.

(e) Conduct of an audit in accordance with SAs: The auditor shall comply with all SAs relevant tothe audit. A Standard on Auditing (SA) is relevant to the audit when the SAs are in effect and thecircumstances addressed by the SAs exist.

The auditor shall have an understanding of the entire text of a SA, including its application and otherexplanatory material, to understand its objectives and to apply its requirements properly.The auditor shall not represent compliance with SA in the auditor's report unless the auditor hascomplied with the requirements of this SA and all other SAs relevant to the audit.

1.10 Relation between Book-keeping, Accountancy, and Auditing

1. Book-Keeping

It is concerned with systematic recording of transactions in the books of original entry and their postingto the concerned ledger accounts. In fact, book-keeping involves the following activities:

(1) Journalize the transactions,

(2) Posting them into respective ledger accounts,

(3) Casting the total of ledger accounts, and

(4) Finding the balances.

2. Accountancy

Accountancy is concerned with the checking of arithmetical accuracy of ledger accounts as preparedby the book-keeper and preparing the trial balance from the balance available of different ledgeraccounts. Finally from the balances, profit and loss account and balance sheet are prepared to knowthe financial result and financial position of the concern. In short, accountancy involves the followingactivities:

(1) Preparation of trial balance.

(2) Incorporation of adjustment entries and passing entries for rectification.

(3) Preparation of profit and loss account.

(4) Preparation of balance sheet.

3. Auditing

When the accountancy work is completed, an auditor is invited to check the accounts prepared by the accountants. That is why, it is said that, 'Auditing begins where accountancy ends'. It is the duty of the auditor to critically examine and verify the accounts. In no case, it is the duty of the auditor to prepare accounts. After completing his work, the auditor has to submit a report of the fact whether or not the profit and loss account exhibits a true and fair financial result of the organization and also the balance sheet reflects the true and fair financial position of the organization.

4. Accountancy vs Auditing

The difference between accountancy and auditing can be outlined in the following ways:

BASIS FOR COMPARISON	ACCOUNTING	AUDITING
Meaning	Accounting means systematically keeping the records of the accounts of an organization and preparation of financial statements at the end of the financial year.	Auditing means inspection of the books of account and financial statements of an organization.
Governed By	Accounting Standards	Standards on Auditing
Work performed by	Accountant	Auditor
Purpose	To show the performance, profitability and financial position of an organization.	To reveal the fact, that to which extent financial statement of an organization gives true and fair view.
Start	Accounting starts where bookkeeping ends.	Auditing starts where accounting ends.
Period	Accounting is a continuous process, i.e. day to day recording of transactions are done.	Auditing is a periodic process.

1.11 Basic Principles Governing an Audit

The basic principles which govern the auditor's responsibilities and which should be complied with whenever an audit is carried out can be outlined in the following ways:

1. Integrity, objectivity and independence: The auditor should be straightforward, honest and sincere in his approach to his professional work and should maintain an impartial attitude.

2. Confidentiality: The auditor should respect the confidentiality of information acquired in the course of his audit work.

3. Skills and competence: The audit should be performed and the report should be prepared with due professional care by persons who have adequate training, experience and competence in auditing.

4. Documentation: The auditor should maintain documents, which are important in providing evidence that the audit was carried out in accordance with the basic principles.

5. Planning: The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner.

6. Audit evidence: The auditor should obtain sufficient appropriate audit evidence to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information.

7. Accounting system and internal control: The auditor should reasonably assure himself that the accounting system is adequate and that all the accounting information, which should be recorded, has in fact been recorded.

8. Audit conclusions and reporting: The auditor should review and assess the conclusions drawn

from the audit evidence and submit a report that contains a clear written opinion on the financial information of the organization.

Case Study

Arun, Badal and Chavan are partners in a firm of constructions business. Since commencing a business15 months ago, they have been fairly successful. Arun who has a diploma in business management aswell as in building constructions has kept the books and he has also prepared the first year's accounts.

Three partners are discussing their accounts, which show a profit in excess of drawings. Badal andChavan suggest that they could draw out the excess but Arun counsels caution, talking about workingcapital needs, which confuses the others.Chavan questions Arun on his interpretation of the partnership agreement, which is a fairly complicateddocument and suggests that they should pay to have the accounts audited. Arun becomes heatedand says that would be a waste of money and he is perfectly capable of maintaining the accounts andmakes no charge to his partners for his work.

Discussion

- What do you mean by the term 'audit' the partners are talked about?
- Why the other partners, except Arun, are interested to have their accounts audited?
- What assurance will they get if their accounts are audited?
- Can the auditor give them the guarantee that the accounts will be correct or if incorrect, he will be able to identify the reasons thereof?
- Can the auditor give assurance that the books of accounts are error-free or fraud-free once it is audited?
- Why Arun is objecting to the other partner's view in favour of appointment of auditors?
- Wherefrom they will get the auditor?
- What are the expected qualities of an auditor?

- Does the auditor require possessing any prescribed qualification?
- What would be the role of auditors in detecting and preventing errors and fraud?
- What is the view of the ICAI regarding the scope and objectives of an audit?
- How the ICAI will ensure that the quality of audit will be maintained?

1.12. Classification of Audit

An audit can be classified under different groups on different basis.

(a) Classification on the basis of organization: Under this category, the audit is classified on thebasis of nature of the organization for which the auditing work is undertaken. It includes the followingtypes:

(1) Audit required under law

- Companies governed by the Companies Act, 2013.
- Banking Companies governed by the Banking Regulation Act, 1949.
- Electricity Supply Companies governed by the Electricity Supply Act, 1948.
- Co-operative Societies registered under the Co-operative Societies Act, 1912.
- Public and charitable trusts registered under various religious and endowment acts.
- Corporations set up under an Act of Parliament or State Legislative. (e.g. Life Insurance Corporation of India)
- Specified entities under various sections of Income Tax Act, 1961.
- Government departments/Public utilities.
- Registered clubs, societies, etc. registered under Societies Registration Act, 1960.

(2) Audit under voluntary category

- Proprietary concern
- Partnership firm
- Hindu undivided family
- Association of persons
- Non-profit-seeking organization.

(b) Classification on the basis of function: Under this category, the audit is classified on the basis offunctional activities of the auditor. In fact, in this group, audit is classified on the basis of auditors'involvement in the work of audit. It includes the following types:

(i) External audit/independent financial audit

(ii) Internal audit.

(c) Classification on the basis of practical approach: The classification of audit under this groupdepends on the practical approach to the work. It includes the following types:

(i) Continuous audit

(ii) Periodical audit

(iii) Interim audit

(iv) Partial audit

(v) Occasional audit

(vi) Standard audit

(vii) Balance sheet audit.

(d) Classification on the basis of audit dimension: Under this category, the audit is classified on thebasis of dimension of audit activities. It includes the following types:

- Management audit

- Cost audit
- Tax audit
- Human resource audit
- System audit
- Propriety audit
- Performance or efficiency audit
- Environment audit
- Social audit
- Cash transactions audit
- Government audit
- Secretarial audit
- Energy audit
- Operational audit
- Other types of audit including special purpose audit (e.g. ABC audit, audit of bonus computation, etc.)

1. Classification of audit on the basis of organization

Audit is not legally obligatory for all types of business organizations. On the basis of organizational structure, audits may be of two broad categories:

1. Audit Required Under Law

This type of audit is also known as statutory audit. The organizations, which require audit under law, arethe following:

(a) Company audit: Audit of accounts of companies, registered under the Companies Act, is compulsory.The introduction of the new Companies Act 2013, whichoutlines the procedure of audit work, the different books of accounts to be maintained, rights, duties andliabilities of the auditor, is definitely a right step towards the protection of shareholders interest over thecompany in the changing environment.

(b) Bank audit: Audit of banking companies is made compulsory under the statute, since it is governedby the Banking Company Regulation Act, 1949. The objective of bank audit is not only to checkthe financial result and financial position, so far as its truth and fairness are concerned, but also to reviewwhether the banks are engaging themselves in those businesses which are given in the Act only andfollow the regulations to operate the banking business as per the regulations given in the Act.

(c) Electricity company audit: The electricity companies are governed by the Electricity Supply Act,1948. The auditor will examine the details of the books of accounts and check thereliability of the internal check system of the organization.

(d) Co-operative society audit: The co-operative societies are governed by the Co-operative Societies Act, 1912, which gives thedetailed procedures of audit for a co-operative society. These types of societies have a good number offinancial transactions. So, this type of organization has the statutory obligation to introduce audit for itsbetter performance.

(e) Trusts audit: The income of the trusted properties is distributed by the trustees among the beneficiariesas per trust deed. As the beneficiaries of the trust, in most of the cases, do not know the techniquesof reading the books of accounts, the chances of being defrauded by the trustees cannot beavoided. So, this type of audit protects the beneficiaries of the trusted properties against the possiblelosses by unscrupulous trustees.

(f) Insurance audit: The Insurance Companies that are governed by Insurance Act, 1938, includesfire, marine and other miscellaneous insurance business. The books of accounts that are to be maintainedby the insurance companies are governed in accordance with the provisions of the said Act.

2. Audit of Other Organizations not Covered by Any Law

There is no basic legal requirement of audit in respect of certain organizations. These organizations mayrequire audit as a matter of internal rules. Some may be required to get their accounts audited on thedirectives of government for various purposes like sanction of loan, grants, etc. These organizationsinclude the following:

(a) Audit of sole proprietors: The sole proprietors are not required to have their accounts audited underany specific statute. The proprietor himself takes decisionabout the scope of audit and the appointment of an auditor. In fact, under this type of audit, the auditingwork will depend upon the agreement of audit and the specific instructions given by the proprietor.

(b) Audit of partnership firm: There is no legal compulsion to get partnership accounts audited. But inpartnership, there are possibilities of mistrust and dissatisfactions among the partners. As such, an independentexternal auditors' view regarding the correctness of accounts is desirable in case of this type oforganization.

(c) Hindu undivided family audit: In respect of accounts of Hindu undivided family, there is no basiclegal requirement of audit. But the important motive for getting the accounts of this type of family businesslies in the inherent advantages that follow from an independent professional audit.

2. Classification on the basis of function

The function of an auditor depends on the role of the auditor, i.e., in which capacity he is conducting theaudit work. So, on the basis of function, auditing can be of the following types:

(a) External Audit: External audit is conducted by an independent external auditor. This type of audit is usually conducted to fulfil the requirement of the provisions of law. The qualified chartered accountants who are not connected with the preparation of accounts or management of the organization can be appointed as an external auditor.

(b) Internal Audit: Internal audit is conducted by specially assigned staff within the organization. It is an audit throughwhich a thorough examination of the accounting transactions as well as the system according to whichthese transactions have been recorded is conducted. The internal audit is undertaken to verify the accuracyand authenticity of the financial accounting and statistical records presented to the management.

3. Classification on the basis of practical approach

On the basis of requirements of audit, the approach to auditing may differ. So, on the basis of practical approach for conducting the audit work, the audit can be classified under the following types:

(a) Continuous Audit*:* A continuous audit or a detailed audit is an audit, which involves a detailed examination of the books of accounts at regular intervals, of say, one month or three months. The auditor visits his clients at regular or irregular intervals of time during the financial year and checks each and every transaction. At the end of the year, he checks the profit and loss account and the balance sheet.

(b) Periodical or Final or Complete Audit*:* Periodical audit is one, which is taken up at the close of the financial period, when all the accounts have been balanced and final accounts have already been prepared. It may also commence before the final accounts are prepared and continue till the *audit is completed even after the close of financial period.*

(c) Interim Audit: Interim audit is an audit, which is conducted in between two annual audits with a view to finding out interim profit of the business to enable it to declare an interim dividend. It is a kind of audit that is conducted between two periodical or balance sheet audit.

(d) Partial Audit:It is a kind of audit where the work of the auditor is curtailed. The auditor is asked to check a few books, for example, he may be asked to check the payment side of the cash book.

Partial audit is not permitted in case of limited companies (private or public) as according to the Companies Act, the duties of an auditor of a company cannot be curtailed. Again, in case of a very big proprietary concern, it may not be possible for the proprietor himself to disburse all payments and if he suspects misappropriation of cash, then he may appoint an auditor to check only the cash book. When an auditor is appointed to conduct partial audit, he must make it clear in his report that he has performed partial audit as per the instructions of the client.

(e) Occasional Audit: As the name indicates, this type of audit is conducted once in a while, whenever the need arises and theclient desires it to be carried out.This is possible only in case of proprietary concerns but in case of joint stock companies, bankingand insurance companies, etc., the audit has to be carried out once or twice a year, according to theCompanies Act.

(f) Standard Audit: Standard audit can be defined as a 'complete check and analysis of certain items and contingent uponeffective internal check, appropriate test checks on remaining items, the whole of work being in accordancewith general auditing standards.'

From the above, it is clear that under this type of audit, certain items in the accounts are thoroughlychecked and analysed and appropriate test checks are applied to other items, provided there is a goodand effective internal check in operation.

(g) Balance Sheet Audit*:* Under this type of audit, the audit is commenced from the balance sheet working back to the books of original entry and the related documents, etc.

This type of audit is more popular in the United States than in England and other European countries. But this type of audit is more widely used.

4. Classification on the basis of audit dimension

The scope of an audit varies widely and depends on the purpose of an audit, the dimension of auditingwork and the conditions of the audit requirement. On the basis of this dimensional aspect, auditing canbe classified under the following types:

(a) Management Audit*:*Management audit is a comprehensive critical review of all aspects of the management process. In fact,it is a tool of management control. It covers all areas of management such as planning, organizing,co-ordination, control, etc. It assists at all levels of the management in the effective discharge of managerialfunctions.

(b) Cost Audit: Cost audit is an effective means of control in the hands of the management to have an idea about theworking of the costing department of the organization and to suggest ways and means for its smoothrunning. It is the detailed checking as well as the verification of the correctness of the costing techniques,systems and cost accounts.

(c) Tax Audit*:*Tax audit refers to audit of incomes or expenses or specific claims of deductions or exemptions for thepurpose of assessment of income tax. Tax audit is required in addition to financial audit, which does notfulfil the specific requirement of the tax authority.

(d) Human Resource Audit*:*The auditor for the purpose of making audit of human resources, if it is included in the annualaccounts, should carefully examine the basis of valuation of human resources. His examination shouldnot relate to the rightness to the process of valuation of the human resources but he should see that informationupon which the calculations are based upon is reliable and authentic. So, human resource auditis concerned about the human asset figure that appears in the balance sheet through checking, inspectingand appraising the various facts and figures, which are based on the estimated value of human resources.

(e) System Audit: The purpose of the system audit is to design appropriate system of accounts suitable to the business andto obtain information, through the process of investigation for improving the accounting method. In fact,accounting systems are required to be revised in order to ensure that it may provide the informationdesired by the executives as an aid to management decision.

(f) Propriety Audit: Propriety audit is concerned with scrutiny of executive decisions bearing on the financial and profit and lossaspect of the concern with special reference to public interest and commonly accepted customs and standardsof conduct. While performing a propriety audit, the auditor would judge whether the standards ofpropriety have been maintained in making payments, incurring expenditure or entering into transactions.

(g) Environment Audit*:*Environmental audit is an excellent management tool for relating productivity to pollution. Environmentalaudit is the examination of the correctness of environmental accounts. In broader sense, environmentalauditing is the examination of accounts of revenues and costs of environmental and naturalresources, their estimate, depreciation and values recorded in the books of accounts.

***(h) Social Audit*:**Social audit is aimed at an assessment of the performance of an entity towards the fulfilment of socialobligations. The objective of social audit is to bring to light for public knowledge how far an organizationhas discharged its responsibility to the society and to make an assessment of the social performanceof an organization. But audit of social accounts is not yet in practice and the term 'Social Audit' is stillin a conceptual stage in our country.

Summary

- The word 'Audit' is derived from the Latin word 'audire', which means, 'to hear'. In early times,whenever the owners of a business suspected fraud, they appointed persons to check the accounts.Such persons sent for the accountant and 'heard' what they to say in connection with theaccounts.
- The dictionary meaning of the term 'audit' is 'official examination of accounts'. In brief, auditing canbe defined as a systematic examination of the books and records of a business or other organizationsin order to check or verify and to report upon results thereof.
- The essential features of auditing are accounting control, safeguard, assuranceassessment, review,reporting tool and practical subject.
- The primary objective of an audit is to promote efficiency and accuracy in accounting. For the fulfilmentof the primary objectives of auditing, certain subsidiary objectives are to be realized, whichinclude detection of errors and frauds and prevention of errors and frauds.
- Errors are the result of carelessness on the part of the person preparing the accounts. Errors can beof different types—errors of omission, errors of commission, compensating error and errors ofprinciples.
- Fraud means false representation or entry made intentionally or without belief in its truth with a viewto defrauding others. Fraud may be activated in different ways—embezzlement of cash, manipulationof accounts and misappropriation of goods.
- It is expected that the auditor should exercise reasonable care and skill, so that he may detect errorsand frauds. But the auditor has no authority to introduce remedial measures for the prevention oferrors and frauds.
- There exists a close relationship between accountancy and auditing. It is said that 'Auditing beginswhere accountancy ends'.
- Company audit, bank audit, electricity company audit, co-operative society audit, trusts audit,insurance audit, etc. are required under law, whereas audits of sole-proprietors, partnership firms,association of persons, non-profit-seeking organizations, etc. are not required under law.
- On the basis of functions, audit can be of two types: external audit and internal audit. External auditis conducted by an independent external auditor, whereas internal audit is conducted by speciallyassigned staff within the organization.

Keywords

- Auditing
- Audit Control
- Audit and Accountancy
- Standard Audit
- System Audit
- Efficiency Audit
- Social Audit

Self Assessment

1. The term ‘Audit’ is derived from a Latin word “audire” which means___________?

A. To inspect

B. To examine

C. To hear

D. To investigate

2. In cases when a new auditor will replace an existing auditor, the code of ethics advises the new auditor to:

A. Present a change of auditor plan to the audit client.

B. Report the change to the SEC.

C. Communicate with the audit committee.

D. Communicate with the existing auditor.

3. Who among the following can be appointed as special auditor by the Central Government?

A. The statutory auditor

B. chartered accountant in practice

C. Any chartered accounted who is not in practice

D. Both (a) and (b)

4. Auditing is the process by which competent independent individuals collect and evaluate the evidences to

A. Form an opinion

B. convince his opinion

C. complain to shareholder

D. None of the above

5. “Auditing is a systematic examination of the books and records of a business or other organisations, in order to ascertain or verify, and to report upon the facts regarding its financial operations and the results thereof”. Definition Given by

A. Montgomery

B. I.M. Pandey

C. F.R.M. de Paula

D. Spicer and Pegler

6. An auditor is like a_______________?

A. Blood haunt

B. Watch dog

C. May both according to situation

D. None of these

7. Auditing is compulsory for____________?

A. Small scale business

B. Partnership firms

C. Joint stock Companies

D. Proprietary Concerns

8. Which is/are the principles of auditing?

A. Integrity

B. Confidentiality

C. Materiality

D. All of the above

9. A sale of Rs. 50.000 to A was entered as a sale to B. This is an example of____________?

A. Error of omission

B. Error of commission

C. Compensating error

D. Error of principle

10.Which one of the following is NOT a duty of the auditor?

A. Duty to report to the company's bankers

B. Duty to report to the members

C. Duty to sign the audit report

D. Duty to report on any violation of law

11. The main object of an audit is ___

A. Creation of opinion
B. Detection and Prevention of fraud and error
C. None of the above
D. Depends on the type of audit.

12. Which of the following statements is not true?

A. Management fraud is more difficult to detect than employee fraud
B. Internal control system reduces the possibility of occurrence of employee fraud and management fraud
C. The auditor's responsibility for detection and prevention of errors and frauds is similar.
D. All statements are correct.

13. Which of the following best describes the purpose of auditing?

A. Ensuring profitability
B. Detecting fraud
C. Conducting market research
D. Creating financial statements

14. What is the primary objective of an audit engagement?

A. Reviewing internal controls
B. Evaluating financial performance
C. Assessing compliance with laws and regulations
D. Providing recommendations for improvement

15. Which of the following is NOT a type of audit?

A. Financial audit
B. Operational audit
C. Marketing audit
D. Internal audit

Answer for Self Assessment

1.	C	2.	D	3.	D	4.	A	5.	A
6.	B	7.	C	8.	D	9.	B	10.	A
11.	B	12.	D	13.	B	14.	C	15.	C

Review Questions

1. Define and explain the term 'Auditing'.
2. Distinguish between the following:
   (a) Principles of auditing and objectives of auditing
   (b) Errors of omission and errors of commission.
3. 'Personal qualities of an auditor are important for the successful conduct of audit.'—Explain with reference to the necessary qualities of an auditor.
4. Define 'Auditing'. Discuss the scope and procedure of an audit.
5. 'Detection and prevention of errors and frauds are the main objectives of auditing'—discuss itfully and explain the duties of an auditor in this regard.
6. Discuss the advantages of audit (a) to the management (b) to the Government (c) to the shareholdersand (d) to the society.
7. 'It is nothing to the auditor whether the business is run prudently or imprudently, profitable orunprofitably'—Do you agree? Give reasons for your answer.
8. 'Auditor does not guarantee that the books of accounts do correctly show the true position of theentity's affairs'—Comment.
9. 'The main objective of an audit is to express an opinion on the truth and fairness of theaccounts.'—Explain the importance of having the accounts audited by an independent professional auditor.
10. Write short notes on the following:
    (a) Standard audit.
    (b) System audit.
    (c) Efficiency audit.
    (d) Social audit.

11. What is statutory audit? Discuss the points of differences between statutory audit and non-statutory audit.
12. What is periodical audit? What are the advantages and disadvantages of periodical audit? Distinguishbetween continuous audit and periodical audit.

Further Readings

https://www.deskera.com/blog/what-is-auditing/

https://www.indeed.com/career-advice/career-development/audit-definition

https://www.investopedia.com/terms/a/audit.asp

https://www.managementstudyguide.com/what-is-auditing-its-types-and-purposes.htm

Unit 02: Audit of Companies

CONTENTS

Objectives

After studying this unit, you will be able to:

- Understand qualification and disqualification of an auditor.
- Know the procedures of appointment, reappointment, filling up of the casual vacancies and removal of auditor.
- Understand powers and duties of auditor.
- Understand the provisions relating to rotational retirement.

Introduction

An auditor is a person who is appointed to conduct an independent examination of books of accounts and supporting vouchers to report on the reliability and fairness of profit and loss statement and balance sheet. He is a professional person having specialized knowledge and expertise in all branches of accounting.

In order to ensure that the person conducting the audit of accounts of company has sufficient knowledge in accounting, the Companies Act requires him to be a chartered accountant within the meaning of the Chartered Accountants Act, 1949. Apart from being well versed in accounting, the auditor should be honest, tactful, methodological, cautious and careful. Lord Justice Lindley in his famous case London and General Bank (1895) held that 'an auditor must be honest, i.e., he must not certify what he does not believe to be true and he must take reasonable care and skill before he believes what he certifies is true'. Learned Judge Lopes in Kingston Cotton Mill case (1896) remarked 'an auditor need not be over-cautious or always suspicious. He is a watchdog but not a bloodhound. He is justifying in believing the tried servants of the company and entitled to rely upon their representation provided he takes reasonable care'.

2.1 Appointment of Auditors

Section 139 of the Companies Act, 2013 contains provisions regarding Appointment of Auditors. Discussion on appointment of auditors may be grouped under two broad headings-

(I) Appointment of First Auditors.

(II) Appointment of Subsequent Auditors.

1.First Auditors

Section 139(6) of the Companies Act, 2013 provides for the appointment of first auditors by the Board of Directors within 30 days of the date of registration of the company. In the case of failure of the Board to appoint such auditor, it shall inform the members of the company, who shall within 90 days at an extraordinary general meeting appoint such an auditor and the auditor or auditors so appointed shall hold office till the conclusion of the first annual general meeting.

The auditor of a company is normally appointed by the shareholders by passing a resolution at the annual general meeting. Once appointed, he holds office from the conclusion of that meeting to the conclusion of every sixth annual general meeting.

A) Appointment of First Auditors in the case of a company, other than a Government Company:

As per Section 139(6), the first auditor of a company, other than a Government company, shall be appointed by the Board of Directors within 30 days from thedate of registration of the company.In the case of failure of the Board to appoint the auditor, it shall inform the members of the company.

The members of the company shall within 90 days at an extraordinary general meeting appoint theauditor. Appointed auditor shall hold office till the conclusion of the first annual general meeting.

Case Study

Facts of the Case: Managing Director of Pigeon Ltd. himself wants to appoint CA. Champ, a practicing Chartered Accountant, as first auditor of the company.

Provisions and Explanation: Section 139(6) of the Companies Act, 2013 lays down that the first auditor of a company shall be appointed by the Board of Directors within 30 days from the date of registration of the company. In the instant case, the proposed appointment of CA. Champ, a practicing Chartered Accountant, as first auditor by the Managing Director of Pigeon Ltd. by himself is in violation of Section 139(6) of the Companies Act, 2013, which authorizes the Board of Directors to appoint the first auditor of the company.

Conclusion: In view of the above, the Managing Director of Pigeon Ltd. should be advised not to appoint the first auditor of the company.

B) Appointment of First Auditors in the case of Government Company:

A "Government company" is a company in which not less than 51% 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 Governments, and includes a company which is a subsidiary company of such a Government company.

Section 139(7) provides that in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company.

In case the Comptroller and Auditor-General of India does not appoint such auditor within the above said period, the Board of Directors of the company shall appoint such auditor within the next 30 days. Further, in the case of failure of the Board to appoint such auditor within next 30 days, it shall inform the members of the company who shall appoint such auditor within 60 days at an extraordinary general meeting. Auditors shall hold office till the conclusion of the first annual general meeting

Case Study

Facts of the Case: The first auditor of Bhartiya Petrol Ltd., a Government company, was appointed by the Board of Directors.

Provisions and Explanation: In the case of a Government Company, the appointment of first auditor is governed by the provisions of Section 139(7) of the Companies Act, 2013 which states that in the case of a Government company, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from thedate of registration of the company. Hence, in the case of Bhartiya Petrol Ltd., being a government company, the first auditor shall be appointed by the Comptroller and Auditor General of India.

Conclusion: Thus, the appointment of first auditor made by the Board of Directors of Bhartiya Petrol Ltd., is null and void.

2. Subsequent Auditors

According to Section 139(1) of the Companies Act, 2013, every company shall, at the first annual general meeting, appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting and the manner and procedure of selection of auditors by the members of the company at such meeting shall be such as may be prescribed.

Rule 3 of the Companies (Audit and Auditors) Rules, 2014 describes the manner and procedure of selection and appointment of auditors. According to this rule—

1. In case of a company that is required to constitute an Audit Committee under Section 177, the committee, and in cases where such a committee is not required to be constituted, the Board shall take into consideration the qualifications and experience of the individual or the firm proposed to be considered for appointment as auditor and whether such qualifications and experience are commensurate with the size and requirements of the company.

It is provided in this case that while considering the appointment, the Audit Committee or the Board, as the case may be, shall have regard to any order or pending proceeding relating to professional matters of conduct against the proposed auditor before the Institute of Chartered Accountants of India (ICAI) or any competent authority or any Court.

2. The Audit Committee or the Board, as the case may be, may call for such other information from the proposed auditor as it may deem fit.

3. Where a company is required to constitute the Audit Committee, the committee shall recommend the name of an individual or a firm as auditor to the Board for consideration and in other cases the Board shall consider and recommend an individual or a firm as auditor to the members in the annual general meeting for appointment.

4. If the Board agrees with the recommendation of the Audit Committee, it shall further recommend the appointment of an individual or a firm as auditor to the members in the annual general meeting.

5. If the Board disagrees with the recommendation of the Audit Committee, it shall refer back the recommendation to the committee for reconsideration citing reasons for such disagreement.

6. If the Audit Committee, after considering the reasons given by the Board, decides not to reconsider its original recommendation, the Board shall record reasons for its disagreement with the committee and send its own recommendation for consideration of the members in the annual general meeting; and if the Board agrees with the recommendations of the Audit Committee, it shall place the matter for consideration by members in the annual general meeting.

7. The auditor appointed in the annual general meeting shall hold office from the conclusion of that meeting till the conclusion of the sixth annual general meeting, with the meeting wherein such appointment has been made being counted as the first meeting.

It is provided that the company shall place the matter relating to such appointment for ratification by members at every annual general meeting.

It is also provided further that before such appointment is made, the written consent of the auditor to such appointment, and a certificate from him or it that the appointment, if made, shall be in accordance with the conditions as may be prescribed, shall be obtained from the auditor.

It is further provided also that the certificate shall also indicate whether the auditor satisfies the criteria provided in Section 141 and that the company shall inform the auditor concerned of his or its appointment, and also file a notice of such appointment with the Registrar within 15 days of the meeting in which the auditor is appointed.

According to Section 139(2) of the Companies Act, no listed company or a company belonging to such class or classes of companies as may be prescribed, shall appoint or reappoint—

(a) An individual as an auditor for more than one term of five consecutive years; and

(b) An audit firm as an auditor for more than two terms of five consecutive years:

However,

(i) an individual auditor who has completed his term under clause

(a) shall not be eligible for reappointment as auditor in the same company for 5 years from the completion of his term;

(ii) an audit firm which has completed its term under clause

(b), shall not be eligible for reappointment as auditor in the same company for 5 years from the completion of such term.

It is provided further that as on the date of appointment, no audit firm having a common partner or partners to the other audit firm, whose tenure has expired in a company immediately preceding the financial year, shall be appointed as an auditor of the same company for a period of 5 years.

It is also provided that every company, existing on or before the commencement of this Act which is required to comply with provisions of this subsection, shall comply with the requirements of this subsection within 3 years from the date of commencement of this Act and nothing contained in this subsection shall prejudice the right of the company to remove an auditor or the right of the auditor to resign from such office of the company.

A) Appointment of Subsequent Auditors in case of Non-Government Companies:

Section 139(1) of the Companies Act, 2013 provides that every company shall, at the first annual general meeting appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting.

The following points need to be noted in this regard-

(i) Before such appointment is made, the written consent of the auditor to such appointment, and a certificate from him or it that the appointment, if made, shall be in accordance with the conditions as may be prescribed, shall be obtained from the auditor.

(ii) The certificate shall also indicate whether the auditor satisfies the criteria provided in section 141.

(iii) The company shall inform the auditor concerned of his or its appointment, and also file a notice of such appointment with the Registrar within 15 days of the meeting in which the auditor is appointed.

B) Appointment of Subsequent Auditors in case of Government Companies:

As per section 139(5), in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, the Comptroller and Auditor-General of India shall, in respect of a financial year, appoint an auditor duly qualified to be appointed as an auditor of companies under this Act, within a period of 180 days from the commencement of the financial year, who shall hold office till the conclusion of the annual general meeting.

3. Filling of a Casual Vacancy

As per Section 139(8), any casual vacancy in the office of an auditor shall-

(i) In the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Board of Directors within 30 days.

If such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting.

(ii) In the case of a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Comptroller and Auditor-General of India within 30 days.

It may be noted that in case the Comptroller and Auditor-General of India does not fill the vacancy within the said period the Board of Directors shall fill the vacancy within next 30 days.

A) Casual Vacancy by Resignation:

As per section 140(2) of the Act, the auditor who has resigned from the company shall file within a period of 30 days from the date of resignation, a statement in the prescribed Form ADT–3 (as per Rule 8 of CAAR) with the company and the Registrar.

In case of the companies referred to in section 139(5) i.e. Government company, the auditor shall also file such statement with the CAG along with the company and the Registrar.

The auditor shall indicate the reasons and other facts as may be relevant with regard to his resignation.

In case of failure, the auditor shall be liable to a penalty of fifty thousand rupees or the remuneration of the auditor, whichever is less, and in case of continuing failure, with further penalty of five hundred rupees for each day after the first during which such failure continues, subject to a maximum of five lakh rupees as per section 140(3).

Case Study

Facts of the Case: CA. Donald was appointed as the auditor of PS Ltd. at the remuneration of Rs. 30,000. However, after 4 months of continuing his services, he could not continue to hold his office of the auditor as his wife got a government job at a distant place and he needs to shift along with her to the new place. Thus, he resigned from the company and did not perform his responsibilities relating to filing of statement to the company and the registrar indicating the reasons and other facts as may be relevant with regard to his resignation.

How much fine may he be punishable with under section 140(3) for non-compliance of section 140(2) of the Companies Act, 2013?

Provisions and Explanation: For non-compliance of sub-section (2) of section 140 of the Companies Act, 2013, the auditor shall be punishable with fine, which shall not be less than fifty thousand rupees or the remuneration of the auditor, whichever is less but which may extend to five lakh rupees, under section 140(3) of the said Act.

Conclusion: Thus, the fine under section 140(3) of the Companies Act, 2013 shall not be less than Rs. 30,000 but which may extend to Rs. 5,00,000

D) Other Important Provisions Regarding Appointment of Auditors

(1) A retiring auditor may be re-appointed at an annual general meeting, if-

(a) he is not disqualified for re-appointment;

(b) he has not given the company a notice in writing of his unwillingness to be re - appointed; and

(c) a special resolution has not been passed at that meeting appointing some other auditor or providing expressly that he shall not be re-appointed.

(2) Where at any annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company.

2.2 Removal of Auditor

An appointed auditor may be removed from his office either in accordance with the provisions of the Companies Act or as per restrictions imposed by the Chartered Accountants Act.

1. Removal as per the companies act

The removal of the auditor in accordance with the provisions of the Companies Act depends upon the option of the concerned company. He may be removed before the expiry of his term or after the expiry of his term.

The Companies Act, 2013 lays down clear procedures about the removal of auditors in Section 140.

1. Removal before the expiry of the term*:* Section 140(1) of the Companies Act prescribes the removal procedures of an auditor. According to this section, the auditor appointed under Section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the previous approval of the Central Government in that behalf in the prescribed manner.

It is provided that before taking any action under this subsection, the auditor concerned shall be given a reasonable opportunity of being heard.

Notes: Direction by Tribunal in case Auditor acted in a Fraudulent Manner:

As per sub-section (5) of the section 140, the Tribunal either suo motu or on an application made to it by the Central Government or by any person concerned, if it is satisfied that the auditor of a company has, whether directly or indirectly, acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its directors or officers, it may, by order, direct the company to change its auditors.

However, if the application is made by the Central Government and the Tribunal is satisfied that any change of the auditor is required, it shall within fifteen days of receipt of such application, make an order that he shall not function as an auditor and the Central Government may appoint another auditor in his place.

It may be noted that an auditor, whether individual or firm, against whom final order has been passed by the Tribunal under this section shall not be eligible to be appointed as an auditor of any company for a period of five years from the date of passing of the order and the auditor shall also be liable for action under section 447.

2. Removal after the expiry of the term: According to Section 140(4), special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor, or providing expressly that a retiring auditor shall not be reappointed, except where the retiring auditor has completed a consecutive tenure of 5 years or, as the case may be, 10 years, as provided under subsection (2) of Section 139.

It is also provided in this section that on receipt of notice of such a resolution, the company shall forthwith send a copy thereof to the retiring auditor.

It is further provided in this section that where notice is given of such a resolution and the retiring auditor makes with respect thereto representation in writing to the company (not exceeding a reasonable length) and requests its notification to members of the company, the company shall, unless the representation is received by it too late for it to do so,—

(a) In any notice of the resolution given to members of the company, state the fact of the representation having been made; and

(b) Send a copy of the representation to every member of the company to whom notice of the meeting is sent, whether before or after the receipt of the representation by the company, and if a copy of the representation is not sent as aforesaid because it was received too late or because of the company's default, the auditor may (without prejudice to his right to be heard orally) require that the representation shall be read out at the meeting

It is also provided that if a copy of representation is not sent as aforesaid, a copy thereof shall be filed with the Registrar.

It is provided further that if the Tribunal is satisfied on an application either of the company or of any other aggrieved person that the rights conferred by this subsection are being abused by the auditor, then the copy of the representation may not be sent and the representation need not be read out at the meeting.

2. Removal as per the chartered accountants act

An auditor may also be removed from his office due to his professional misconduct. Following are some of the important clauses of the Chartered Accountants Act, 1949, which define the professional misconduct for which a chartered accountant may be removed from his office—

1. If a chartered accountant accepts the position as an auditor previously held by another chartered accountant without first communicating him in writing.

2. If a chartered accountant is grossly negligent in the conduct of his professional duties.

3. If a chartered accountant is engaged in any business or occupation other than the profession of accountancy unless permitted by the council of the Institute.

4. If a chartered accountant contravenes any of the provisions of the Act and regulation made there under, etc.

2.3 Ceiling on Number of Audits

It has been mentioned earlier that before appointment is given to any auditor, the company must obtain a certificate from him to the effect that the appointment, if made, will not result in an excess holding of company audit by the auditor concerned over the limit laid down in section 141(3)(g) of the Companies Act, 2013 which prescribes that a person who is in full time employment elsewhereor a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than Rs. 100 crore, shall not be eligible for appointment as an Auditor of a Company.

In the case of a firm of auditors, it has been further provided that 'specified number of companies' shall be construed as the number of companies specified for every partner of the firm who is not in full time employment elsewhere.

This limit of 20 company audits is per person. In the case of an audit firm having 3 partners, the overall ceiling will be 3 × 20 = 60 company audits. Sometimes, a chartered accountant is a partner in a number of auditing firms. In such a case, all the firms in which he is partner or proprietor will be together entitled to 20 company audits on his account. Subject to the overall ceiling of company audits, how they allocate the 20 audits between themselves is their affairs.

Council General Guidelines, 2008 (Chapter VIII): In exercise of the powers conferred by clause (ii) of Part II of the Second Schedule to the Chartered Accountants Act, 1949, the Council of the Institute of Chartered Accountants of India hereby specifies that a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he holds at any time appointment of more than the "specified number of audit assignments of the companies under Section 224 and /or Section 226 of the Companies Act, 1956 (now section 141(3)(g) of the Companies Act, 2013).

It may be noted that in the case of a firm of chartered accountants in practice, the specified number of audit assignments shall be construed as the specified number of audit assignments for every partner of the firm.

It may also be noted that where any partner of the firm of chartered accountants in practice is also a partner of any other firm or firms of chartered accountants in practice, the number of audit assignments which may be taken for all the firms together in relation to such partner shall not exceed the specified number of audit assignments in the aggregate.

It is further provided that where any partner of a firm or firms of chartered accountants in practice accepts one or more audit assignments in his individual capacity, or in the name of his proprietary firm, the total number of such assignment which may be accepted by all firms in relation to such chartered accountant and by him shall not exceed the specified number of audit assignments in the aggregate.

(1) In computing the specified number of audit assignments-

(a) the number of such assignments, which he or any partner of his firm has accepted whether singly or in combination with any other chartered accountant in practice or firm of such chartered accountants, shall be taken into account.

(b) the number of partners of a firm on the date of acceptance of audit assignment shall be taken into account.

(c) a chartered accountant in full time employment elsewhere shall not be taken into account.

(2) A chartered accountant in practice as well as firm of chartered accountants in practice shall maintain a record of the audit assignments accepted by him or by the firm of chartered accountants, or by any of the partner of the firm in his individual name or as a partner of any other firm as far as possible, in the prescribed manner.

Case Study

"ABC & Co." is an Audit Firm having partners "Mr. A", "Mr. B" and "Mr. C", Chartered Accountants. "Mr. A", "Mr. B" and "Mr. C" are holding appointment as an Auditor in 4, 6 and 10 Companies respectively.

(i) Provide the maximum number of Audits remaining in the name of "ABC & Co."

(ii) Provide the maximum number of Audits remaining in the name of individual partner i.e. Mr. A, Mr. B and Mr. C.

(iii) Can ABC & Co. accept the appointment as an auditor in 60 private companies having paid- up share capital less than Rs. 100 crore, 2 small companies and 1 dormant company?

(iv) Would your answer be different, if out of those 60 private companies, 45 companies are having paid-up share capital of Rs. 110 crore each?

Fact of the Case: In the instant case, Mr. A is holding appointment in 4 companies, whereas Mr. B is having appointment in 6 Companies and Mr. C is having appointment in 10 Companies. In aggregate all three partners are having 20 audits.

Provisions and Explanations: Section 141(3)(g) of the Companies Act, 2013 states that the following persons shall not be eligible for appointment as an auditor of a company i.e. a person who is in full time employment elsewhere; or a person, or a partner of a firm holding appointment as its auditor, if such person, or partner is at the date of such appointment, or reappointment holding appointment as auditor of more than twenty companies other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than Rs. 100 crore.

As per section 141(3)(g), this limit of 20 company audits is per person. In the case of an audit firm having 3 partners, the overall ceiling will be 3 × 20 = 60 company audits. Sometimes, a chartered accountant is a partner in a number of auditing firms. In such a case, all the firms in which he is partner or proprietor will be together entitled to 20 company audits on his account.

Conclusion:

(i) Therefore, ABC & Co. can hold appointment as an auditor of 40 more companies:

Total Number of Audits available to the Firm Number = 20*3 = 60 of Audits already taken by all the partners

In their individual capacity = 4+6+10 = 20

Remaining number of Audits available to the Firm = 40

(ii) With reference to above provisions an auditor can hold more appointment as auditor = ceiling limit as per section 141(3)(g)- already holding appointments as an auditor. Hence (1)Mr. A can hold: 20 - 4 = 16 more audits. (2) Mr. B can hold 20-6 = 14 more audits and (3) Mr. C can hold 20-10 = 10 more audits.

(iii) In view of above discussed provisions, ABC & Co. can hold appointment as an auditor in all the 60 private companies having paid-up share capital less than Rs. 100 crore, 2 small companies and 1 dormant company as these are excluded from the ceiling limit of company audits given under section 141(3)(g) of the Companies Act, 2013.

(iv) As per fact of the case, ABC & Co. is already having 20 company audits and they can also accept 40 more company audits. In addition they can also conduct the audit of one person companies, small companies, dormant companies and private companies having paid up share capital less than Rs. 100 crores. In the given case, out of the 60 private companies, ABC & Co. is offered 45 companies having paid-up share capital of Rs. 110 crore each.

Therefore, ABC & Co. can also accept the appointment as an auditor for 2 small companies, 1 dormant company, 15 private companies having paid-up share capital less than Rs. 100 crore and 40 private companies having paid-up share capital of Rs. 110 crore each in addition to above 20 company audits already holding.

2.4 Remuneration of the Auditors

As per section 142 of the Act, the remuneration of the auditor of a company shall be fixed in its general meeting or in such manner as may be determined therein. However, board may fix remuneration of the first auditor appointed by it.

Further, the remuneration, in addition to the fee payable to an auditor, include the expenses, if any, incurred by the auditor in connection with the audit of the company and any facility extended to him but does not include any remuneration paid to him for any other service rendered by him at the request of the company. Therefore, it has been clarified that the remuneration to Auditor shall also include any facility provided to him.

According to Section 142(1), the remuneration of the auditor of a company shall be fixed in its general meeting or in such manner as may be determined therein, provided that the Board may fix remuneration of the first auditor appointed by it.

According to Section 142(2), the remuneration under Subsection (1) shall, in addition to the fee payable to an auditor, include the expenses, if any, incurred by the auditor in connection with the audit of the company and any facility extended to him but does not include any remuneration paid to him for any other service rendered by him at the request of the company.

2.5 Eligibility, Qualifications and Disqualifications of an Auditor

The provisions relating to eligibility, qualifications and disqualifications of an auditor are governed by section 141 of the Companies Act, 2013 (hereinafter referred as the Act). The main provisions are stated below:

(1) A person shall be eligible for appointment as an auditor of a company only if he is a chartered accountant. It may be noted that a firm whereof majority of partners practicing in India are qualified for appointment as aforesaid may be appointed by its firm name to be auditor of a company.

(2) Where a firm including a limited liability partnership is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm.

(3) Under sub-section (3) of section 141 along with Rule 10 of the Companies (Audit and Auditors) Rules, 2014 (hereinafter referred as CAAR), the following persons shall not be eligible for appointment as an auditor of a company, namely-

(a) a body corporate other than a limited liability partnership registered under the Limited Liability Partnership Act, 2008;

(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, or his relative or partner -

(i) is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company; It may be noted that the relative may hold security or interest in the company of face value not exceeding Rs. 1,00,000.

It may also be noted that the condition of Rs. 1,00,000 shall, wherever relevant, be also applicable in the case of a company not having share capital or other securities.

Students may also note that in the event of acquiring any security or interest by a relative, above the threshold prescribed, the corrective action to maintain the limits as specified above shall be taken by the auditor within 60 days of such acquisition or interest.

Did You Know?

State whether the following statement is "True" or "False"

The first auditor of a Government company was appointed by the Board in its meeting after 10 days from the date of registration:

- True
- False

Correct answer: False

The following points merit consideration in this regard:

(i) The value of shares of Rs. 1,00,000 that can be hold by relative is the face value not the market value.

(ii) The limit of Rs. 1,00,000 would be applicable where the securities are held by the relative of an auditor and not where the securities are held by an auditor himself or his partner. In case of an auditor or his partner, securities of even small value shall be a disqualification.

(iii) Grace period of 60 days for corrective action shall apply only in respect of securities held by relatives. This would not apply to auditor or his partner.

[The term "relative", as defined under the Companies Act, 2013, means anyone who is related to another as members of a Hindu Undivided Family; husband and wife; Father (including step-father), Mother (including step-mother), Son (including step- son), Son's wife, Daughter, Daughter's husband, Brother (including step- brother), Sister (including step-sister).]

Example:

Ex 1: Mr. A, a practicing Chartered Accountant, is holding securities of XYZ Ltd. having face value of Rs. 900. Whether Mr. A is qualified for appointment as an auditor of XYZ Ltd.?

As per section 141(3)(d)(i), an auditor is disqualified to be appointed as an auditor if he, or his relative or partner holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company.

In the present case, Mr. A is holding security of Rs. 900 in XYZ Ltd. Therefore, he is not eligible for appointment as an auditor of XYZ Ltd.

(ii) is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of Rs. 5,00,000; or

(iii) has given a guarantee or provided any security in connection with the indebtedness of any third person to the Company or its Subsidiary, or its Holding or Associate Company or a Subsidiary of such Holding Company, in excess of Rs. 1,00,000.

(e) a person or a firm who, whether directly or indirectly has business relationship with the Company, or its Subsidiary, or its Holding or Associate Company or Subsidiary of such holding company or associate company, of such nature as may be prescribed;

(f) a person whose relative is a Director or is in the employment of the Company as a director or key Managerial Personnel.

(g) a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than Rs. 100 crore.

(h) a person who has been convicted by a Court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction.

(i) a person who, directly or indirectly, renders any service referred to in section 144 to the company or its holding company or its subsidiary company.

It may be noted that, for the purposes of this clause, the term "directly or indirectly" shall have the same meaning as assigned to it in the Explanation to section 144, i.e.

In case of auditor being an individual, either himself or through his relative or any other person connected or associated with such individual or through any other entity, whatsoever, in which such individual has significant influence or control, or whose name or trade mark or brand is used by such individual, shall be termed as rendering of services directly or indirectly by the auditor; and

In case of auditor being a firm, either itself or through any of its partners or through its parent, subsidiary or associate entity or through any other entity, whatsoever,

in which the firm or any partner of the firm has significant influence or control, or whose name or trade mark or brand is used by the firm or any of its partners, shall be termed as rendering of services directly or indirectly by the auditor.

Section 144 of the Companies Act, 2013 prescribes certain services not to be rendered by the auditor. An auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case may be, but which shall not include any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company), namely:

(i) accounting and book keeping services;

(ii) internal audit;

(iii) design and implementation of any financial information system;

(iv) actuarial services;

(v) investment advisory services;

(vi) investment banking services;

(vii) rendering of outsourced financial services;

(viii) management services; and

(ix) any other kind of services as may be prescribed.

It may be noted that an auditor or audit firm who or which has been performing any non- audit services on or before the commencement of this Act shall comply with the provisions of this section before the closure of the first financial year after the date of such commencement.

Example:

CA. Poshin is providing the services of investment banking to C Ltd. Later on, he was also offered to be appointed as an auditor of the company for the current financial year. Advise.

Section 141(3)(i) of the Companies Act, 2013 disqualifies a person for appointment as an auditor of a company who, directly or indirectly, renders any service referred to in section 144 to the company or its holding company or its subsidiary company. Section 144 of the Companies Act, 2013 prescribes certain services not to be rendered by the auditor which includes investment banking services.

Therefore, CA. Poshin is advised not to accept the assignment of auditing as the investment banking service is specifically notified in the list of services not to be rendered by him as per section 141(3)(i) read with section 144 of the Companies Act, 2013.

(4) Where a person appointed as an auditor of a company incurs any of the disqualifications mentioned in sub-section (3) after his appointment, he shall vacate his office as such auditor and such vacation shall be deemed to be a casual vacancy in the office of the auditor.

Case Study

Facts of the Case: Mr. A, a chartered accountant, has been appointed as an auditor of Laxman Ltd. in the Annual General Meeting of the company held in September, 2016, which assignment he accepted. Subsequently in January, 2017 he joined Mr. B, another chartered accountant, who is the Manager Finance of Laxman Ltd., as partner.

Provisions and Explanation: Section 141(3)(c) of the Companies Act, 2013 prescribes that any person who is a partner or in employment of an officer or employee of the company will be disqualified to act as an auditor of a company. Sub-section (4) of Section 141 provides that an auditor who becomes subject, after his appointment, to any of the disqualifications specified in sub-sections (3) of Section 141, he shall be deemed to have vacated his office as an auditor.

Conclusion: In the present case, Mr. A, an auditor of Laxman Ltd., joined as partner with Mr. B, who is Manager Finance of Laxman Limited. The given situation has attracted sub-section (3)(c) of Section 141 and, therefore, he shall be deemed to have vacated office of the auditor of Laxman Limited in accordance with sub-section (4) of section 141**.**

2.6 Rights of a Company Auditor

An auditor of a company is required to report on the truth and fairness of the financial statement of the company. To perform his duties effectively, he requires some rights and powers. In case of sole proprietor or partnership firm, the rights and duties of an auditor are determined by the agreement entered into by him with the sole proprietor or the partnership firm as the case may be. But the Companies Act, 2013, has specifically laid down the rights and duties of a statutory auditor of a joint stock company. These rights and duties are absolute and cannot be curtailed in any way. Any resolution or provision in the Articles in this regard will be null and void. It was held in the case of Newton vs Birmingham Small Arms Co. Ltd. (1906) that any resolution precluding the auditor from any information to which he is entitled to as per Companies Act is inconsistent with the Act.

The Companies Act provides the following rights to the auditor to enable him to discharge his duties properly:

1. Right of access to books and vouchers: Section 143(1) of the Companies Act, 2013 provides that the auditor of a company shall have the right of access, at all times, to the books and vouchers of the company whether kept at the head office or elsewhere. This right of the auditor is the fundamental basis on which the auditor can proceed to examine and inspect the records of the company for the purpose of making his report.

2. Right to obtain information and explanations: Section 143(1) also entitles the auditor to require from the officer of the company such information and explanations as the auditor may think necessary for the performance of his duties.

3. Right to visit branch offices and access to branch accounts: Section 143(8) of the Companies Act gives specific rights to the company auditor, where the accounts of any branch office are audited by another person. The company auditor has the right to visit branch office, if he deems it necessary to do so for the performance of his duties and has the right of access to books and accounts along with vouchers maintained by the branch office.

4. Right to receive branch audit reports: Section 143(8) of the Companies Act also provides that the company auditor has also the right to receive the audit report from the branch auditor for his consideration and deal with it in such a way, as he considers necessary while preparing his audit report on the accounts of the company.

5. Right to receive notices and to attend general meeting: Section 146 of the Companies Act entitles the auditors of a company to attend any general meeting of the company and to be heard on any part of the business, which concerns him as the auditor. He is also entitled to receive all notices and communications relating to any general meeting of the company.

6. Right to make representation: Pursuant to Section 140, the retiring auditor is entitled to receive a copy of the special notice intending to remove him or proposing to appoint any other person as auditor in his place. The retiring auditor sought to be removed has a right to make his representation in writing and request that the same be circulated amongst the members of the company. In case, the same could not be circulated, the auditor may require that the representation shall be read out at the general meeting.

7. Right to sign audit report: According to Section 145 of the Companies Act, only the person appointed as auditor of the company, or where a firm is so appointed only a partner in the firm practicing in India, may sign the auditor's report.

8. Right to seek legal and technical advice: The auditor of a company is entitled to take legal and technical advice, which may be required in the performance of conduct of audit or discharge of his duties. [London and General Bank Case]

9. Right to be indemnified: For different purposes, an auditor is considered to be an officer of the company. As an officer, he has the right to be indemnified out of assets of the company against any liability incurred by him in defending himself against any civil or criminal proceedings by the company, if he is not held guilty by the law.

10. Right to receive remuneration: On completion of his work, an auditor is entitled to receive his remuneration. The rights of the auditor cannot be limited by any resolution of the members passed in the general meeting

2.7 Duties of a Company Auditor

The duties of a company auditor can be described by classifying it in the following categories—

(a) Statutory duties:

1. Duty to report: According to Section 143(1) of the Companies Act, 2013, it is the duty of the company auditor to make a report to the members of the company on the accounts examined by him and on balance sheet and profit and loss account laid before the company in its general meeting.

2. Duty to enquire: Section 143(1) of the Companies Act also specifies six matters, which are required to be looked into by a company auditor. The statement on Qualifications in the Auditor's Report issued by the ICAI clarifies that the auditor is not required to report on the matters specified, unless he has any special comments to make on any of the items referred to therein.

3. Duty to comply with the Auditing Standards: According to Section 143(9), every auditor has to comply with the auditing standards. The Central Government may prescribe the standards on auditing as recommended by the ICAI in consultation with and after examination of the recommendations made by the National Financial Reporting Authority.

4. Duty to follow CARO: Under Section 143(11) of the Companies Act, the Central Government has the power to direct by a general or special order that in the case of specified companies, the auditor's report shall include a statement on such matters as may be specified in its order. In accordance with the provision, the Central Government issued revised order in 2003, namely Companies (Auditor's Report) Order. The auditor has the duty to follow the order.

5. Other duties under the Companies Act: The auditor has the following other duties under the Companies Act—

(i) Duty of the auditor or a partner of a firm of chartered accountants practising in India to sign audit report (Section 145).

(ii) Duty of the auditor to report on prospectus on the accounting part (Section 26).

(iii) Duty to assist the inspector appointed by the Central Government to investigate the affairs of the company (Section 217).

(iv) Duty to report on profit and loss account for the period from the last closing date to the date of declaration of insolvency by the directors and also on balance sheet (Section 305).

(b) Contractual duties:

A professional accountant may be hired by a company for purposes other than the statutory audit. In all such cases, the duty of the auditor will depend upon the terms and conditions of his appointment.

(c) Duty to have reasonable care and skill:

An auditor of a company must be honest and must exercise reasonable care and skill to perform his audit work; otherwise, he may be sued for damages. It was observed in Kingston Cotton Mills Case (1896) that the auditor should perform his audit work with such care, skill and caution that is reasonably competent, careful and cautious auditor will use.

(d) Duty of an auditor regarding mandatory accounting standards:

According to the decision of the Council of the ICAI, it has been resolved that while discharging their functions, it is the duty of the members of the Institute, to ensure that the mandatory accounting standards are followed in the presentation of the financial statements covered by their audit report. In the event of any deviation from the standards, it is also be the duty of the auditor to make adequate disclosure in their reports so that the users of such statements may be aware of such deviations.

Section 143(2) of the Companies Act also states that the auditor’s report shall state whether the company’s balance sheet and profit and loss account comply with the Accounting Standards referred to in Section 133.

(e) Duty to the profession itself:

Every profession has its own code of conduct and professional ethics. The ICAI has also issued the required code of conduct and professional ethics, which has to be maintained by the members of the ICAI. So, it is the duty of the company auditor to follow code of conduct and his professional ethics.

2.8 Liabilities of a Company Auditor

The auditor holds a position of great responsibility and has to perform certain duties, statutory or otherwise, assigned to him. In performing his duties, he has to exercise reasonable care and skill. His client expects him to follow the generally accepted auditing standards and he may be held liable in case he does not act with reasonable care and skill required from him in a particular situation.

The liabilities of an auditor can be described by classifying them under the following categories in Fig. 1.

I. Liabilities on the basis of legal implications

On the basis of legal implication, liabilities may be divided into three categories, namely:

1. Liabilities under the Companies Act:

Under the Companies Act, the liability of an auditor may arise in the following cases:

(a) Misappropriation and retention of client’s money: If an auditor has misapplied or retained or become liable or accountable for any money or property of the company, or has been guilty of any misfeasance or breach of trust in relation to the company, the court may compel him to repay or to restore the money or property of or any part thereof with interest at certain rate or to contribute such sum to the assets of the company by way of compensation (Section 340).

(b) Misstatements in the prospectus: He shall be liable with regard to misstatements in the prospectus of the company under Section 35. The auditor is liable to pay compensation to every person who subscribes for any shares or debentures on the faith of the prospectus issued by the company for any loss or damage he may have sustained.

(c) False statement in returns, reports, etc.: He shall be liable if he makes a false statement with material particulars in returns, reports or other statements knowing it to be false or omits any material fact knowing it to be material (Section 448).

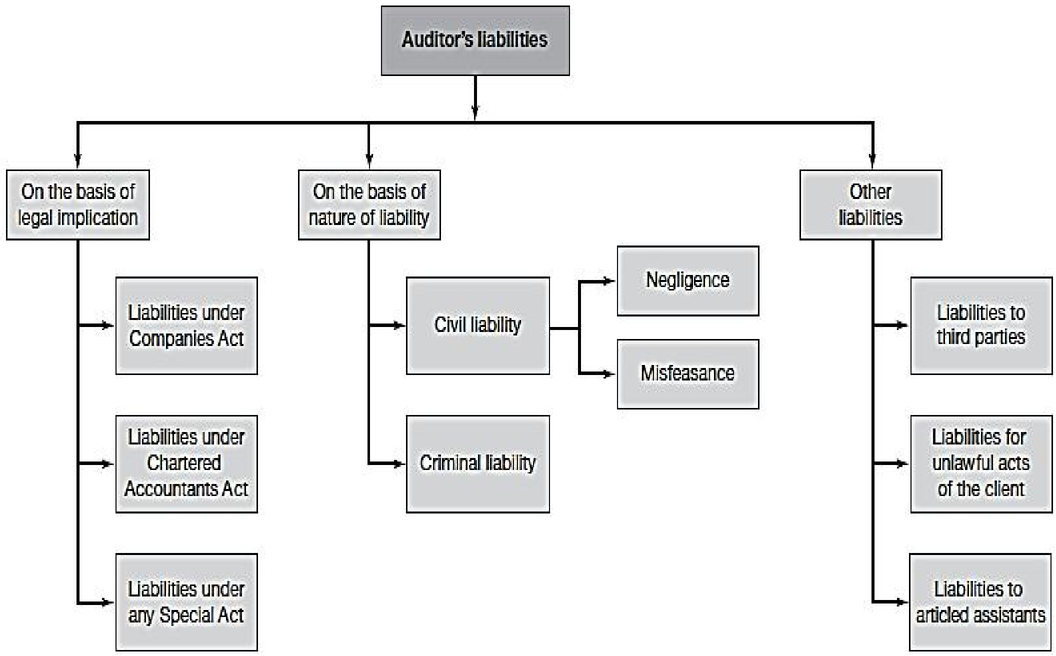
(d) Intentional false evidence: He shall be liable if he gives false evidence intentionally upon any examination upon oath or solemn affirmations, authorized under this Act or in any affidavit, deposition or solemn affirmations, in or about the winding-up of any company under this Act (Section 449).

(e) Liability for delinquency: The liquidators may prosecute an auditor as an officer of the company during the course of winding-up of the company for delinquency (Section 342).

(f) Wilful default in report making: He will be held liable if he wilfully makes a default in making his report to the shareholders according to the provisions of Sections 143 and 145 (Section 233).

(g) Destruction, alteration of books, etc.: If he is found guilty of destruction, mutilation, alteration, falsification or secreting of any books, papers or securities or if he makes any false or fraudulent entry in any register, books of accounts or documents of the company, he may be held liable (Section 336).

(h) Authorizing false statement in the prospectus: If he authorizes the issue of the prospectus ofa company containing a false and untrue statement, he will be held liable (Section 34).



(i) Party to the issue of prospectus: He may be held liable if he is party to the issue of prospectusincluding statement purporting to be made by him as an expert, unless he is not interested in theformation or promotion or in the management of the company (Sections 26, 73 and 74).

(j) Inducing fraudulently to invest money: He will be liable if he induces a person fraudulently toinvest money by knowingly or recklessly making a statement or promise which is false or misleading,or if he dishonestly conceals the material fact (Section 36).

2. Liabilities under the Chartered Accountants Act: Liability of Chartered Accountant, acting as anauditor, may be in the form of disciplinary proceedings under the Chartered Accountants Act, 1949. Itmay arise on account of professional misconduct on the part of the auditor.

There are separate provisions for professional misconduct in relation to (a) chartered accountants inpractice (b) members of the Institute in service and (c) members of the Institute in general.

The Council, under Section 21, refers the case of professional misconduct on the part of the membersto the Disciplinary Committee. The latter holds the enquiry and reports its findings to the Council. Incase the Council finds, on the basis on its report that the member is guilty of professional misconduct, itgives chance to the member to explain his conduct. On the basis of hearing, the Council takes necessarydecisions.

3. Liabilities under any Special Act: In addition to the Companies Act and the Chartered AccountantsAct, the auditor is also held liable under different special Acts, which are stated below:

(a) Under Banking Companies Regulation Act, 1940:

(i) Under Section 46 of the Banking Companies Act, 1940, if an auditor in any return, balance sheetor other document, wilfully makes a statement, which is false in any material particular, knowingit to be false, or wilfully omits to make a material statement, he will be held responsible.

(ii) Under Section 45G of the Banking Companies Act, 1940, an auditor of a banking companymay be publicly examined in the winding-up proceedings. On such examination, the HighCourt may make an order, if he is not found fit to act as an auditor, that he will not act asauditor of any company for such period not exceeding 5 years as may be specified in the order.

(b) Under the Life Insurance Corporation Act: Under Section 104 of the Life Insurance CorporationAct, 1956, an auditor may be sentenced to imprisonment or fine, or both, if he gives a falsestatement knowingly in any return, report or other such forms to be issued under the Act.

(c) Under the Indian Penal Code: Under Section 197 of the Indian Penal Code, if any personincluding auditor issues or signs a certificate required by law to be given or signed or relating toany fact of which such certificate is by law admissible in evidence, knowing or believing that suchcertificate is false in any material point, he shall be punishable in the same manner as if he gavefalse evidence.

(d) Under the Income Tax Act: Under Section 278 of the Income Tax Act, 1961, if any personincluding an auditor abets or induces in any manner another person to make and deliver an account,statement or declaration relating to any income chargeable to tax which is false and which he eitherknows to be false or does not believe to be true, he shall be punishable.

II. Liabilities on the basis of nature of liability

On the basis of nature of liability, it can be divided into two groups—

1. Civil liability: The civil liability of an auditor can be for (a) negligence or (b) misfeasance. In thesecases, he may be called upon to pay damages as decided by the court.

(a) Liability for negligence: An auditor is appointed to perform certain duties. To the extent of hisduties as an auditor, he acts as an agent of his client. In this capacity, he must exercise reasonable careand skill to perform his duties for which he is employed. If he acts negligently on account of whichthe client has to suffer loss, the auditor may be held liable and may be called upon to make good thedamages, which the client suffered due to his negligence.

It should be noted that if an auditor fails to discover frauds, he might not be failing in his duty. Infact, fraud and other irregularities may not be disclosed by an annual audit and even a detailed auditmay not discover certain types of fraud. Under such circumstances, whether the auditor will be heldresponsible that depends on the fact that whether the auditor should have been able to discover thatfraud if he applies reasonable care and skill. If he could, he will be held responsible, otherwise not.

(b) Liability for misfeasance: The term 'misfeasance' implies breach of trust or breach of duty. Anauditor has to perform certain duties, which may arise out of a contract with the client as in the case

of sole proprietor or partnership or it may be statutory as laid down under various statutes. The dutiesof a company auditor have been statutorily laid down in the Companies Act, 2013. If the auditor doesnot perform his duties properly and as a result his client suffers, he may be held liable for misfeasance.

It should be noted that according to Section 340 of the Companies Act, 2013, the court mightassess damages against delinquent director or other officers of the company, including an auditor formisfeasance or breach of trust. In the case of an auditor, who also comes within the definition ofofficer in Section 2(59) for the purpose of this section, if he is guilty of neglect of duty or misfeasance,so as to cause loss to the company in any way, proceedings may be taken under this sectionagainst him either independently or other officers or jointly with them.

2. Criminal liability: An auditor of a company can be held guilty of criminal offences, if he wilfullymakes a false statement in any report, return, certificate or balance sheet.

Under Section 448 of the Companies Act, 2013, 'if an auditor in any report, certificate, balance sheet,prospectus, statement or other document required by or for the purpose of any of this Act, makes astatement (a) which is false in any material particular, knowing it to be false or (b) omits any materialfact, knowing it to be material, he will be held liable on criminal offence'.

Again, Section 197 of the Indian Penal Code provides that whoever issues or signs any certificaterequired by law to be given or signed or relating to any fact which such certificate is by law admissiblein evidence, knowing or believing that such certificate is false in any material point, shall be punishablein the same manner as he gave false evidence.

III. Other liabilities

The other liabilities of an auditor may include the following:

1. Liability to third parties: There are several persons who completely rely upon the financial statementsaudited by the auditor and enter into transactions with the company without any further enquiry.

These parties may include creditors, the bankers, the tax authorities, the prospective investors, etc.In general, the auditor is not liable to third parties since no contractual obligation exists between theauditor and the third parties. Since they do not appoint him, he owes no duty to them and hence there isno question of any liability to them. He cannot be held liable unless he owes any duty to the persons,who hold him liable for damages caused.The third parties, however, can hold him liable, if there has been any fraud on the part of the auditor.

Even if there is no contractual obligation between the auditor and the third parties, the latter can sue theauditor if the report of the auditor is of such a nature as amounts to fraud.

2. Liability for unlawful act of the client: An auditor may obtain knowledge about the unlawful actsor defaults committed by his client during the course of his audit. The question arises whether he shouldform the proper authorities about it and whether he can be held liable if he does not do so. It is a difficultquestion indeed since it involves breach of confidence placed on him by his client.

Under such circumstances, he must act very carefully. He must not act in such a way, which unnecessarilyinjures the confidence of his client on him. If required, he should terminate his association withthe client rather than open himself to such liability.

3. Liability to article assistants: The auditor may be held liable to his article assistants in thefollowingcircumstances:

(i) If he does not act honestly with his article assistants.

(ii) If he removes any of his article assistants without any prior notice.

(iii) If he does not pay the required amount of monthly stipend to the article assistants.

(iv) If he gives a false certificate of payment of stipend to his article assistants.

The auditor, however, cannot be held liable to his article assistants to pay compensation to them in case theirservices are terminated by the auditor. The question of payment of compensation to a retrenched or dismissedworker arises under the Industrial Dispute Act, 1956 only, which is not applicable to article assistants.

Summary

- As in case of a company, the ownership is separated from the management, it becomes essential for a company to appointment an independent and qualified auditor to verify and certify the truth and fairness of the financial statements.
- The provisions regarding the appointment of the auditors are contained in Section 139 of the Companies Act. The first auditors are usually appointed by the Board of Directors and subsequent auditors are appointed by the shareholders in the annual general meeting for a period of 5 or 10 years depending on the nature of the audit firm. In some cases, auditors are appointed by the central government or by passing a special resolution.
- Usually a retiring auditor shall be automatically reappointed by passing an ordinary resolution. An individual auditor cannot be the auditor of more than 20 companies at a time. The remuneration of the auditors is fixed by the appointing authority.
- The auditor of a company must be a practicing chartered accountant.

- An appointed auditor may be removed from his office either in accordance with the provisions of the Companies Act or as per restrictions imposed by the Chartered Accountants Act.
- The auditor of a company can be considered a servant of the company, an agent of the shareholders as well as an officer of the company.
- Rights of the company auditor include right of access to books and vouchers, right to obtain information and explanations, right to visit branch offices and to receive branch audit report, right to receive notices to attend general meeting, right to sign audit report and right to receive remuneration.

Keywords

- Casual Vacancy
- First Auditor
- Subsequent Auditors
- Company Auditors
- Chartered Accountant

Self Assessment

1. What is the primary objective of an audit of financial statements of a company in India?

A. To detect all instances of fraud and errors in the financial statements
B. To express an opinion on whether the financial statements are free from material misstatements
C. To ensure that the company complies with all applicable laws and regulations
D. To identify areas of weakness in the company's internal controls

2. Which of the following is not a type of audit in India?

A. Statutory audit
B. Internal audit
C. Tax audit
D. Financial planning audit

3. Who is responsible for appointing the statutory auditor of a company in India?

A. The managing director of the company
B. The board of directors of the company
C. The Registrar of Companies
D. The Securities and Exchange Board of India

4. What is the maximum number of years for which an auditor can be appointed by a company in India?

A. 3 years
B. 5 years
C. 7 years
D. 10 years

5. Which of the following is a mandatory requirement for an individual to be appointed as an auditor of a company in India?

A. The individual must be a Chartered Accountant
B. The individual must be a Certified Public Accountant
C. The individual must hold a Master's degree in Commerce
D. The individual must have at least 5 years of experience in auditing

6. Which of the following is not a component of the audit risk model?

A. Inherent risk
B. Control risk
C. Detection risk
D. Financial risk

7. What is the primary purpose of a management representation letter in an audit of a company in India?

A. To identify any instances of fraud or errors in the financial statements
B. To confirm that all significant transactions have been properly recorded in the financial statements
C. To provide the auditor with access to all relevant documents and records
D. To confirm that the auditor has complied with all applicable auditing standards

8. Which of the following is not a requirement of the Companies Act, 2013 with respect to the audit of a company in India?

A. The audit report must state whether the company has adequate internal financial controls
B. The auditor must report on any instances of fraud or violations of laws and regulations
C. The auditor must disclose any instances of conflicts of interest
D. The audit report must include the auditor's opinion on the company's future prospects

9. Which of the following is not a type of audit in India?

A. Statutory audit
B. Internal audit
C. Tax audit
D. Financial planning audit

10. Who is responsible for appointing the statutory auditor of a company in India?

A. The managing director of the company
B. The board of directors of the company
C. The Registrar of Companies
D. The Securities and Exchange Board of India

11. Which of the following is a mandatory requirement for an individual to be appointed as an auditor of a company in India?

A. The individual must be a Chartered Accountant
B. The individual must be a Certified Public Accountant
C. The individual must hold a Master's degree in Commerce
D. The individual must have at least 5 years of experience in auditing

12. Which of the following is not a component of the audit risk model?

A. Inherent risk
B. Control risk
C. Detection risk
D. Financial risk

13. What is the primary purpose of a management representation letter in an audit of a company in India?

A. To identify any instances of fraud or errors in the financial statements
B. To confirm that all significant transactions have been properly recorded in the financial statements
C. To provide the auditor with access to all relevant documents and records
D. To confirm that the auditor has complied with all applicable auditing standards

14. Which of the following is not a requirement of the Companies Act, 2013 with respect to the audit of a company in India?

A. The audit report must state whether the company has adequate internal financial controls
B. The auditor must report on any instances of fraud or violations of laws and regulations
C. The auditor must disclose any instances of conflicts of interest
D. The audit report must include the auditor's opinion on the company's future prospects

15. What is the primary objective of an internal audit function in a company in India?

A. To detect all instances of fraud and errors in the financial statements
B. To provide assurance to the management on the effectiveness of the company's internal controls
C. To ensure that the company complies with all applicable laws and regulations
D. To identify areas of weakness in the company's external environment

Answer for Self Assessment

1.	B	2.	D	3.	B	4.	D	5.	A
6.	D	7.	B	8.	D	9.	D	10.	B
11.	A	12.	D	13.	B	14.	D	15.	B

Review Questions

1. Explain in brief the legal provisions as well as the Schedule III requirements regarding auditors’

remuneration.

2. How are the first auditors of a limited company appointed?

3. Describe the qualifications of an auditor according to the Chartered Accountants Act, 1949.

4. State the circumstances when a person will be disqualified for being appointed as a company auditor.

5. How is the auditor of a government company appointed?

6. Discuss the auditors' liability to third party.

7. What are the points to which you would direct your attention, while accepting an appointment as an auditor of a company? State under what circumstances, an appointed auditor can be removed from his office.

8. 'Under the Companies Act, an auditor may be held liable both for negligence and misfeasance'. Do you agree? Give reasons for your answer.

Further Readings

- Auditing: Principles And Techniques By S. K. Basu, Pearsonn.S.
- A Hand Book Of Practical Auditing By B N Tandon, S Sudharsnam& S Sundharabahu, S Chand Publishing
- Auditing And Corporate Governance By Anil Kumar Jyotsna Rajan Arora Lovleen Gupta, Taxmann Publisher

Web Links

https://corporatefinanceinstitute.com/resources/accounting/legal-liability-of-auditors/#:~:text=The%20auditor%20has%20a%20duty,for%20mere%20errors%20in%20judgment

https://www.indeed.com/career-advice/career-development/audit-definition

https://www.investopedia.com/terms/a/audit.asp

https://www.managementstudyguide.com/what-is-auditing-its-types-and-purposes.htm

Unit 03: Audit Planning

CONTENTS

Objectives

After studying this unit, you will be able to:

- To have practical knowledge regarding Audit Planning and preparation of audit notebook.
- To have the knowledge of preparation and usage of Audit programme, working papers, audit files and audit manual.
- To have the concept clarity of analyses of audit procedure.
- Recognizing, how to delegate, supervise and control the quality and risk of the auditing work.

Introduction

Before the auditor can determine his basic approach to an audit, he must ensure that he fully understands the enterprise with which he is dealing. He must familiarize himself with its organizations and must visit the location at which it operates. He will comprehend the nature of the business and have a detailed knowledge of its products or services. He must ensure that he has fully grasped the technicalities peculiar to the business. Only then he will be in a position to comprehend and identify the transactions which are being recorded in the accounting records, and in relation to which the internal controls will be operating.

The auditor should take the appropriate audit procedure and adopt different techniques of auditing by following the principles of auditing in conducting audit of an organization in order:
(a) To ascertain and record the accounting system and internal controls, assess the adequacy of the accounting system and evaluate the controls on which the auditor wishes to place reliance.
(b) To test the accounting records, and perform compliance tests on the operation of those internal controls on which the auditor wishes to place reliance.
(c) To compare the financial statements with the accounting records and perform substantive tests to see that they are in agreement.
(d) To carry out a review of the financial statements.
(e) To report on the financial statements as required by the terms of auditor's appointment, and in compliance with any relevant statutory obligation.
On the basis of his assessment of the accounting system and evaluation of the internal controls, the auditor will propose an audit programme specifically designed for that particular audit. The auditor's task for the conduct of an audit of financial statements of an entity is a complete process, which starts with the receiving of the appointment letter from the client entity and ends with the submission of the audit report on the financial statement by the auditor. On the basis of the analytical procedures adopted and sufficient qualitative audit evidence collected, the auditor will have to arrange the instruments for the audit which, in turn will help the completion of the audit procedures after applying the effective and correct audit techniques. Therefore, it is evident that an auditor will require audit instrument for the completion of audit procedures with the help of different audit techniques.

3.1 Preparatory Steps Before Commencement of a New Audit

Effective execution of any audit work requires appropriate planning and well-designed audit programme. For effective audit planning and designing appropriate audit programme, the auditor should prepare himself before the commencement of his audit work. For this purpose, the auditor should take the following steps:

(1) Receiving appointment letter: The auditor is usually appointed by the shareholders in the annual general meeting and shall hold office till the conclusion of the next annual general meeting. The auditor should receive the appointment letter before starting his audit work as he has to conduct his audit work on the basis of terms of references as given in the appointment letter.

(2) Communication with the existing auditor*:* Before accepting the work of a new audit, in the case of a continuing business, it is established professional etiquette for the proposed auditor to communicate with the previous auditor to see whether he has any objections to raise. This is also an official requirement as per the Chartered Accountants Act, 1949 (as amended in 2006), and has to be adhered to by the practicing-chartered accountants.

(3) Acceptance of appointment: If the auditor is satisfied with the reasons for not appointing the previous auditor, he can then accept the appointment. The auditor should confirm his acceptance to the concerned organization through a letter of acceptance.

(4) Ascertaining the scope of audit*:* After accepting his appointment, he should ascertain the precise nature and scope of his audit work. In case of statutory audit, the scope and the nature of audit work can be ascertained by referring to the statute. In case of other types of audit, the auditor should discuss with the client about his area of auditing work.

(5) Knowledge about the organization*:* Before the auditor can determine his basic approach to an audit, he must ensure that he fully understood the enterprise. He must comprehend the nature of the business and have a detailed knowledge of its activities. He must familiarize himself with the organization and visit the location at which it operates. This will enable him to understand the nature of transactions, which are recorded in the books of accounts.

(6) Knowledge of the accounting system*:* The auditor should obtain a list of all books maintained by the organization for recording its accounting transactions along with the information relating to the existing accounting system. He should also acquire full information about the internal control system of the organization. In fact, the extent of his work is greatly influenced by the reliability of internal control system and appropriateness of accounting system adopted.

(7) Complete list of principal officers*:* The auditor should also obtain a list of the principal officers of the organization. He should also acquire knowledge about the area and extent of authority of each one of them. This will help the auditor to have appropriate clarification from the concerned officer.

(8) Knowledge of technical details: The auditor must ensure himself that he has fully grasped the required technicalities peculiar to the business. Only then he will be in a position to identify the transactions of the accounting records and to relate the accounting system with the internal control system adopted.

(9) Observation of the previous auditor's report*:* The auditor should go through the previous auditor's report as well as the final accounts of the previous year. This will help him to understand the nature of accounts, important areas for which detailed checking are required and the techniques to be used to conduct his audit work effectively.

(10) Instructions to the client*:* After completing the abovementioned steps, the auditor should issue clear instructions to his client that the accounts should be finalized and kept ready for audit and the necessary schedules required to support the final accounts be prepared and made available to the auditor.

3.2 Preparation by the Auditor

Modern techniques require a new approach to the practical aspects of the auditor's work. Detailed checking and vouching no longer constitute the main aspect of the operations involved; the ascertainment of the internal control system, the investigation of its working and the verification of assets and liabilities in order to ensure the presentation of the true and fair view, now prevail. The attitude that an audit was mainly useful for the discovery or prevention of fraud is no longer accepted. It is now more generally appreciated that an audit ensures not only the true and fair presentation of the affairs of the organization, but also that it can be of real benefit in bringing about the institution and maintenance of efficient business methods

So, in order to conduct the work of audit smoothly and efficiently, at present, the auditor should prepare himself for the following audit instruments:

A. audit Planning
B. audit Programme
C. audit note book
D. audit working Papers
E. audit files
F. audit manual
G. audit memorandum

3.3 Audit Planning

1. Concept

Audit planning is necessary for efficient and effective conduct of an audit. It should be continuously followed throughout the course of audit assignment. According to SA-300 (Planning an audit of financial statement), plans should be made to cover, among other things:

(a) Acquiring knowledge of the client's accounting systems, policies and internal control procedures;

(b) Establishing the expected degree of reliance to be placed on internal control;

(c) Determining and programming the nature, timing and extent of the audit procedures to be performed; and

(d) Coordinating the work to be performed.

2. Objectives

The main objectives of audit planning are—

1. to ensure that the auditing work is conducted efficiently and profitably, and

2. to ensure that high standards of audit work are maintained, so that the risk of litigation against the practice for negligence is minimized.

It is important that audit should be carefully planned to ensure that the correct number of staff of the appropriate level of seniority are available when they are required. In addition to that, in case of large audits, the work must be planned so that as much as possible is done on an interim basis during the year. This has the double advantage of employing staff effectively throughout the year and ensuring that the only audit work that is left to the year end is worked that cannot be performed earlier. To enable this planning to be carried out efficiently, the auditor will need to liaison with the chief financial officer/accountant of the organization and ensure that the audit firm is fully aware of the exact proposed timing of the client's own accounting procedures.

3. Factors to be considered while planning

In the light of the expected scope of the assignment, the auditor should prepare his audit plan after taking into consideration the following factors:

1. The statutory requirement under the assignment
2. The terms and conditions of engagement
3. The nature of timings of reporting
4. The significant audit areas
5. The applicable legal provisions
6. Reliability of accounting and internal control system
7. The existing accounting practices followed
8. The areas requiring special attentions.

4. Advantages

As per Standard on Auditing 300 (SA-300), adequate audit planning helps to:

- ensure that appropriate attention is devoted to important areas of the audit;
- ensure that potential problems are promptly identified;
- ensure that the work is completed expeditiously;
- utilize the assistants properly; and
- co-ordinate the work done by other auditors and experts.

5. Continuity features of audit planning

As prescribed in SA-300, planning should be continuous throughout the engagement and involves:

- developing an overall plan for the expected scope and conduct of the audit; and
- developing an audit programme showing the nature, timing and extent of audit procedures.

Changes in conditions or unexpected results of audit procedures may cause revisions of the overall plan and of the audit programme. The reasons for significant changes may be documented.

3.4 Audit Programme

1. Concept and definition

Before starting an audit, a programme of work is usually drawn up. This is known as the 'Audit Programme'.It is a detailed plan of work, prepared by the auditor, for carrying out an audit. It is comprisedof a set of techniques and procedures, which the auditor plans to apply to the given audit for forming anopinion about the statement of account of an organization.

The auditor should prepare a written audit programme setting forth the procedures that are needed toimplement the audit plan. The programme may also contain the audit objectives for each area andshould have sufficient details to serve as a set of instructions to the assistants involved in the audit andas a means to control the proper execution of the work.

Professor Meigs defined audit programme as, 'a detailed plan of the auditing work to be performed,specifying the procedure to be followed in verification of each item in the financial statements andgiving the estimated time required.'

So, audit programme may be defined as a careful flexibly written layout of the work to be done bythe auditor and his staff in the conduct of an audit. The preparation of audit programme involves thefollowing considerations:

(a) Area or extent of work

(b) Allocation of work

(c) Time duration for the completion of the work

(d) Responsibility of the persons, who have been assigned the work for its timely completion.

2. Purposes of audit programme

There is no denying the fact that audit programme not only serves as the plan of action to be taken forthe completion of assigned audit work efficiently and effectively, but the progress of the audit work mayalso be ascertained by it. However, different purposes of audit programme are given below:

1. For the purpose of co-coordinating the procedures of audit.

2. For the purpose of ascertaining the progress of audit work.

3. For the purpose of recording the work done during the process of auditing. Such records can act as anevidence of work done.

4. For the purpose of assigning responsibilities to the audit staff for the completion of audit workwithin the time limit.

3. Types of audit programme

An audit programme can be of the following two types:

(a) Predetermined audit programme: In this audit programme, all the procedures of audit must beoutlined in general, even though all procedures may not be relevant in a particular type of audit. Thepurpose of this type of audit programme is to offer either procedural guideline or to serve as a 'check offlist. For this reason, this predetermined audit programme has been considered as 'Taylor made' auditprogramme.

(b) Progressive audit programme: The progressive form of audit programme is known as 'skeleton'form of audit programme. It sets forth briefly general scope, character and limitations of audit work.This type of programme is suitable in those cases where the condition of the business changes year afteryear.

4. Developing the audit programme

It is stated in SA-300 (Planning an audit of financial statement) issued by the ICAI, that—

(a) The auditor should prepare a written audit programme setting forth the procedures that are neededto implement the audit plan. The programme may also contain the audit objectives for each area andshould have sufficient details to serve as a set of instructions to the assistants involved in the auditand as a means to control the proper execution of the work.

(b) In preparing the audit programme, the auditor, having an understanding of the accounting systemand related internal controls, may wish to rely on certain internal controls in determining the nature,timing and extent of required auditing procedures. The auditor may conclude that relying on certaininternal controls is an effective and efficient way to conduct his audit.

5. Advantages of an audit programme

1. Assurance of completion of work: It ensures that all necessary work has been done and nothinghas been omitted.

2. Information about work progress: The auditor is in a position to know about the progress of thework done by his assistants.

3. Uniformity of work: A uniformity of the work can be attained, as the same programme will befollowed at subsequent audits.

4. Simplification of work allocation: It simplifies the allocation of works to various grades of articledand audit assistants.

5. Guidance to the staff: It is a kind of guidance to the audit assistant for the work he has toperform.

6. Defence against charge of negligence: The auditor can defend himself in case of a charge of negligenceon the basis of the audit programme.

7. Division of responsibility: Work of the audit can be divided amongst different juniors who will beheld responsible for their work.

8. Final review of work: An audit programme facilitates the final review of work before the report issigned.

9. Helpful to the new employees: For a new employee, the audit programme is a guide to his duty.

10. Basis of future programmes: It is a useful basis for planning the programme for the subsequentyears.

6. Disadvantages of an audit programme

1. Loss of initiative: An efficient clerk loses his initiative, because he has to follow the programmewhich has been fixed in advance.

2. Want of flexibility: Even if the audit programme is well drawn up, it may not cover everything thatmight come up during the course of audit.

3. Rigidity in programme: Each business may have a separate problem of its own and hence a rigidprogramme cannot be laid down for each type of business.

4. Unsuitable for small concerns: Drawing up of an audit programme may be unnecessary for a smallconcern.

5. No scope of changes: The audit programme may be followed mechanically year after year thoughsome changes might have been introduced by the client.

6. Concealment of incapacity of staff: Inefficient audit assistants may also take shelters behind theprogramme.

The aforesaid shortcomings can be overcome by obtaining up-to-date information and encouragingaudit assistants to inform the deviations from the standard and the audit programme and accordingly theprincipal may modify the programme.

3.5 Audit Note Book

An audit note book is usually a bound book in which a large variety of matters observed during the course of audit are recorded. It is thus a part of the record of the auditor available for reference later on, if required. The matters may be observed during the course of audit for which no satisfactory answer have been given by the client or those which require to be incorporated in the audit report. It is a kind of permanent record available to the auditor.

The audit notebook may be in two parts.

1. For keeping a record of general information as regards the audit as a whole.

2. For recording special points which have been observed during the course of audit of the accounts of different years.

1. Value of audit notebook

The audit notebook is of great value to an auditor at the time of preparing the report to be submitted to the shareholders. In case a charge of negligence is filed against the auditor, a notebook may prove to be good evidence.

From this notebook, an auditor may know the exact volume of work performed by his assistants. It also helps for future reference and guidance. This can serve as a guide also in framing the audit programme in future, in so far as the points recorded in the notebook indicate the weaknesses in the system of the accounting of the client, which requires to be looked into.

2. Contents of audit notebook

Some of the important points, which are noted down in an audit notebook, are given below:

1. A list of books of accounts maintained by the clients.

2. The names of the principal officers, their powers, duties and responsibilities.

3. The technical terms used in the business.

4. The points that require further explanations.

5. The particular of missing vouchers, the duplicate of which have to be obtained.

6. The mistakes and errors discovered.

7. Total or balances of certain books of accounts, bank reconciliation statement, etc.

8. Notes and queries that might be required at a subsequent audit.

9. The points that have to be incorporated in the audit report.

10. Any matter which requires discussions with the senior officials or with the auditor.

11. Accounting method followed in the business.

12. Date of commencement and completion of audit.

13. Provisions in the Articles and Memorandum of Association affecting the accounts and audit.

14. Abstracts from minutes, contracts, etc. having a bearing upon accounts.

15. Particulars of accounting and financial policies followed.

3. Advantages of audit note book

1. From the audit note book, an auditor may know the exact volume of work performed by his assistants.

2. It helps for future reference and guidance. This can serve as a guide in framing the audit programme in future.

3. It facilitates the preparation of the audit report.

4. In case of change of audit assistants, no difficulty is faced by the new assistant in continuing the incomplete work.

5. It ensures that the audit programme has been sincerely followed.

6. It is reliable evidence in the eye of law, if an auditor has to defend himself.

7. The responsibility of errors undetected can be fixed on the assistant concerned.

8. The important matters relating to the audit work may be easily recalled.

Did You Know?

State whether the following statement is “True” or “False”

The first auditor of a Government company was appointed by the Board in its meeting after 10 days from the date of registration:

- True
- False

Correct answer: False

3.6 Audit Working paper

1. Concept

Audit working papers are the written records kept by the auditor of the evidence accumulated during the course of the audit, the methods and procedures followed and the conclusions reached. They should include all the information that the auditor considers necessary to adequately conduct his examination and provide support for his audit report.

In short, audit working papers are those papers, which contain essential facts about accounts, which are under audit.

2. Purpose of working papers

Working papers are actually the compilation of all evidences, which are collected by the auditor in course of his audit. They serve the following purposes:

1. They show the extent of adherence to accounting principles and auditing standards.

2. They are useful as evidence against the charge of negligence.

3. They assist the auditor in co-coordinating and organizing the work of audit assistants.

4. They ensure the possibility of quick preparation of audit report.

5. Through the working papers, the auditor can know the distribution and accomplishment of work.

6. Measurement of the efficiency of the assistants can be done with the help of working papers.

7. They can be used as permanent record for future references.

8. They can act as a means to give training to the audit clerk.

9. They provide a means to control the on-going audit work.

10. Working papers assist the auditor in forming an opinion on the financial statements.

3. Contents of working papers

Audit working papers should include a summary of all significant matters identified which may require the exercise of judgement, together with the auditor’s conclusion thereon. If difficult questions of principle or of judgement arise during the course of the audit, the auditor should record the relevant information received and summarize both the management viewpoints and his conclusions.

The ICAI makes the following suggestions regarding the form and contents of working papers—

1. The working papers should record the audit plan, the nature, timing and extent of auditing procedures performed and the conclusions drawn from the evidence obtained.

2. The exact form and content of working papers are affected by various matters such as—

(a) the nature of the engagement.

(b) the form of the audit report.

(c) the nature and complexity of client’s business.

(d) the nature and conditions of the client’s records and degree of reliance on internal controls.

(e) the need in particular circumstances for direction, supervision and review of work performed by assistants.

3. Working papers should be designed and properly organized to meet the circumstances of each audit and the auditor's need in respect thereof.

4. Working papers should be sufficiently complete and detailed for an auditor to obtain an overall understanding of the audit.

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

6. To improve audit efficiency, the auditor normally obtains and utilizes schedules, analysis and other working papers prepared by the client such as analysis of important revenue accounts receivables.

7. In case of recurring audits, some working papers may be classified as permanent audit files materials as distinct from current audit files materials relating primarily to the audit of a single period.

3.7 Audit Files

The file, which is used by the auditor for preserving the written statements of necessary matters relating to audit, is called the audit file. It maintains different audit documents, namely audit notes, audit programme, audit working papers, etc. The efficient audit filling system strengthens the integrity of the audit work.

The audit file is generally of two types:

(1) Permanent audit file*:* In the case of recurring audits, some working paper files may be classified as permanent audit files which are updated currently with information of continuing importance to succeeding audit.

A permanent audit file normally includes—

(a) Information regarding the legal and organizational structure of the organization. In case of company form of organization, this includes the Memorandum and Articles of Association.

(b) Extracts or copies of important legal documents, agreements and minutes relevant to the audit.

(c) A record of the study and evaluation of the internal controls relating to the accounting system.

(d) Copies of audited financial statements for previous years.

(e) Analysis of significant ratios and trends.

(f) Copies of management letters issued by the auditor, if any.

(g) Record of communication with the retiring auditor, if any, before acceptance of the appointment as auditor.

(h) Notes regarding significant accounting policies.

(i) Significant audit observations of earlier years.

(2) Temporary audit file: In the case of single period audit, some working paper files may be classified as temporary audit file, which contain information relating primarily to the audit of a single period. A temporary audit file usually includes the following:

(a) Draft financial statements being audited.

(b) Schedules supporting the financial statements.

(c) Extracts from relevant minutes.

(d) Audit programme and time budget.

(e) Internal control questionnaire and where applicable, flow charts and notes on the system of internal control.

(f) Confirmations obtained from banks and other relevant organizations regarding items in the financial statements.

(g) Details of queries raised during the audit, and the answers for them.

(h) Copy of letter of representation.

3.8 Audit Manual

Audit manual may be defined as a 'written internal auditing document.' Thus, it provides differentinformation as to detailed auditing procedures, objectives of auditing, standard of performance, timerecording procedure, preparation of audit report, etc. The audit manual is prepared for the generalguidance of the auditors with the objective of planning the procedure of audit.

1. Advantages

1. Different information regarding polices of the concern and procedure of audit is available in themanual.

2. Information relating to required steps to be followed for conducting different auditing work can becollected from the manual.

3. Audit manual provides answers routine questions to the audit staff.

4. Efficient distribution of work among the audit staff can be made possible.

5. Audit manual provides useful information to the new entrants to the profession.

2. Disadvantages

1. Different audit procedures as contained in the manual become very mechanical.

2. Creative thinking on the part of the audit staff is discouraged.

3. If the manuals are not kept up to date, it may, instead of providing useful guidance, misguide theworking staff.

4. It discourages the individual initiative.

5. The procedure of audit as given in the audit manual may sometime fail to co-ordinate the activities ofaudit staff during the course of audit.

3.9 Procedures Followed in Course of Audit

There is no fixed rule regarding the procedures the auditor would follow in the course of audit. He wouldfix up the procedures after reviewing the situations on the basis of auditor's own knowledge, intelligence,efficiency and experience. But the generally accepted procedures followed by an auditor includethe following:

1.Audit Evidence

It is the auditor's duty to express a professional opinion on financial statements and it must always be amatter of judgement whether the auditor has sufficient evidence on which to base such an opinion. Theauditor can never be absolutely certain that the financial statements show a true and fair view; the questionis whether as an honest and careful auditor he has adequate evidence on which to base a reasonable opinion.The term evidence includes 'all influences on the mind of an auditor which affect his judgementabout the truthfulness of the propositions, submitted to him for review.'

A) Nine types of audit evidences, which are as follows:

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

2. Statement by independent third parties:

(a) Oral evidence

(b) Written evidence

3. Authoritative documents:

(a) Prepared outside the enterprise under examination

(b) Prepared inside the enterprise under examination

4. Statements by officers and employees of the concern under examination:

(a) Formal statement

(b) Informal statement

5. Calculations performed by the auditors

6. Satisfactory internal control procedures

7. Subsequent actions by the concern under examination and by others

8. Subsidiary or detail records with no significant indications of irregularity

9. Interrelationship within the date examined.

B) Methods of obtaining audit evidence

(1) Inspection

(2) Observation

(3) Inquiry and confirmation

(4) Computation

(5) Analytical review

2. Routine checking

Routine checking is a total process of accounting control, which includes—

1. Examination of the totalling and balancing of the books of prime entry.

2. Examination of the posting from the primary books to the ledger accounts.

3. Examination of totalling and balancing of the ledger accounts and of the trial balance preparedwith those balances and

4. Overall examination of writing up the transactions properly.In short, the routine checking is concerned with ascertaining the arithmetical accuracy of casting, postingand carry forwards. For the purpose of confirming the arithmetical accuracy and detecting fraudsand errors of very simple nature, this method is adopted as basic to all types of audit work. The scope ofapplication of routine checking depends upon the nature and size of the organization as well as theeffectiveness of the internal check and control system.

3. Test Checking

The term 'test checking' stands for the method of auditing, where instead of a complete examination ofall the transactions recorded in the books of accounts only some of the transactions are selected andverified. The underlying intention is to test some of the transactions to form an opinion for the whole.

According to Prof. Meigs 'test checking means to select and examine a representative sample from alarge number of similar items.'The justification of test checking lies on theory of probability which states, in effect that a sampleselected from a series of items will tend to show the same characteristics present in the full series ofitems, which is commonly referred to as 'population' or 'universe.'

4. Auditing in depth

Auditing in depth is a technique, which assists the auditor in conducting test checking and adoption ofsuch a system becomes essential in large organizations, where detailed examination of all the records isnot possible. It is a method of auditing under which a few selective transactions are subjected to a thoroughscrutiny for arriving at the accuracy of the data.

This technique involves the selection of a sample of transactions from one area of accounting andtracing them from the beginning to the conclusion. This system is undertaken to examine the effectivenessof the internal control and internal check system. In order to conduct the work of auditing in depthof a specific transaction, the auditor has to examine thoroughly the different stages of the transaction.

For example, in respect of goods purchased, the auditing in depth technique will be applied throughthe following stages—

1. Examine the requisition note from the stores, ensuring that it has been signed by the appropriateofficial.

2. Examine the copy of the order placed by the purchasing department, ensuring that it was properlyexecuted on the official form, complied with all the client's regulations and was authorized by theappropriate official.

3. Examine the delivery note from the supplier and compare it with the copy of the order.

4. Examine the goods inward note made out when the goods were received, noting if it has beenproperly signed, if it indicates that the correct goods have been received and if their quantity andcondition have been checked.

5. Check the entries in the store records.

6. Check in the accounts department that the invoice received from the supplier has been matchedwith the copy of the order and the copy of the goods received note before being processed, and thatthe calculations have been checked.

7. Check the appropriate entries in the accounting records, and

8. Compare the returned cheque with the invoice and supplier's statement, if any.

5. Walk-through tests

Walk-through tests are defined as tracing one or more transactions through the accounting systemand observing the application of relevant aspects of the internal control system. For example, the auditormight look at the sales system of a whole seller and trace a sale from its initiation through the salesfigure in the profit and loss account. This will involve looking at customers' orders, how the orders aredocumented and recorded, credit control approval, how the goods are selected and packed, raising of anadvice note and/or delivery note, invoicing procedures, recording the invoice in the books of accountsand so on. At each stage, the controls applied are examined.

Walk-through tests will also be applied in the following areas:

(a) In any situation where the auditor has not obtained his description of the system from a personalinvestigation of the system by questioning operating staff and documents and records.

(b) At the final audit when he needs to review the system from the date of the interim completion to theyear ends. He must first determine if the system has changed and walk-through tests will achieve this.

6. Rotational tests

Rotational tests are of two kinds—

(a) Rotation of audit emphasis—the auditor performs a system audit on all areas of the client's businessevery year, but each year he selects one area (wages, sales, stock control, purchase, etc.) for specialin-depth testing.

(b) Visit rotation—where the client has numerous branches, factories, locations, etc., it may be impracticalto visit them all each year. In such cases, the auditor visits them in rotation so that while eachwill not be visited every year, all will be visited over a period of years.

7. Cut-off examination

Cut-off procedures are the procedures designed to ensure that at the year-end trading transactions areentered in the period to which they relate. In other words, the term 'Cut-off' refers to the procedureadopted to ensure the separation of transactions as at the end of one accounting year from those at thecommencement of the next following year, especially for items which may overlap, for example, sales,purchase, and stock.

8. Physical examination

Auditors use the term 'physical examination' to describe a special type of evidence-gathering activityusually performed in the substantive testing stage of the audit engagement. Physical examination isdifferent to inspection and observation. Physical examination refers to the examination by the auditor ofa physical assistant of the entity, such as machinery, equipment and inventory.

When evidence of completeness of an asset is required, the auditor gathers evidence that the assetphysically examined has been included in the accounting records. For example, if evidence of the completenessof inventory is required, the auditor physically examines a quantity of inventory items andthen ensures those items have been included in the accounting records.

When evidence of validity (existence) of an asset already included in the accounting records isrequired, the auditor physically examines that asset. For example, if evidence of the validity (existence)of the recorded quantity of inventory is required, the auditor selects a number of inventory items that hasbeen recorded, and then ensures that quantity of items actually exists by physically examining the items.

In the substantive testing stage, physical examination provides complete and highly reliable evidenceas to the validity (existence) of physical assets and incomplete, although highly reliable evidence of thecompleteness of the physical assets. This assumes that the person making the physical examination iscompetent and appropriately experienced.

9. Statistical Sampling

Auditors have long considered it sufficient in given circumstances not to check all the items within anysection of the work, but to test them to satisfy themselves whether they may consider the whole groupas being satisfactory for their purposes. This is based upon the assumption that, subject to special circumstancessuch as beginning or end of period test, the number tested are sufficiently indicative of theaccuracy or otherwise of the whole group.

Statistical sampling is only the extension of this common-sense point of view by the application ofthe mathematical theory broadly stated that, provided a sufficiently large and representative sample istaken from a large population, the sample will reveal the same characteristics of the whole group withinmeasurable limits.

The use of these methods in practice does not require a detailed mathematical or statistical knowledgeof the formulae on which the actual tests are based. Sets of tables are available which, on havingdecided the degree of confidence the auditor wishes to place in the result and the accuracy he desires,he can consult, and the amount of the tests to be carried out is specified.

3.10 Delegation, Supervision and Review of Audit Work

Except for the smallest audit engagements, it is not possible for an auditor to perform the entire audithimself. This is because the audit would take too long to complete and/or the cost of performing theaudit would be prohibitive. This means that it is usually necessary for the auditor to delegate significantwork (or authority to delegate further work) to other staff members within the audit firm. Delegation isonly possible if there is appropriate supervision and review of the work performed. The person whosupervises and reviews works performed by others is a person who is at least as equally experienced andcompetent as the person to whom the work/authority has been delegated and is usually the person thatdelegated the work/authority.

1. Delegation

An auditor only delegates work/authority to persons with the appropriate experience and competence.This applies to all levels of organizations within the audit firm. Thus, a senior staff member to whomwork/authority has been delegated only further delegates work/authority to other staff members whohave appropriate experience and competence.An auditor/staff member delegating work/authority ensures that the person to whom the work/authorityhas been delegated completely understands the nature of the work that the person is required toperform as well as the limits of any delegated authority.

2. Supervision

Auditors and audit staff members supervise the work delegated by them to others so as to minimize therisk of a lessoning of the standard of care. The more complex the nature of the work delegated and lessexperienced and competent the staff member to whom the work has been delegated, then the greater thedegree of supervision.

Auditors supervise work while the delegatee is performing it. This contrasts with the review of workwhich auditors carry out after the delegatee has performed the work.The purpose of supervision is to provide the supervisor with a degree of assurance that the work ofthe delegatee is being performed in accordance with the instructions given and with the appropriatestandard of care.

3.Review

Work performed by the auditor and his audit staff is reviewed. Work performed by the auditor (theengagement partner) is reviewed by a person not personally involved with the client (the review partnerand/or personnel from quality control). The person that delegated the work to those staff members usuallyreviews work performed by the auditor's staff member.

The purpose of this quality review is to ensure that the work was performed in accordance with theinstructions given, with the appropriate standard of care and in accordance with any delegatedauthority. In relation to work performed in the control testing, substantive testing and opinion formulationstages, the reviewer ensures that audit procedures performed conform to the audit programmes,that audit procedures required to be performed have been properly performed, that the evidenceobtained has been properly documented and that conclusions reached as consistent with the evidenceobtained.

Summary

- The auditor should follow the appropriate audit procedure and adopt different techniques of auditing.On the basis of his assessment of the accounting system and evaluation of the internal controls, theauditor will propose an audit programme specially designed for that particular audit.
- For effective audit planning and for designing appropriate audit programme, the auditor should preparehimself before the commencement of his audit work. For this purpose, he should take a numberof preparatory steps.
- Audit planning is the process of deciding in advance what is to be done, who is to do it, how it is tobe done and when it is to be done by the auditor in order to have effective and efficient completion ofaudit.
- Audit programme is a detailed plan of work, prepared by the auditor for carrying out an audit. Itcomprises a set of techniques and procedures, which the auditor plans to apply to the given audit forforming an opinion about the statement of accounts of an organization. Audit programme can be oftwo types: predetermined audit programme and progressive audit programme.
- Audit note book is a bound book in which a large variety of matters observed during the course ofaudit are recorded. It is of great value to the auditor at the time of preparing the audit report. In caseof a charge of negligence is filed against the auditor, a note book may prove to be a good evidence.
- Audit working papers are the written records kept by the auditor of the evidence accumulated duringthe course of audit. As the working papers are prepared in respect of the client's business, they shouldbe treated as top secret and should be preserved carefully.
- Audit file maintainsdifferent audit documents. Audit file is generally of two types: permanent auditfile and temporary audit file.
- Audit manual is a written internal document, which provides different information regarding detailedauditing procedure. It is prepared for the general guidance of the auditors with the objective of planningthe procedure of audit.
- An audit memorandum is a statement containing all useful information regarding the business of theclient. It indicates the method of operation, policies of different aspects of the business as well as theconditions in respect of audit.

Keywords

- Audit Manual
- Audit Report
- Audit Programme
- Audit File
- Audit Note-book
- Audit Working paper

Self Assessment

1. Which of the following is NOT an objective of audit planning?

A. Identifying areas of potential risk
B. Assessing the effectiveness of internal controls
C. Selecting audit procedures
D. Preparing the financial statements

2. Which of the following is a key element of an audit programme?

A. The auditor's personal experience and intuition
B. The size of the client's business
C. The auditor's professional judgement and skepticism
D. The client's financial statements

3. Which of the following is a reason why an auditor might modify their planned audit programme?

A. To increase the level of assurance provided
B. To reduce the risk of material misstatement
C. To decrease the cost of the audit
D. To make the audit more efficient

4. What is the primary purpose of an audit programme?

A. To ensure that the audit complies with auditing standards
B. To provide a detailed record of the auditor's work
C. To identify areas of potential risk in the client's operations
D. To guide the auditor in performing the audit procedures needed to achieve the audit objectives.

5. Which of the following is NOT a step in the audit planning process?

A. Understanding the client's business and industry
B. Identifying significant accounts and disclosures
C. Developing an audit programme
D. Issuing an unqualified audit opinion

6. Which of the following is an example of a substantive audit procedure?

A. Inquiry of management
B. Observation of inventory counts
C. Inspection of bank statements
D. Assessment of internal control effectiveness

7. Which of the following is a benefit of developing a detailed audit programme?

A. Ensuring that all required audit procedures are performed
B. Reducing the level of auditor judgment required
C. Decreasing the time and effort required to complete the audit
D. Eliminating the need for audit documentation

8. Which of the following is a potential limitation of an audit programme?

A. It may be too detailed and restrictive
B. It may not adequately address areas of potential risk
C. It may not be based on the auditor's professional judgment
D. It may not comply with auditing standards and regulations.

9. Which of the following is NOT a component of the audit risk model?

A. Inherent risk
B. Control risk
C. Detection risk
D. Financial risk

10. Which of the following is an example of a control test?

A. Analyzing financial ratios
B. Confirming account balances with third parties
C. Reconciling bank statements
D. Observing inventory counts

11. Which of the following is a key objective of an audit programme?

A. To identify fraud and errors in the financial statements
B. To ensure that the auditor complies with professional standards
C. To document the auditor's understanding of the client's business and industry
D. To guide the auditor in performing specific audit procedures

12. What is the purpose of a preliminary analytical review in audit planning?

A. To determine the scope of the audit
B. To identify areas of potential risk and materiality
C. To develop an audit programme
D. To issue an audit opinion

13. Which of the following is a factor that might lead an auditor to increase the planned level of substantive testing?

A. A low level of inherent risk
B. A high level of control risk
C. A high level of detection risk
D. A high level of assurance from the client's internal controls

14. Which of the following is a limitation of analytical procedures in an audit?

A. They are not suitable for testing internal controls
B. They are only effective for testing revenue accounts
C. They require a high level of auditor judgment
D. They are not based on factual data

15. Which of the following is an example of a substantive audit procedure for testing accounts receivable?

A. Reconciling bank statements
B. Inspecting bank statements
C. Analyzing aging schedules
D. Observing inventory counts

Answer for Self Assessment

1.	D	2.	C	3.	A	4.	D	5.	D
6.	B	7.	A	8.	B	9.	D	10.	D
11.	D	12.	B	13.	B	14.	A	15.	C

Review Questions

1. What are the considerations to be kept in mind by an auditor before commencement of an audit?

2. 'Test check is based on presumption'—what is that presumption?

3. What is an audit manual?

4. Distinguish between principles of auditing and techniques of auditing.

5. What is an audit programme? Discuss the advantages and disadvantages of conducting an auditaccording to a predetermined audit programme. How can these disadvantages be overcome?

6. How an audit programme is prepared? State the objectives of an audit programme. What are the steps to be followed in drawing an audit programme?

7. What are audit files? What are the contents of audit files? What are the advantages of audit files?

8. What is an audit note book? Of what purpose does it serve? What are the contents of an audit note book?

Further Readings

- Auditing: Principles And Techniques By S. K. Basu, Pearsonn.S.
- A Hand Book Of Practical Auditing By B N Tandon, S Sudharsnam& S Sundharabahu, S Chand Publishing
- Auditing And Corporate Governance By Anil Kumar Jyotsna Rajan Arora Lovleen Gupta, Taxmann Publisher

Web Links

https://corporatefinanceinstitute.com/resources/accounting/legal-liability-of-auditors/#:~:text=The%20auditor%20has%20a%20duty,for%20mere%20errors%20in%20judgment

https://www.indeed.com/career-advice/career-development/audit-definition

https://www.investopedia.com/terms/a/audit.asp

https://www.managementstudyguide.com/what-is-auditing-its-types-and-purposes.htm

Unit 04: Audit Program

CONTENTS

Objectives

After studying this unit, you will be able to:

- have the knowledge of preparation and usage of Audit programme
- have the knowledge to control the quality of audit work
- have the concept clarity of control of audit risk.
- Recognize the preliminaries activities before company' audit.

Introduction

An audit program is a systematic and structured approach to evaluating an organization's financial, operational, and compliance processes. It involves a series of steps that are designed to assess the effectiveness of an organization's internal controls and identify areas where improvements can be made. The primary objective of an audit program is to provide reasonable assurance that an organization's financial statements are accurate, complete, and in compliance with applicable laws and regulations. A well-designed audit program is critical for ensuring that an organization operates with integrity and in accordance with industry best practices. In this day and age of increasing regulatory scrutiny and heightened expectations for corporate governance, having a robust audit program is more important than ever before.

The process of developing an audit program begins with an assessment of the organization's risks and controls. This involves identifying the potential risks that could impact the organization's financial statements, as well as the controls that are in place to mitigate these risks. The audit program should be tailored to the specific risks and controls of the organization, as well as any relevant regulatory requirements.

Once the risks and controls have been identified, the audit team can begin to develop the audit program itself. This typically involves creating a set of procedures and testing protocols that will be used to evaluate the effectiveness of the organization's internal controls. The audit program should also establish clear objectives and scope, so that the audit team can focus their efforts on the most critical areas.

The next step is to execute the audit program, which involves performing the procedures and testing protocols that were developed in the planning phase. During this phase, the audit team will gather evidence and documentation to support their findings and conclusions. They may also conduct interviews with key personnel to gain a deeper understanding of the organization's processes and controls.

Once the audit has been completed, the audit team will prepare a report that summarizes their findings and recommendations. This report will typically include a description of the scope and objectives of the audit, a summary of the findings, and recommendations for improvements to the organization's internal controls.

In conclusion, an effective audit program is critical for ensuring that an organization operates with integrity and in compliance with applicable laws and regulations. By identifying potential risks and weaknesses in internal controls, the audit program can help organizations to improve their financial reporting processes and reduce the risk of fraud or other financial irregularities.

4.1 Audit Programme

1. Concept and definition

An essential step in conducting an audit is the creation of an audit program. An audit program is a detailed plan of work, prepared by the auditor, that outlines the procedures and techniques to be used in evaluating an organization's financial statements. The program serves as a guide for the auditor and their assistants and contains instructions for the proper execution of the work.

The auditor must prepare a written audit program that sets out the procedures required to implement the audit plan. The program should also include audit objectives for each area, along with sufficient detail to control the proper execution of the work. According to Professor Meigs, an audit program is "a detailed plan of the auditing work to be performed, specifying the procedure to be followed in verification of each item in the financial statements and giving the estimated time required."

In summary, an audit program is a carefully crafted and flexible plan that outlines the work to be performed by the auditor and their staff during the audit. The program considers the extent of work, the allocation of responsibilities, the time required for completion, and the responsibility of the individuals assigned to complete the work within the given time frame. The audit program is an essential tool in ensuring the efficient and effective execution of the audit.

2. Purposes of audit programme

It is evident that an audit program plays a crucial role in ensuring the efficient and effective completion of assigned audit work. It serves as a detailed plan of action that guides the auditor and their assistants in conducting the audit. However, the audit program also serves several other purposes, which are outlined below:

To coordinate the procedures of the audit: The audit program serves as a guide for the auditor and their assistants, ensuring that all procedures are coordinated and executed in a structured manner.

To monitor the progress of the audit: The audit program provides a framework for monitoring the progress of the audit work. This helps the auditor to identify any issues or delays that may arise and take appropriate corrective action.

To document the work done during the audit process: The audit program also serves as a record of the work done during the auditing process. This documentation can be used as evidence of the work performed and the conclusions reached.

To assign responsibilities to audit staff: The audit program also assigns responsibilities to the audit staff, ensuring that each member is aware of their duties and has a clear understanding of the time limits for completion.

In conclusion, an audit program not only serves as a detailed plan of action for conducting an audit but also plays a critical role in coordinating procedures, monitoring progress, documenting work, and assigning responsibilities. By fulfilling these purposes, the audit program helps ensure the efficient and effective completion of the audit work.

3. Types of audit programme

There are two types of audit programs: predetermined audit programs and progressive audit programs.

(a) Predetermined audit programme:A predetermined audit program outlines all audit procedures in general, even though not all procedures may be relevant to a particular type of audit. The purpose of this type of audit program is to provide a procedural guideline or a "check off" list. This type of program is also referred to as a "Taylor made" audit program.

(b) Progressive audit programme: On the other hand, a progressive audit program is a "skeleton" form of an audit program. It briefly sets forth the general scope, character, and limitations of the audit work. This type of program is suitable in cases where the condition of the business changes year after year.

In summary, the predetermined audit program serves as a detailed guideline for conducting an audit and provides a "check off" list of procedures to follow. The progressive audit program is a more flexible plan that briefly outlines the scope, character, and limitations of the audit work and is suitable for businesses that experience changes year after year.

4. Developing the audit programme

The ICAI's SA-300 (Planning an Audit of Financial Statements) outlines the importance of preparing a written audit programme to implement the audit plan. This programme should include the necessary procedures and audit objectives for each area and should be detailed enough to provide clear instructions to the audit assistants and ensure proper execution of the work.

In preparing the audit programme, the auditor should have an understanding of the accounting system and related internal controls. The auditor may rely on certain internal controls to determine the nature, timing, and extent of required auditing procedures. If the auditor concludes that relying on certain internal controls is an effective and efficient way to conduct the audit, they may choose to do so.

5. Advantages of an audit programme

1. Assurance of completion of work: The audit programme ensures that all necessary work has been completed and nothing has been omitted.
2. Information about work progress: The auditor can keep track of the progress of the work done by their assistants.
3. Uniformity of work: A consistent approach can be achieved by following the same programme during subsequent audits.
4. Simplification of work allocation: The allocation of work to different levels of audit assistants can be simplified.
5. Guidance to the staff: The audit programme serves as a guide for the audit assistant in performing their work.
6. Defence against charge of negligence: The audit programme can be used by the auditor to defend themselves against any charges of negligence.
7. Division of responsibility: The work of the audit can be divided among different assistants, who will be held responsible for their assigned tasks.
8. Final review of work: The audit programme facilitates a final review of the work before the report is signed.
9. Helpful to new employees: The audit programme can be a useful guide for new employees in understanding their duties.
10. Basis of future programmes: The audit programme provides a useful basis for planning subsequent years' audit programmes.

6. Disadvantages of an audit programme

1. Loss of initiative: An efficient clerk may lose their initiative since they have to follow a fixed programme.

2. Want of flexibility: Even a well-drawn audit programme may not cover everything that arises during the audit process.
3. Rigidity in programme: Since each business may have unique problems, a rigid programme may not be suitable for every business.
4. Unsuitable for small concerns: Small businesses may not require an audit programme.
5. No scope for changes: The audit programme may be followed mechanically year after year, even if changes have been introduced by the client.
6. Concealment of staff incapacity: Inefficient audit assistants may hide behind the programme.

To overcome these shortcomings, up-to-date information must be obtained, and audit assistants should be encouraged to inform the principal of any deviations from the standard programme. The principal can then modify the programme accordingly.

4.2 Control of Quality of Audit Work

Quality control policies and procedures are critical to ensure that all audits conducted by an audit firm are in compliance with Auditing and Assurance Standards. SA-220 sets out the objectives of quality control policies and procedures, which include:

(a) Professional requirements: Personnel involved in conducting the audit must adhere to principles of independence, integrity, objectivity, confidentiality, and professional approach to maintain audit quality. These principles ensure that the audit is conducted in a manner that is free from any bias or influence.

(b) Skills and competence: Technical knowledge and professional competence are essential for personnel to perform their duties effectively, efficiently, and with competence, thereby maintaining the quality of audit work. The personnel involved in the audit should possess the requisite technical skills and knowledge to conduct the audit.

(c) Assignment: The effective assignment of work is necessary to ensure audit quality. The right person should be assigned to the right job, i.e., audit work should be assigned to personnel with the appropriate technical training and proficiency required for the job. Assigning the wrong person for the job may lead to inadequate audit work.

(d) Delegation: To ensure that work performed meets appropriate quality standards, sufficient direction, supervision, and review of work at all levels is necessary. Delegation of work should be done in a manner that ensures that the work performed meets the required standards of quality.

(e) Consultation: Expert opinion from within or outside the audit firm can be sought to maintain the quality of audit work. Consultation should occur with those who have the appropriate authorities, if necessary. The firm should have a mechanism to seek expert opinion when required to maintain the quality of the audit work.

(f) Acceptance and retention: When deciding whether to accept or retain existing and new clients, the ability of the firm to serve the client properly and the independence aspects of the firm should be considered. For this purpose, an evaluation of prospective clients and an ongoing review of existing clients should be conducted. The firm should ensure that they are not compromised in terms of independence when accepting or retaining clients.

(g) Monitoring: To maintain audit quality, continuous monitoring of the adequacy and operational effectiveness of the quality control policies and procedures adopted by the firm should be conducted. The firm should have a mechanism to monitor the quality of the audit work and the effectiveness of the quality control policies and procedures.

The general quality control policies and procedures of the firm should be communicated to its personnel in a manner that provides reasonable assurance that the policies and procedures are understood and implemented. The firm should ensure that the personnel are aware of the quality control policies and procedures and how to implement them. This communication should be done regularly to ensure that personnel are up to date with the policies and procedures.

4.3 Audit Risk and Materiality

To ensure the accuracy and reliability of financial statements, it is essential that all items are subject to substantive tests. However, the extent of such tests may vary depending on the materiality and inherent risk of the item in question. For instance, in the case of petty cash, even if there are discrepancies, it may not significantly impact the financial statements. On the other hand, in the evaluation of the value of work in progress in a construction company, the valuation may be crucial to the financial statements, but it may be challenging to establish with precision.

To reduce the extent of substantive procedures, the auditor may rely on their preliminary assessment of control risk. The auditor should make a preliminary assessment of control risk for material financial statement assertions and plan and perform compliance tests to support that assessment. For example, if the preliminary walk-through tests reveal good controls over debt collections in an enterprise, the auditor may assess the control risk attached to the assertion that all debts that should have been collected have been collected. Compliance tests should then be planned and performed to support that assessment. If the compliance tests support the assessment, then the extent of substantive tests can be reduced.

It is crucial for auditors to exercise professional judgment in determining the extent of substantive tests required for each item. The auditor must ensure that they have obtained sufficient and appropriate evidence to support their opinion on the fairness of the financial statements. This may involve performing additional procedures if the initial assessments indicate a higher inherent risk or a lower control risk.

1. Concept of materiality

An auditor's responsibility is to provide an opinion on the accuracy and fairness of a set of accounts, rather than to ensure that every item within the accounts is completely correct. While errors can exist within the accounts, they can still present a true and fair view. The tolerable error, which is the maximum error that a specific magnitude can contain without detracting from the true and fair view, is a key aspect of auditing materiality. According to SA-320 on 'Materiality in Planning and Performance of an Audit,' information is considered material if its misstatement could influence the economic decisions made by users based on the financial information provided. Materiality is determined by the size and nature of the item, as well as the circumstances surrounding its misstatement.

During audit planning, the auditor must determine the amount of tolerable error within a given population and conduct tests to ensure that the actual errors are lower than the tolerable error. For instance, stock can be a substantial amount in a set of accounts, and it is computed by counting, weighing, multiplying quantity by price, and adding individual values. Errors can occur at any of these stages, such as incorrect applied prices, resulting in a stock figure that is either above or below the correct figure by an amount that surpasses the tolerable limit.

2. Audit Risk

Audit risk is a term that has gained significant importance in the accounting world in recent years. It refers to the possibility that an auditor could suffer harm as a result of providing an audit opinion that is incorrect in some way. Audit risk is therefore the chance that the auditor may arrive at a wrong or invalid conclusion from their audit procedures. For instance, an incorrect audit opinion could occur if the auditor mistakenly gives a true and fair view of the accounts when they do not.

The concept of audit risk encompasses three distinct components: inherent risk, control risk, and detection risk.

a) Inherent risk: pertains to the susceptibility of any particular population to errors or material misstatements. Several factors may increase the inherent risk of a particular population, such as the type of industry, previous errors, or prone populations. For example, a newly established manufacturing hi-tech company is more susceptible to errors than a stable business like a brewery. Work-in-progress valuation and stock calculation are populations that are generally more prone to errors.

b) Control risk: refers to the risk that internal controls may fail to prevent or detect significant errors in the population under audit. If the control risk is high, the auditor may decide to conduct only substantive tests rather than compliance tests.

c) Detection risk: is the risk that the auditor's procedures, such as substantive tests and analytical reviews, will not identify material errors or misstatements. Detection risk is generally the only component of audit risk that auditors can control directly through their audit procedures.

To ensure that the auditor attains the required level of assurance, the auditor has to keep in mind the audit risk that he perceives while performing his sampling procedures. The sample size required is directly proportional to the level of audit risk and materiality. Therefore, it is important for the auditor to evaluate the level of audit risk associated with the population under audit to determine the appropriate sample size required for the audit.

3. Relationship between materiality and audit risk

According to SA-320, there exists an inverse relationship between materiality and audit risk. This means that as the materiality level increases, the audit risk decreases and vice versa. The auditor takes this relationship into consideration when deciding the nature, timing, and extent of audit procedures. For instance, if the auditor plans for specific audit procedures and finds that the acceptable materiality level is lower, it increases the audit risk.

In such a situation, the auditor can compensate for the increased audit risk in either of two ways:

(a) By reducing the assessed degree of control risk, if possible, and supporting the reduced degree by carrying out extended or additional tests of control.

(b) By modifying the nature, timing, and extent of planned substantive procedures, thereby reducing detection risk.

Therefore, the auditor must carefully assess the acceptable materiality level and its impact on audit risk to determine the appropriate course of action for the audit procedures.

4. Advantages

Audit costs have been on the rise in recent years due to factors such as higher salaries, office costs, and professional indemnity premiums. Meanwhile, competition, slow market growth, and the growth of competitive tendering for audits have resulted in increased resistance to audit fees. As a result, audit firms are constantly looking to reduce audit costs while simultaneously reducing audit risk. This has given rise to the concept of risk-based auditing, which is a distinct approach to auditing.

Historically, auditing has progressed from being a mostly substantive testing process to a system-based process and ultimately to a risk-based approach that utilizes a range of audit techniques, including substantive testing, internal control compliance, analytical review, and the use of inherent factors. Inherent factors include client background knowledge and past audit records indicating no special difficulties.

Auditing essentially involves gathering evidence about each part of the accounts, but as it is impossible to provide absolute assurance, some residual risk must be accepted. The extent of that acceptable risk is a matter of judgment and can be seen as the product of the separate risk accepted in each type of evidence gathering.

Thus: Overall risk = Inherent risk * Control risk * Analytical review risk * Substantive risk.

As per SA-320, there is an inverse relationship between materiality and the degree of audit risk. The higher the materiality level, the lower the audit risk and vice versa. The auditor considers this inverse relationship when determining the nature, timing, and extent of audit procedures. For example, if the auditor determines that the acceptable materiality level is lower after planning for specific audit procedures, audit risk increases. To compensate for this, the auditor would either reduce the assessed degree of control risk, where possible, and support the reduced degree by carrying out extended or additional tests of control or reduce detection risk by modifying the nature, timing, and extent of planned substantive procedures.

Suppose an audit situation was examined, found to be material, and the risk factors assessed, the following set of figures might be assembled, for instance, in the case of a debtor:

Overall acceptable risk: 5% (5 chances in 100 of giving a wrong opinion)

Inherent risk: 50% (the client is old-established, well-managed, and has no problems encountered in the area previously)

Control risk: 20% (internal control is strong, unchanged from last year, and has little possibility of management override)

Analytical control risk: 50% (figures tie up with credit sales, with previous years, and with budgets, subject to small changes stemming from different external conditions)

$$\boldsymbol{Sustantive\ risk} = \frac{\boldsymbol{OR}}{\boldsymbol{IR \times CR \times AR}}$$

=0.05/ (0.5*0.2*0.5) = 1

According to the text, the level of assurance required from substantive testing is determined by subtracting the acceptable risk level from 100%. For example, if the acceptable risk level is 5%, the level of assurance required from substantive testing is 100% - 5% = 95%. However, auditors may find this level of assurance too strong.

If the risk factor related to control is changed to 30%, then the substantive risk becomes 67%, and the level of assurance required from substantive testing decreases to 100% - 67% = 33%. In other words, the auditor only needs to be 33% confident in the evidence gathered through statistical sampling tests.

This suggests that the required sample size for statistical sampling tests will be very small.

4.4 Preliminaries Before Commencement of Company Audit

Before commencing the actual audit work of a company, the auditor should go through the followingpreliminaries:

1. Ensuring Whether his Appointment is in Order

To avoid any potential issues or conflicts of interest, an auditor should ensure that their appointment is made in accordance with relevant sections of the Companies Act, 2013. Before accepting an appointment, the auditor should verify that the company has fulfilled all necessary formalities.

The auditor should undertake the following steps:

1. Obtain a copy of the resolution passed at the board or shareholders meeting that appointed them as auditor. This will confirm that the appointment was made in compliance with Section 139 of the Companies Act, 2013.
2. If the auditor is being appointed to replace a retiring auditor, they should verify whether due notice was served to the retiring auditor. They should also consult with the retiring auditor to ascertain the circumstances under which they retired and whether they have any objections to the appointment. This is a professional requirement as per the Chartered Accountants Act, 1949.
3. Within 15 days of the appointment, the company should inform both the Registrar and the appointed auditor of the appointment.
4. If the auditor is being appointed to fill a casual vacancy caused by the death of the previous auditor, they should obtain a copy of the board meeting minutes regarding the appointment and also verify the death of the previous auditor.
5. If the company has failed to appoint or reappoint any auditor during the annual general meeting, the Central Government should have appointed the auditor to fill the vacancy.
6. If the auditor is being appointed due to the resignation of the previous auditor, they should verify that their appointment was made during a general meeting of shareholders. The Board of Directors do not have the right to appoint the auditor under these circumstances.

7. The auditor should also verify that their remuneration has been fixed in accordance with the provisions of the Companies Act.

By ensuring that all necessary formalities have been maintained and following the above steps, an auditor can accept an appointment with confidence and avoid any potential issues in the future.

2. Inspection of Statutory Books and Documents

(a) Documents: Before the auditor commences the work of audit, he should examine the followingdocuments:

*(i) Memorandum of association:*During an audit, the auditor will typically review various aspects of the company's operations to ensure compliance with relevant laws and regulations. This may involve examining specific items, such as:

1. Confirming that the company's activities are consistent with its stated "objective clause" or purpose as outlined in its memorandum of association.
2. Verifying that the amount of share capital issued by the company is within the limits of its authorized capital.
3. Checking for any amendments to the memorandum of association and ensuring that any legal formalities required for such changes have been properly followed.

By carrying out these checks and reviewing these items, the auditor can ensure that the company is operating within the bounds of the law and in compliance with its own governing documents.

*(ii) Articles of association:*During an audit, the auditor will review various aspects of the company's operations to ensure compliance with relevant laws and regulations. These may include specific items such as:

1. The issue of share capital and any subdivisions or changes made to it.
2. The payment of underwriting commission and brokerage fees associated with the issuance of shares.
3. The amount of minimum subscription required for share offerings.
4. The dates and amounts of calls made on shares.
5. The appointments, duties, and powers of auditors beyond their statutory obligations.
6. The appointment and remuneration of directors.

These items are just a few examples of what may be included in the company's Articles of Association. The Articles may contain numerous other provisions that the auditor should carefully review.

It is crucial that the auditor reviews the Articles of Association to ensure they have a complete understanding of the company's operations and that they are auditing properly. Failure to do so may lead to liability, as was demonstrated in the case of Leeds Estate Building and Investment Society Ltd. vs Shepherd (1887). Therefore, it is essential that the auditor thoroughly reviews all relevant documentation to ensure they are conducting an accurate and comprehensive audit.*(iii) Prospectus*: In case of newly started company and company gone for public issue, the auditorwill examine the prospectus to see the matters like whether shares can be issued at a discount, theamount payable on application, allotment and calls, underwriting commission and brokerage, etc.

*(iv) Certificate of incorporation and certificate of commencement:*As part of an audit, the auditor may be required to examine various certificates and documents to ensure that the company has been properly incorporated and is operating in compliance with relevant laws and regulations. In particular, for public limited companies, the auditor will need to verify that the company has obtained a commencement of business certificate before it begins its operations.

By examining these certificates and documents, the auditor can confirm that the company is operating within the bounds of the law and is in compliance with its legal obligations. Therefore, it is crucial that the auditor thoroughly reviews all relevant documentation to ensure that they have a complete understanding of the company's operations and are able to conduct an accurate and comprehensive audit.

(b) Books and registers: The following is the list of books and registers required to be maintained bythe companies:

(i) Register of Members (Section 88)

(ii) Index of Members (Section 88)

(iii) Register and Index of Debenture-holders (Section 88)

(iv) Register of Mortgage and Charges (Section 85)

(v) Register of Investments (Section 113)

(vi) Foreign Register (Section 88)

(vii) Register of contracts with companies and firms in which the directors are interested (Section184, 188 and 189)

(viii) Register of directors, managing director, manager and secretary (Section 170)

(ix) Register of director’s shareholdings (Section 170)

(x) Minute books (Section 118).

3. Inspection of Contracts:

The auditor should inspect and examine the contracts, which have been entered into by a company withothers, for example,

(i) Contracts with the vendors of any property,

(ii) Contracts with the brokers and underwriters for their commission,

(iii) Contracts with the promoters for the preliminary expenses, etc.

4. Study of Previous Year’s Balance Sheet and Auditor’s Report:

During an audit, the auditor is required to examine the previous year's balance sheet to verify the opening balances for the current year. Additionally, the Companies Act stipulates that the balance sheet for the current year must include corresponding figures from the previous year.

Moreover, the auditor should also review the audit report(s) from the previous year(s) to identify areas of concern and determine whether any issues identified in those reports have been adequately addressed. By doing so, the auditor can gain a better understanding of the company's financial performance and assess whether it is operating in compliance with applicable laws and regulations.

It is essential that the auditor reviews all relevant documentation, including previous year's balance sheets and audit reports, to ensure that they are conducting a comprehensive and accurate audit. This allows the auditor to identify any issues or irregularities and make appropriate recommendations for corrective action.

5. Study of Internal Control System in Operation

The study and evaluation of the internal control system in operation is important, because it serves as a basis for reliance thereon. It helps the auditor in determining the extent of the test to which auditing procedures can be restricted.

Summary

- Before beginning the actual audit work of a company, the auditor should complete certain preliminaries, including ensuring that their appointment is in order, inspecting the statutory books and documents, inspecting contracts with third parties, studying the previous year's balance sheet and audit report, and studying the internal control system of the company.

- During the audit of share capital transactions, the auditor must ensure that the legal requirements have been duly complied with, confirm that the share issue is properly authorized, that there is no over-issue beyond the prescribed limit, and that the rights of the shareholders are duly protected. Additionally, the auditor must ensure that the generally accepted accounting principles are followed while recording the transactions relating to the issue.
- The auditing in depth is a technique that assists the auditor in conducting test checking. In this technique, a few selective transactions are subjected to thorough scrutiny for arriving at the accuracy of the data.
- There is an inverse relationship between materiality and the degree of audit risk; that is, the higher the materiality level, the lower the audit risk and vice versa. The auditor takes the inverse relationship between materiality and audit risk into account when determining the nature, timing, and extent of audit procedures.

Keywords

- Audit Quality
- Audit risk
- Inherent risk
- Company Audit
- Control risk
- Analytical risk

Self Assessment

1. What is audit risk?

A. The risk that the auditor will not find all material misstatements
B. The risk that the auditor will find all material misstatements
C. The risk that the financial statements will be incorrect
D. The risk that the auditor will not complete the audit on time

2. Which of the following is not a component of audit risk?

A. Detection risk
B. Control risk
C. Inherent risk
D. Analytical risk

3. What is inherent risk?

A. The risk that arises from a material misstatement that is not detected by the company's internal control system
B. The risk that arises from the nature of the business and the economic environment in which it operates
C. The risk that arises from the auditor's failure to detect a material misstatement
D. The risk that arises from a misstatement that is intentionally made by management

4. Which of the following is an example of detection risk?

A. The risk that a material misstatement will not be prevented or detected by the company's internal control system
B. The risk that arises from the nature of the business and the economic environment in which it operates
C. The risk that the auditor's sample may not be representative of the population being tested
D. The risk that management may intentionally misstate the financial statements

5. Which of the following is true regarding audit risk?

A. It is the same for all audit engagements
B. It is determined by the auditor's assessment of the client's internal control system
C. It is composed of inherent risk, control risk, and detection risk
D. It is not affected by the materiality of the financial statements

6. Which of the following is not a component of quality control in audit work?

A. Independence and objectivity
B. Competence and professional care
C. Ethical requirements
D. Payment terms

7. Which of the following standards provide guidance for the control of quality of audit work?

A. International Financial Reporting Standards (IFRS)
B. International Standards on Auditing (ISAs)
C. Generally Accepted Accounting Principles (GAAP)
D. Generally Accepted Auditing Standards (GAAS)

8. Which of the following is the responsibility of the engagement partner in the control of quality of audit work?

A. Ensuring compliance with ethical requirements
B. Ensuring that audit team members are competent
C. Reviewing the audit work performed by the team
D. All of the above

9. Which of the following is not a step in the quality control process for an audit firm?

A. Monitoring
B. Hiring new employees
C. Documentation
D. Reviewing work performed

10. What are the preliminaries that an auditor should go through before commencing the company audit?

A. Inspecting contracts with third parties

B. Studying internal control system of the company
C. Reviewing previous year's financial statements and audit report
D. All of the above

11. Why is it important for an auditor to review the previous year's financial statements and audit report before commencing the audit?

A. To identify any problem areas in the company
B. To check for inconsistencies between the current and previous year's financial statements
C. To identify any material misstatements in the financial statements
D. None of the above

12. Which of the following is not a preliminary step that an auditor should take before commencing the audit?

A. Ensuring the appointment is in order
B. Reviewing the company's marketing strategy
C. Inspecting statutory books and documents
D. Inspecting contracts with third parties

13. What is the purpose of inspecting statutory books and documents before commencing the audit?

A. To ensure compliance with legal requirements
B. To identify any fraudulent activity
C. To identify any material misstatements in the financial statements
D. None of the above

14. Which of the following is NOT a type of audit opinion?

A. Qualified opinion
B. Adverse opinion
C. Disclaimer of opinion
D. Positive opinion

15. Which of the following is an example of inherent risk?

A. Misstatement in financial statements due to fraud by management
B. Misapplication of accounting principles by a junior staff member
C. Error in recording transactions due to inadequate training of accounting personnel
D. Inaccuracy in tax calculation due to changes in tax laws

Answer for SelfAssessment

1.	A	2.	D	3.	B	4.	C	5.	C
6.	D	7.	B	8.	D	9.	B	10.	D

11. A 12. B 13. A 14. D 15. A

Review Questions

1What are the steps to be taken by a statutory auditor before commencement of an audit of a company?
2. What are the considerations to be kept in mind by an auditor before commencement of an audit?

3. A trader is worried that in spite of substantial increase in sales compared to the earlier year, there isconsiderable fall in gross profit. After satisfying himself that sales and expenses are correctlyrecorded and that the valuation of inventory is on consistent basis, he wants you as an auditor toensure that the purchases have been truthfully recorded. In the given circumstances, how would youproceed with the assignment?

Further Readings

- Auditing: Principles And Techniques By S. K. Basu, Pearsonn.S.
- A Hand Book Of Practical Auditing By B N Tandon, S Sudharsnam& S Sundharabahu, S Chand Publishing
- Auditing And Corporate Governance By Anil Kumar Jyotsna Rajan Arora Lovleen Gupta, Taxmann Publisher

Web Links

https://www.compliancequest.com/quality-audit/

https://en.wikipedia.org/wiki/Audit_risk

https://discover.hubpages.com/business/Preliminary-steps-before-commencing-a-Company-Audit

Unit 05: Vouching of Items in Financial Statements

CONTENTS

Objectives

After studying this unit, you will be able to:

- Understand the meaning, objectives, and challenges of vouching
- Identify vouching process of assets and liabilities
- Identify vouching process of expenses and incomes

Introduction

The process of examining documentary evidence to support transactions recorded in the books of account is commonly referred to as "vouching" in auditing. Vouching is an important technique used by auditors to establish the authenticity of the transactions recorded in the primary books of accounts.

Vouching involves verifying the records of transactions in the books of accounts with relevant documentary evidence and authority, which formed the basis for making the entries. It also involves ensuring that the amount mentioned in the voucher is correctly posted to the appropriate account, which helps to disclose the nature of the transaction when included in the final statements of account.

5.1 Meaning of Vouching

According to Taylor and Perry, vouching is "the examination of the evidence offered in substantiation of entries in the books, including in such examination the proof, so far as possible, that no entries have been omitted from the books." Similarly, Joseph Lancaster defined vouching as "a device used to prove that various transactions for the period are fairly, truly, and sincerely reflected in the books of accounts."

From the above definitions, it can be inferred that vouching is a technique used in auditing to verify the accuracy of entries made in the books of accounts by referring to available documentary evidence.

5.2 Objectives of Vouching

Vouching is a crucial auditing technique that involves the examination of documentary evidence to establish the authenticity of entries in the books of accounts. Its primary objective is to enable the auditor to assess the accuracy and truthfulness of the transactions recorded in the books of accounts.

The success of an audit largely depends on the effectiveness of vouching, which is why auditors adopt vouching techniques to achieve the following objectives:

1. To ensure that all transactions recorded in the books of accounts are supported by relevant and reliable documentary evidence.
2. To verify that no fraud or errors have occurred while recording the transactions in the books of accounts.
3. To ascertain that each transaction recorded has been authorized by a responsible person in accordance with the established policies and procedures.
4. To ensure that all transactions have been appropriately classified as capital or revenue items while recording them in the books of accounts.
5. To enhance the precision and accuracy of the financial information presented in the financial statements and to report it as true and fair.
6. To ensure the reliability and accuracy of the figures presented in the books of accounts, which will provide a solid foundation for the financial statements.
7. To confirm that no transactions have been recorded in the books of accounts that are unrelated to the entity under audit, which could lead to inaccurate financial reporting.
8. To ensure that the amounts recorded in the accounts are accurately totaled, carried forward, and recorded, which will ensure that the financial statements are accurate and reliable.

Overall, vouching plays a critical role in enabling auditors to conduct an accurate and reliable audit by ensuring that the transactions recorded in the books of accounts are legitimate and correctly reflected in the financial statements.

5.3 Importance of Vouching

The audit is typically conducted long after the transactions have occurred, and the auditor was not present during that time to directly experience the transactions. As a result, the auditor must rely on evidence, and the voucher serves as the primary evidence of the transaction. The auditor's duty is not only to check the arithmetical accuracy of the accounts but also to ensure their substantial accuracy and report on them. The substantial accuracy of the accounts and resulting financial statements can be determined primarily by examining vouchers, which are the primary documents related to the transactions. If the primary document is incorrect or irregular, the entire accounting statement will be incorrect and irregular. Therefore, vouching is essential for auditors to determine whether financial statements are incorrect or irregular.

The significance of vouching was emphasized in the case of Armitage vs Brewer & Knott (1930), where it was held that vouching is a crucial part of an auditor's duty. If an auditor fails to exercise care while vouching the books of accounts, the client can claim damages. The efficiency with which the vouching technique is applied during the audit process determines the success of the audit. Vouching is particularly critical in detecting various frauds, which can only be detected if the auditor conducts vouching intelligently. In cases where an auditor suspects fraud, they must also verify the sources of documentary evidence. Fictitious bills of expenses and purchases may be produced, and payments against these bills may be misappropriated, but intelligent vouching can detect this type of fraud.

It is evident from the discussion above that vouching is a fundamental aspect of auditing. If conducted faithfully and effectively, vouching helps to establish the reliability of the profit and loss account and balance sheet. Therefore, vouching can be considered the essence of auditing.

5.4 Vouching and Verification

Vouching is an auditing technique used to verify the authenticity and accuracy of transactions recorded in the books of accounts. This process involves examining all available documentary evidence to support the genuineness of the transactions. The objective of vouching is to obtain reasonable assurance regarding the completeness, accuracy, and validity of the data produced by the accounting system.

1. The auditor aims to establish that transactions recorded in the books of account are properly allocated to the accounting period and the relevant accounts,
2. A transaction pertains to the entity and took place during the relevant period.
3. Vouching is a crucial auditing procedure that involves examining all documentary evidence available to authenticate the genuineness of transactions recorded in the books of accounts.
4. This technique is used by auditors to obtain evidence regarding the completeness, accuracy, and validity of data generated by the accounting system.

Through vouching, auditors aim to obtain reasonable assurance about assertions related to transactions recorded in the books of accounts, including whether they are recorded in the proper account, properly allocated to the accounting period, pertain to the entity, and have been classified and disclosed in accordance with recognized accounting policies and practices.

Verification, on the other hand, typically refers to the auditing process that examines whether assets and liabilities are correctly stated in the balance sheet. This term may also apply to profit and loss account items for checking the account balances and their presentation. When verifying assets, auditors check whether the assets are owned by the client, whether any charges have been created on those assets, and whether the same has been disclosed appropriately. With regard to liabilities, the auditor confirms that they are actually owed by the organization.

It is worth noting that vouching primarily deals with the examination of transactions at their point of origin, while verification usually deals with the balances presented in the balance sheet and profit and loss account.

5.5 Vouching and Routine Checking

Routine checking is an accounting control process that encompasses several steps, including

(a) verifying the accuracy of the books of prime entry,

(b) checking the posting from primary books to the ledger accounts,

(c) verifying the accuracy of the ledger accounts' balances and preparing a trial balance with those balances, and

(d) overall verification of the proper writing up of the transactions.

In essence, routine checking aims to ensure the arithmetical accuracy of casting, posting, and carrying forward of balances.

There is sometimes confusion about whether the concepts of vouching and routine checking are similar and complementary to each other. However, in practice, vouching includes routine checking and is considered a part of it. Vouching includes the checking of all totals, subtotals, carry-forwards, and ledger accounts, going beyond the books of account to trace out the source of transactions. The scope of routine checking is confined to the books of accounts.

5.6 Concept of Voucher

It is important to acknowledge that vouching and vouchers are closely related, as vouching cannot be performed without vouchers. Vouchers, both internal and external, are considered an essential part of the vouching process as they provide the documentary evidence to support the entries made in a company's books of accounts.

For a transaction to be recorded in the books of account, the relevant documentary evidence must be available to support it. This evidence may take various forms, such as receipts, counterfoils, resolutions passed in meetings, cash memos, pay-in slips, purchase invoices, and minutes of meetings. All these forms of documentary evidence are known as vouchers.

Vouchers can be of two types—

1. Primary vouchers, and

2. Collateral vouchers.

1. Primary vouchers: When written evidence is available in original, it is known as primaryvoucher.

For example: purchase invoices, counterfoil of cash receipt, etc.

2. Collateral vouchers: In certain cases, evidence in original is not available. Copies of such evidencesare made available for the purpose of audit. These vouchers or documents are known as collateralvouchers.

For example: Copies of resolution passed at a meeting, photo copy of demand drafts, etc.On the basis of sources of documents, vouchers can again be of two types—

1. Internal vouchers and

2. External vouchers.

1. Internal vouchers: Vouchers originating within the organization are known as internal vouchers.For example: Sales invoices, minute book of board meetings, material requisition slip, etc.

2. External vouchers: Vouchers originating from the outside sources are known as external vouchers.For example: Mortgage deed, bank statement, etc.

5.7 Internal and External Evidence

Vouchers can provide different types of evidence, which fall into two main categories:

1) Internal evidence: This type of evidence is created and used within the client's organization, and it is not shared with outside parties. Examples of internal evidence include duplicate sales invoices, employees' time reports, purchase requisitions, and minute books. These documents are part of the organization's records and are prepared in the normal course of business.

2) External evidence: This type of evidence comes from outside the client's organization. It may include documents issued by a person with whom the organization has had business transactions, such as payee's receipts, lease agreements, and bank statements. Auditors sometimes obtain external evidence directly, such as when they confirm balances with debtors and creditors.

The auditor should aim to obtain as much external evidence as possible, as it is generally more reliable than internal evidence. External evidence is preferred because it is less likely to be fabricated, since it requires collusion with an outsider. However, if external evidence is not available or appropriate, the auditor may have to rely on internal evidence. Regardless of the type of evidence, the auditor should subject it to appropriate scrutiny and obtain corroboration whenever possible. A lack of corroboration will require the auditor to investigate further to arrive at the facts.

5.8 General Principles of Vouching

To conduct vouching appropriately and effectively, auditors should follow certain principles, including:

1. Verify the authenticity of the transaction, accuracy of the recorded amount, and proper classification of accounts when vouching a transaction.
2. Cancel or mark vouchers that have already been checked by the auditor to prevent their reuse for fictitious transactions.
3. Ensure that every voucher is authorized by an officer responsible for this purpose.
4. Require the concerned officer's initials to support any alterations made to vouchers.
5. Keep in mind the distinction between capital and revenue items while vouching transactions.
6. Ensure that the voucher date falls within the accounting period.
7. Ensure that the voucher is made out in the client's name.
8. Ensure that the voucher includes all relevant documents expected to have been received or brought into existence when the transactions were entered into, making it complete in all aspects.
9. Make sure that the account in which the amount of the voucher is adjusted clearly discloses the character of the receipt or payment posted when included in the final accounts.
10. Number all vouchers serially and include the date.
11. Show the amount in the receipt in both words and figures and investigate if there are any differences.
12. Investigate any missing vouchers and request a proper explanation from the concerned official. If no satisfactory explanation is received, further investigation is necessary.

5.9 Challenges to Vouching

1. Teeming and lading

The fraudulent practice of misappropriating cash is often executed through the method of teeming and lading. This technique involves creating false entries for a transaction which are subsequently cancelled out by further entries, leading to a delay in recording cash receipts and hiding any shortages. Teeming and lading is also known as "delayed accounting of money received".

For instance, let's say that 50,000 is due from Mr. X, 1,00,000 is due from Mr. Y, and 1,50,000 is due from Mr. Z. In the first week of January, 50,000 is received from Mr. X, but the cashier fails to record it in the cash book and instead misappropriates the cash. In the next month, when 1,00,000 is received from Mr. Y, the cashier records 50,000 in the name of Mr. X and the remaining 50,000 in the name of Mr. Y. Then, in the following month, when Mr. Z pays his debt of 1,50,000, the cashier records 50,000 in the name of Mr. Y and 1,00,000 in the name of Mr. Z. The amount of `50,000 due from Mr. Z is then written off as bad debt in the balance sheet, and the misappropriated money is thus concealed.

If the auditor detects this fraudulent activity, the cashier may pass a false entry to record the receipts from Mr. Z and then use their own funds to pay `50,000, thereby using the company's money without any authority.

Detecting teeming and lading fraud can be challenging for auditors. However, by adopting appropriate vouching techniques, auditors can prevent misappropriation of cash. To detect this type of fraud, the auditor should take the following steps:

1. Verify the debtor’s ledger, especially for those who make partial payments of their dues.
2. Collect balance confirmation certificates from debtors whose accounts have been shown as due.

3. Evaluate the efficiency of the internal check system regarding the receipts of cash from customers before commencing vouching work.
4. Understand the discount facility provided to customers and the amount of bad debts to be written off.
5. Verify transactions shown in the cash book as deposited into the bank, and check the bank reconciliation statement if fraud is suspected.
6. Send statements of accounts to customers whose accounts have been shown as due and request that they contact the auditor immediately if any discrepancies are found.

5.10 Vouching of Income and Expenditure

1. Credit purchases

(a) Documents to be checked

(i) Purchase invoices,

(ii) Copies of orders placed,

(iii) Goods received note,

(iv) Copies of challans from supplier,

(v) Goods inward register and

(vi) Stock records.

(b) Duty of the auditor

(i) Vouching of credit purchases aims to ensure that all purchase invoices are accurately recorded in the purchase book, and that the goods listed in the purchases book are actually received by the client, who pays for only those goods that are delivered by the supplier.

(ii) As part of this process, the auditor should examine the internal check system in place to confirm that only credit purchases of goods are recorded in the purchases book.

(iii) It's also important to verify that the purchase of goods is authorized by a responsible official, and that the organization only purchases goods it deals with.

(iv) To confirm that the goods purchased are actually received by the client, the auditor should review the goods inward register, stock records, and challans from the supplier.

(v) Finally, the auditor should exercise extra care when vouching for purchases made in the first and last month of the accounting period. This is because purchases made in the last year may be included in the purchases of the first month of the current year, or purchases made in the last month of the current year may be recorded in the next year. This can result in the profit and loss account of the current year not presenting a true and fair position of the organization's operating results.

2. Credit sales

(a) Documents to be checked

(i) Sales invoices,

(ii) Challans,

(iii) Sales register/Goods outward register,

(iv) Stock records and

(v) Purchase order from customers.

(b) Duty of an auditor

(i) The primary objective of vouching credit sales is to ensure that all sales invoices are recorded in the sales book and the goods sold are actually sold by the client, and the client receives payment only for those goods that are supplied to the customers.

(ii) The auditor should review the internal check system to ensure that only credit sales of goods are recorded in the sales book.

(iii) The sales register should be checked against copies of sales invoices, and the sale of capital goods should not be recorded in the sales book.

(iv) Sales tax, goods and service tax, and other taxes collected through sales invoices should be recorded under separate accounts.

(v) It should be verified that all sales invoices are based on challans, and sales invoices are entered in the sales book and posted to the respective customer account. No sales invoice should be left unrecorded.

(vi) Trade discounts given to customers should be examined, and no separate entry for discounts should be made in the books.

(vii) The statement of account should be verified by obtaining confirmation from the customers.

(viii) The auditor should be especially careful when verifying sales made in the first and last months of the accounting period, as sales from the previous year may be included in the first month's sales of the current year or sales from the last month of the current year may be recorded in the next year. As a result, the profit and loss account of the current year may not present a true and fair position of the operating results.

3. Consignment sale

(a) Documents to be checked

(i) Consignment day book,

(ii) Account sales,

(iii) Agreement between the consignor (client) and the consignee,

(iv) Balance confirmation certificate from the consignee,

(v) Pro-forma invoices and

(vi) Goods outward book.

(b) Duty of the auditor

(i) The primary objective of vouching of credit sales on consignment is to ensure that only the profit on the goods sold through the consignee before the year-end is taken into account. No profit should be recognized for the goods that remain in the hands of the consignee.

(ii) To show the result of each consignment, goods sent on consignment through the consignment day book should be debited to the consignment account. The auditor should verify the debits in each consignment account using the pro-forma invoice, consignment day book, goods outward book, transport documents of the goods, acknowledgment of the goods by the consignee, and account sales.

(iii) The credits in the consignment account should be cross-checked with the account sales received from the consignee.

(iv) The agreement between the consignor and the consignee should be examined to ensure that the commission and other expenses credited to the consignee account are accurate.

(v) The stock held by the consignee at year-end should be included in the balance sheet at a consistent cost and credited to the consignment account to determine the result of the consignment transactions.

(vi) Confirmation of the consignee's account balance from the consignee should be obtained.

(vii) Sometimes, goods are consigned at an inflated price instead of cost. The auditor should ensure that the necessary adjustments to remove the loading are made at the end of the year.

(viii) It is possible that consigned goods are treated as ordinary sales. The auditor should ensure that the necessary adjustments are made at year-end with respect to unsold goods, commission, and expenses incurred by the consignee. The consignee should not be listed as a debtor for unsold goods, and these goods should be included in the valuation of stock at a consistent cost.

4. Goods on sale or return

(a) Documents to be checked

(i) Receipt of approval from the customer,

(ii) Sales invoices,

(iii) Stock records,

(iv) Goods inward book and

(v) Goods outward book.

(b) Duty of the auditor

(i) The auditor needs to verify whether there is a separate record for goods sold on approval basis.

(ii) It is the auditor's responsibility to ensure that goods sent on approval basis are not included in sales unless the customer has either intimated their approval or the stipulated time limit for approval has expired.

(iii) The internal control system regarding sales on approval basis should be checked by th auditor. Usually, sales invoices are prepared and sent to the customer on the receipt of approval or after the expiry of time limit.

(iv) It is also the auditor's duty to ensure that necessary arrangements have been made to retrieve the goods if the customer informs about the return of the goods within the stipulated time.

(v) The auditor must verify whether the goods sent on sale or return basis have been taken into the closing stock as stock with the customer if no intimation has been received from the customer, or the time limit has not expired yet.

(vi) The auditor must obtain a statement from the customer stating that the goods are still with them on approval basis.

5. Interest and dividend received on investments

(a) Documents to be checked

(i) Bank statement

(ii) Dividend warrants

(iii) Schedule of securities and

(iv) Agreement with party.

(b) Duty of the auditor

(i) When verifying dividends, the auditor must examine the counterfoils of the dividend warrants and any accompanying cover letters.

(ii) If dividends and interest are collected via a bank, the auditor must confirm the amount through the bank statement. In the case of warrants received but not yet collected, the auditor should ensure that they are shown as outstanding cheques.

(iii) When verifying interest, the auditor should examine the statement for fixed interest-bearing securities. Interest on bank deposits should be verified through the bank passbook, while interest on loans to parties can be checked against the relevant agreement.

(iv) The auditor should ensure that all interest received and accrued has been recorded in the books and correctly reflected in the balance sheet.

(v) If interest or dividend was received for the pre-acquisition period, the auditor should confirm that the cost of investment was adjusted accordingly for this pre-acquisition dividend or interest.

6. Bad debts recovered

(a) Documents to be checked

(i) Notification from the court/bankruptcy trustee

(ii) Letter from collection agency

(iii) Letters from debtors

(iv) Schedule of bad debts and

(vi) Bank passbook.

(b) Duty of the auditor

(i) The auditor needs to verify the total amount of bad debts and ensure that it has been properly accounted for in the company's books. This information is particularly important in cases where an insolvent debtor's recovered amount is distributed proportionally to their creditors.

(ii) The auditor should check that all recovered bad debt has been accurately recorded in the books.

(iii) It's important to review the credit manager's files to determine the exact amount of bad debt recovered.

(iv) The auditor should confirm that the amount collected from the bad debt has been promptly deposited into the bank.

(v) The auditor should cross-check the amount recovered against the receipt counterfoils or carbon copies issued to the debtors, and ensure that all receipts are serially numbered.

7. Insurance claim received

(a) Documents to be checked

(i) Counterfoil of the receipt

(ii) Insurance policy

(iii) Statement of claim submitted

(iv) Copy of the survey report and

(v) Correspondence with the insurance company.

(b) Duty of the auditor

(i) The auditor should check the counterfoil of the acknowledgement of receipt issued by theclient to know the actual amount recovered from the insurance company.

(ii) The auditor should examine the statement of the claim submitted by the client along with theinsurance policy to ensure that the claim has been submitted according to the provisions inthe insurance policy.

(iii) All the correspondences with the insurer on final determination of claim and payment thereofshould be examined along with the copy of survey report.

(iv) The accounting treatment of the amount received should be seen in order to ensure thatrevenue is credited with the appropriate amount and that in respect of claim against anasset, the profit and loss account is debited with the shortfall of the claim admitted againstthe book value.

(v) The auditor should also see that entries in the profit and loss account have been appropriatelydescribed, if the claim was lodged in a previous year but no entries were then passed.

8. Income from house property

(a) Documents to be checked

(i) Bills issued to tenants

(ii) Tenancy agreement

(iii) Rent receipts

(iv) Statement of rent received and

(v) Rent reconciliation statement,

(b) Duty of the auditor

(i) The auditor should verify the rent received from rental properties by comparing the counterfoils of rent receipts to determine the amount and duration of the rent paid.

(ii) The auditor should cross-check the copies of bills issued to tenants by referring to the tenant agreement and the charges paid by the client on behalf of tenants, such as electricity charges.

(iii) The auditor should examine the rent statement prepared by the client, if any, for each tenant or property and compare it to the rent register, if maintained, for accuracy.

(iv) The auditor should also verify the entries for rent received in advance or accrued rent and ensure that the necessary adjustment entries have been made for the corresponding accounting year.

(v) The auditor should reconcile the amount of rent received with the amount of rent receivable and investigate any discrepancies, including any adjustments made against the deposit.

(vi) The auditor should obtain a certificate from the responsible officer regarding any vacant property during the year.

9. Remuneration paid to directors

(a) Documents to be checked

(i) Resolutions of the general meeting,

(ii) Articles of Association,

(iii) Agreement with the directors,

(iv) Director's attendance registers and

(v) Receipts issued by the directors.

(b) Duty of the auditor

(i) The auditor should review the terms and conditions of appointment of directors by checking the minutes of the general meeting.

(ii) The Articles of Association should also be examined to determine the payment method.

(iii) The auditor should check the agreement with the directors to determine the amount to be paid to them for attending board meetings and other work, such as commission. The auditor should also verify the attendance of directors in board meetings by referring to the attendance register.

(iv) The auditor should ensure that all legal formalities as per the provisions of Sections 197 and 198 and Schedule V of the Companies Act, 2013, where applicable, have been properly followed.

(v) The auditor should thoroughly review the computation of net profits and commission payable to directors in accordance with Part II Schedule V to the Companies Act.

(vi) The auditor should verify the amount paid to the directors as remuneration by checking the receipts issued by the directors for this purpose.

10. Travelling expenses

(a) Documents to be checked

(i) Travelling rules of the organization,

(ii) Approved tour programmes,

(iii) Tour report,

(iv) Board meetings minutes,

(v) Reserve Bank of India (RBI) Permission letter

(vi) Air, railways tickets, etc.

(b) Duty of the auditor

(i) Prior to conducting the vouching of travelling expenses, it is crucial for the auditor to familiarize themselves with the organization's regulations on the admissibility and rates of travelling expenses and daily allowances.

(ii) The auditor should verify whether the travelling expenses have been incurred solely for those tour programmes that have been authorized by the competent authority.

(iii) The auditor should then meticulously scrutinize the travelling expenses invoices submitted by the staff, along with the appropriate supporting documents.

(iv) The auditor should also ascertain that the employees have submitted a statement of business done or a tour report, which has been reviewed by the proper authority.

(v) In the case of foreign trips, the auditor should examine the board's resolution to ensure that the trip has been authorized. The auditor should also ensure that the necessary authorization has been obtained from the RBI for foreign exchange transactions associated with the foreign trip.

(vi) The auditor should also ensure that any advances taken by the employees for this purpose have been correctly accounted for.

11. Salaries and wages paid

(a) Documents to be checked

(i) Salary bills,

(ii) Wage sheets or payroll,

(iii) Counterfoil of cheques,

(iv) Appointment letters,

(v) Service agreement and

(vi) Employment registers.

(b) Duty of the auditor

(i) Prior to conducting vouching work on salaries and wages, the auditor should verify the internal procedures and confirm that they have not been altered since the last audit.

(ii) The auditor should examine the salary bills and wage sheets, ensuring that all additions, calculations, and castings are correct.

(iii) The total amount paid for salaries and wages should be compared with the entries in the cash book. The auditor should compare the total of wage sheet and salary bill with the amount of cheque withdrawn. Any excess amount withdrawn should be deposited into the bank immediately, and the auditor should verify that this has been done.

(iv) The auditor should confirm that unclaimed salaries and wages have been deposited into the bank or that the concerned cheque has been cancelled.

(v) The auditor should verify that the wage sheet and salary bill have been certified by a responsible officer and check the employment register for dummy employees and workers.

(vi) The auditor should examine attendance records, salary bills, and wage sheets of earlier months, as well as appointment letters of new employees. If there is a significant increase in the wages and salaries of a month compared to the previous month, the auditor should investigate the reason for such an increase.

12. Travelling salesman's commission

(a) Documents to be checked

(i) Agreement with the salesman,

(ii) Receipts issued by salesman,

(iii) Statement of sales,

(iv) Appointment letters of the salesman and

(v) Commission statement.

(b) Duty of the auditor

(i) Before conducting vouching work for sales commission, the auditor should refer to the appointment letter or agreement to know the commission rate and terms of the salesman's assignment.

(ii) The auditor should examine the sales records and statement submitted by the salesman to verify the sales made and commission entitlement. The commission is typically paid based on the sales made by the salesman.

(iii) The accuracy of the commission calculation should be checked by the auditor, and the statement of commission submitted by the salesman should be cross-checked.

(iv) The auditor should ensure that the commission is paid only on the sales booked and executed within the year, and the payment of commission should be verified with receipts signed by the salesman.

(v) The auditor should also check if any provision has been made in the accounts for commission due but not paid to the salesman.

13. Freight, carriage and custom duty

(a) Documents to be checked

(i) Freight note,

(ii) Transport receipts,

(iii) Rate schedule of transport charges,

(iv) Rate of custom duty,

(v) Custom duty payment challans and

(vi) Correspondence with transporters and customs authorities

(b) Duty of the auditor

(i) The auditor should begin by determining the nature of the expenses, whether they are related to the purchase of raw materials, assets or the sale of goods, as the accounting treatment depends on the purpose for which they were incurred.

(ii) The auditor should verify that all expenses incurred are authorized properly.

(iii) The auditor should check whether there is a possibility of duty drawback or customs duty refund, and ensure that necessary adjustments have been made in the books of accounts.

(iv) The auditor should also review the purchase and sales terms and conditions to determine whether the expenses incurred can be recovered from third parties.

(v) The adequacy of transit insurance to cover the risk of loss due to goods lost in transit should be verified by the auditor.

(vi) The auditor should also examine all relevant documents to confirm that all payments made have been correctly accounted for.

14. Preliminary expenses

(a) Documents to be checked

(i) Board's minute book,

(ii) Receipts for the registration fees paid,

(iii) Bills and receipts issued by the printers,

(iv) Prospectus,

(v) Statutory report and

(vi) Other supporting papers and vouchers.

(b) Duty of the auditor

(i) Before accepting the preliminary expenses as capitalized expenses, the auditor should confirm whether these expenses are genuinely connected with the formation of the company.

(ii) The expenses incurred for the formation of the business should be authorized by the Board of Directors in their meeting, and the auditor should ensure that the expenses incurred have the required approval from the authority.

(iii) The auditor should evaluate the expenses incurred from the perspective of business propriety and verify the appropriateness of the expense amount.

(iv) The auditor should review the accounting policy of the entity concerning writing off of preliminary expenses to determine its justification.

(v) In some cases, obtaining shareholder approval is necessary to incur expenses on account of preliminary expenses. The auditor should confirm whether the required authorization has been received from the shareholders in this regard.

(vi) The entity is entitled to exemption for the preliminary expenses incurred in calculating business income under the Indian Income Tax Act. The auditor should ensure that this aspect has been correctly addressed.

5.11 Vouching of Assets and Liabilities

1. Land and building

(a) Documents to be checked

(i) Title deed,

(ii) Mortgage deed in case of mortgaged property,

(iii) Broker's note,

(iv) Contract,

(v) Receipts,

(vi) Architect's certificate,

(vii) Fixed asset register and

(viii) Minutes of the directors meeting.

(b) Duty of the auditor

(i) The Land and building may be freehold or leasehold. If it is freehold, it should be verified withthe owner's title. But if it is leasehold, the lease deed should be examined,

(ii) If the property is purchased directly from the vendor and if any contract is made with thevendor, that contract should have to be checked,

(iii) It also requires to be examined whether the ownership title of the property in favour of theclient is legal or not.

(iv) The various incidental charges are required to be incurred for the purchase of land and buildings,for example, registration expenses of the property. These expenses should be verifiedwith proper documents and receipts and the auditor should also confirm that these expenseshave been duly capitalized.

(v) If any building is constructed for the purpose of the business, the contract made with the buildingcontractor should be examined and in order to confirm the cost of construction, the certificatefrom the architect should be examined.

2. Trademark and copyright

(a) Documents to be checked

(i) Schedule of trademarks and copyright,

(ii) Assignment deed or agreement and

(iii) Contracts.

(b) Duty of the Auditor

(i) A schedule of trademarks and copyright duly signed by the responsible officer should beobtained and the same should be scrutinized. It should be confirmed that all of them areshown in the balance sheet.

(ii) The written agreement in case of assignment of copyright and the assignment deed in case oftransfer of trademarks should be examined.

(iii) Existence of copyright should be verified by reference to contract between the client and theother party.

(iv) It should be seen that the value has been determined properly and the cost incurred for thepurpose of obtaining the trademarks and copyrights have been capitalized.

(v) It should also be ascertained that the legal life of the trademarks and copyright have not yetexpired.

(vi) It should also be ensured that the amount paid for both the intangibles and assets is properlyamortized having regard to appropriate legal and commercial consideration.

3. Vouching of Borrowing from Banks

a) Documents to be checked

(i) Certificate from bank for securities deposited,

(ii) Minute of the board meeting,

(iii) Bank statement,

(iv) Letter of loan sanction and

(v) Bank passbook.

b) Duty of the auditor

(i) Borrowing from bank may be either in the form of overdraft limits or cash credit. The auditorshould confirm about the type of the loan from the letter of loan sanctioned from the bank.

(ii) Reconciliation of the balances in the overdraft or cash credit with that shown in the passbookshould be done and it should be confirmed that the last mentioned balance by obtaining acertificate from the bank showing the balance in the accounts as at the end of the year.

(iii) A certificate from the bank showing particulars of securities deposited with the bank as securityfor the loan should be obtained. It should be confirmed that the same has been correctly disclosedand duly registered with the Registrar of Companies and recorded in the register of charges.

(iv) The auditor should verify the authority under which the loan has been raised. In the case of acompany, only the Board of Directors is authorized to raise a loan or borrow from a bank.

(v) It should also be ascertained the purpose for which the loan has been raised and the mannerin which it has been utilized and that this has not prejudicially affected the concern.

4. Collection from debtors

(a) Documents to be checked

(i) Sales invoices

(ii) Receipts issued to customers

(iii) Statement of customers' accounts

(iv) Existing and past discount chart and

(v) Correspondence with the customers.

(b) Duty of the auditor

(i) The auditor should first of all check the existing internal control system in respect of cash collection,particularly collection from customers. When cash is received from customers, a cashmemo is issued; a counterfoil or carbon copy of such cash memo is retained by the receivingclerk. The auditor should verify the amount received from customers from that counterfoils orcarbon copies issued.

(ii) He should also ensure that amount received from customers has been entered in the cash bookon the day it is received.

(iii) He should also ensure that all these receipts are serially numbered. If any receipt is found tobe missing, he should ask the clarification from the concerned officials.

(iv) It should be seen that the discount allowed to customers is authorized by a responsible officer.In addition to that, the terms and conditions of discount should be properly ascertained andthe discount rates should be compared with the rates prevailing in the market.

(v) In case of suspicion, the auditor can contact the customers directly with the approval of theclient to verify the receipt of cash from them.

Summary

- The examination of documentary evidence in support of transactions contained in the books of account is referred to as vouching. It is the technique followed in an audit for establishing authenticity of the transactions recorded in the primary books of accounts.
- Objectives for which an auditor adopts vouching technique include checking that all transactions recorded in the books of accounts, verifying that no fraud or error has been committed, ensuring that every transaction to be recorded has been adequately recorded, confirming that the figures presented in the books of accounts are reliable, etc.

- Vouching is the backbone of an audit. Without vouching, auditing of financial statements cannot be conducted. By conducting vouching, the auditor ensures that a transaction is recorded in the proper account, a transaction pertains to the organization, there is proper authorization for all transactions, all transactions have been recorded and transactions have been classified and disclosed according to generally accepted accounting principles.
- Vouching and verification are not same. Vouching deals with the examination of the transactions at their point of origin, while verification usually deals with the balances contained in the balance sheet and profit and loss account.
- Vouching includes routine checking, checking of all totals, subtotals, carry forwards, posting and checking of all ledger accounts. The scope of routine checking is confined to the books of accounts but in case of vouching, the auditor has to go beyond the books of accounts in order to trace out the source of transaction.
- Voucher is documentary evidence, both internal and external, which is used to support the entries made in the books of accounts of an enterprise. Vouchers can be of two types: primary voucher and collateral voucher.

Keywords

- Vouching
- ***Audit risk***
- ***Verification***
- ***Teeming and Lading***
- ***Vouching of cash transactions***
- ***Vouching of capital expenditure***

Self Assessment

1. Which of the following is NOT a step in the vouching of assets?

A. Tracing the transaction to its source document
B. Examining supporting documents for authenticity
C. Verifying the accuracy of the accounting entry
D. Ensuring that the transaction has been properly authorized

2. What is the main purpose of vouching liabilities?

A. To ensure that all liabilities have been recorded in the books of accounts
B. To verify the accuracy of the liabilities recorded in the books of accounts
C. To ensure that all liabilities have been paid in a timely manner
D. To verify the authenticity of the supporting documents for liabilities

3. Which of the following is an example of a document that can be used for vouching an asset?

A. Purchase order
B. Sales invoice
C. Bank statement
D. Customer complaint

4. Which of the following is an example of a liability that may require vouching?

A. Accounts receivable
B. Accounts payable
C. Inventory
D. Prepaid expenses

5. Which of the following is NOT a purpose of vouching?

A. To detect errors in the accounting records
B. To ensure compliance with accounting standards
C. To verify the existence of assets and liabilities
D. To determine the profitability of the company

6. Which of the following is the primary purpose of vouching income?

A. To ensure that all income has been recorded in the books of accounts
B. To verify the authenticity of the supporting documents for income
C. To ensure that all income has been received and deposited in the bank
D. To verify the accuracy of the income recorded in the books of accounts

7. Which of the following documents can be used for vouching income?

A. Purchase order
B. Sales invoice
C. Bank statement
D. Employee timesheet

8. Which of the following is NOT a step in the vouching of income?

A. Examining supporting documents for authenticity
B. Ensuring that the income has been properly authorized
C. Tracing the income to its source document
D. Ensuring that all expenses have been recorded in the books of accounts

9. Which of the following is an example of a document that can be used for vouching expenditure?

A. Sales invoice
B. Bank statement
C. Purchase order
D. Customer complaint

10. What is the main purpose of vouching expenditure?

A. To ensure that all expenses have been paid in a timely manner
B. To verify the accuracy of the expenditure recorded in the books of accounts
C. To ensure that all expenses have been recorded in the books of accounts

D. To verify the authenticity of the supporting documents for expenditure

11. What is Teeming and Lading?

A. A method of recording inventory transactions
B. A method of verifying income and expenses
C. A method of detecting fraud in financial statements
D. A method of reconciling bank statements

12. What is the main purpose of teeming and lading?

A. To identify errors in the inventory records
B. To detect fraud in the inventory records
C. To reconcile the physical inventory with the recorded inventory
D. To track the movement of inventory in and out of the company

13. Which of the following is a step in the teeming and lading process?

A. Comparing the physical inventory count with the recorded inventory count
B. Examining the supporting documents for inventory transactions
C. Verifying the accuracy of the accounting entries for inventory
D. Tracing the inventory transaction to its source document

14. What is vouching?

A. The process of verifying the accuracy of financial statements
B. The process of reconciling bank statements
C. The process of tracing transactions from the source document to the ledger
D. The process of detecting errors in financial statements

15. Which of the following is a reason for vouching?

A. To detect fraud in financial statements
B. To reconcile the bank statements
C. To verify the accuracy of the financial statements
D. To track the movement of inventory

Answer for SelfAssessment

1.	C	2.	B	3.	A	4.	B	5.	D
6.	D	7.	B	8.	D	9.	C	10.	B
11.	A	12.	C	13.	A	14.	C	15.	C

Review Questions

1Write the objectives of vouching.

2. What do you mean by vouchers? What are its different types?

3. Distinguish between vouching and routine checking.

4. Explain the following statements—

(a) 'Vouching is the essence of auditing'.

(b) 'In vouching payments, the auditor does not merely seek proof that money has been paidaway'.

5. What do you mean by 'teeming' and 'lading'? What is the duty of an auditor in this respect?

6. How do you vouch the following?

(a) Custom duty paid on import of machinery.

(b) Income from house property.

(c) Royalty payable to a foreign collaborator.

(d) Travelling expenses.

(e) Interest and dividend received.

(f) Directors' fees paid.

(g) Preliminary expenses.

(h) Insurance premium paid.

Further Readings

- Auditing: Principles And Techniques By S. K. Basu, Pearsonn.S.
- A Hand Book Of Practical Auditing By B N Tandon, S Sudharsnam& S Sundharabahu, S Chand Publishing
- Auditing And Corporate Governance By Anil Kumar Jyotsna Rajan Arora Lovleen Gupta, Taxmann Publisher

Web Links

https://www.thkjaincollege.ac.in/onlineStudy/commerce/5thSem/audit/Unit-4%20Vouching-and-verification.pdf

https://www.krayonnz.com/user/doubts/detail/612cfc57efe8380049d8e733/what-is-teeming-and-lading

Dr. Arpit Sidhu, Lovely Professional University

Unit 06: Verification and Valuation of Assets and Liabilities

CONTENTS

Objectives

After studying this unit, you will be able to:

- Understand the meaning, objectives and challenges of verification and valuation
- Identify verification and valuation process of assets and liabilities

Introduction

One of the crucial responsibilities of an auditor in relation to auditing the accounts of a company is to authenticate the assets and liabilities presented in the balance sheet. The auditor's role extends beyond merely verifying the accuracy of the transactions recorded in the accounting books through vouching; they must also ensure that the assets mentioned in the balance sheet truly exist.

Failure on the part of the auditor to verify the assets can result in liability, as illustrated in the case of 'London Oil Storage Co. Ltd. vs Seear, Hasluck & Co. (1904)'. In this particular case, it was determined that the auditor is obliged to confirm the existence of the assets as stated in the balance sheet; otherwise, they will be held accountable for any harm suffered by the client

6.1 Meaning of Verification of Assets

Verification refers to the process of substantiating the existence or validating the presence of assets and liabilities as of the balance sheet date. Typically, verification entails examining the value, ownership, existence, and possession of assets in a company. Spicer and Pegler state that "Verification of assets implies an inquiry into the value, ownership and title, existence and possession, and the presence of any charge on the assets."

Hence, verification involves the following steps:

(a) Assessing the assets at their appropriate value.

(b) Establishing ownership and title of the assets.

(c) Confirming the existence of the assets.

(d) Ensuring that the assets are unencumbered by any charge or mortgage.

By conducting this comprehensive verification process, auditors can ascertain the accuracy and reliability of the assets reported in the balance sheet, thereby providing assurance to stakeholders.

6.2 Meaning of Valuation of Assets

Asset valuation refers to the assessment of the correctness and appropriateness of the recorded values assigned to assets appearing in a concern's balance sheet at the end of the fiscal year. Valuation involves the following key steps:

(a) Gathering all essential information related to the valuation process.

(b) Analyzing all available figures and data.

(c) Ensuring that the valuation is conducted in accordance with widely accepted conventions and accounting principles.

(d) Verifying the consistency of valuation methods used across consecutive years.

(e) Seeking an expert opinion to validate the accuracy of the valuation.

By performing these operations, auditors can ascertain the reliability and accuracy of asset values presented in the financial statements. This process is crucial for upholding transparency and ensuring that financial information provided to stakeholders adheres to established accounting standards and practices.

6.3 Importance of Verification of Assets

The auditor's responsibilities extend beyond the mere verification of entries recorded in the books. Merely substantiating an entry at the date it is made does not prove the existence of the corresponding asset at the balance sheet date, nor does it guarantee that the asset's value remains unchanged since the original entry. It is the auditor's duty to further substantiate the existence and value of such items as of the balance sheet date, which can be achieved through proper asset verification.

If the balance sheet includes assets that do not actually exist or are valued unreasonably, both the balance sheet and the profit and loss account will be inaccurate. For example, if the balance of sundry debtors includes irrecoverable debts amounting to 5000 and no provision has been made for such bad debts, the reported profit, asset value, and proprietor's fund will be overstated by that amount.

Under the Companies Act, the auditor's duties have been expanded through the Companies (Auditors Report) Order 1988, issued under Section 227(4A) of the Companies Act, 1956. This order requires auditors to include additional matters in their reports, such as the verification of fixed assets and stock. Therefore, it is crucial to conduct asset verification with utmost care. This order has been revised in 2003 and 2004.

Please note that Section 143(11) of the Companies Act, 2013 states that the Central Government, in consultation with the National Financial Reporting Authority, may direct, through general or special orders, that the auditor's report for specified classes or descriptions of companies should include a statement on certain matters as specified in the order.

6.4 Importance of Valuation of Assets

The auditor's primary responsibility is to verify the original cost of assets and ensure, to the extent possible, that such valuation is fair and reasonable. There are well-defined methods of valuation that auditors are expected to follow.

Assets can be valued based on either a 'going concern' or 'break-up value' basis. The going concern method involves determining the cost of acquisition of the assets and calculating the required depreciation rate. The break-up value basis is used when a company is being liquidated, and assets are valued at their realizable value. Different approaches are used to determine the value of assets in different situations.

The auditor is expected to apply their knowledge and expertise to assess the value of each asset, ensuring it is true and fair according to generally accepted valuation principles. While the auditor is not a valuer and cannot perform valuation functions, they verify the original cost and ascertain whether the current values are reasonable and in line with accepted commercial principles, as expressed by Lancaster.

Valuation plays a crucial role in every audit since the accuracy of the balance sheet relies on correctly valuing assets and liabilities. The auditor must ensure that the assets and liabilities reported in the balance sheet reflect their appropriate values.

6.5 Problems on Verification

The auditor's certification of the balance sheet, which reflects a true and fair view of the business's state of affairs, relies heavily on the proper verification of assets and liabilities. Without this verification, the auditor cannot fulfill their responsibilities or exercise their expertise and knowledge effectively.

For instance, when the auditor is tasked with verifying the stock-in-trade at the end of the accounting period, this process can be time-consuming, often taking weeks or even months to complete. Additionally, the auditor may need to seek assistance from experts in the field. Furthermore, certain assets such as goodwill, patents, copyrights, and trademarks do not have a physical presence. In such cases, the auditor must rely on available documents to conduct the verification.

In the Kingston Cotton Mills Ltd. Case (1896), it was established that "it is no part of an auditor's duty to take stock. No one contends that it is. He must rely on others for the details of stock-in-trade." Therefore, as long as there are no suspicious circumstances, the auditor is not expected to physically take stock themselves and can accept a stock certificate from a trusted official of the company without breaching their duty.

In summary, proper verification of assets and liabilities is crucial for the auditor to provide an accurate certification of the balance sheet, ensuring that it presents a true and fair view of the business's financial position. The auditor's role primarily involves relying on appropriate procedures and expert assistance to carry out this verification effectively.

6.6 Problems on Valuation

When conducting the valuation of assets and liabilities, auditors often encounter various challenges, which are outlined as follows:

(a) Character of the assets: In certain instances, it may be difficult to determine the character of an asset for valuation purposes, specifically whether it is a fixed asset or a current asset. The valuation process for fixed assets differs from that of current assets or investments, for example.

(b) Use of assets: Some assets may serve dual purposes, being available for sale while also being utilized within the organization. The valuation process is influenced by the nature of how these assets are used, such as in the case of furniture stock.

(c) Estimated life: The lifespan of fixed assets is not always certain. Valuation of these assets is based on estimated lifespans. However, determining the estimated life of an asset is a challenging task.

(d) Eventual problems: Auditors are unable to account for events that occur after the balance sheet date, which could impact the valuation of assets. Such post-balance sheet events are beyond the auditor's consideration.

(e) Lack of information: The auditor may not have access to all the necessary and relevant information required for determining the value of assets. This lack of information can hinder the accurate valuation process.

In conclusion, auditors face several obstacles when valuing assets and liabilities. Challenges arise from factors such as asset classification, utilization, estimating asset lifespan, post-balance sheet events, and the availability of complete and relevant information. It is crucial for auditors to navigate these difficulties to ensure an accurate valuation of assets and liabilities.

6.7 Window Dressing—a Challenge to Verification

Window dressing refers to an artificial practice employed to present a favourable current ratio position in accounting statements. When window dressing techniques are utilized in financial statement presentations, the financial position is portrayed in a manner that appears better than it actually is. It should be noted that window dressing is more of a misrepresentation than outright fraud.

Window dressing can be practiced in several ways, including:

(a) Deferring purchases: This involves showing purchases made in one year as if they occurred in the following year.

(b) Aggressive debt collection efforts: A significant drive is undertaken to collect book debts in order to make the book balance appear favourable.

(c) Recording future-year incomes in advance: Incomes expected in the next year are recorded prematurely in the current year's accounts.

(d) Misclassifying borrowed capital: Borrowed capital can be falsely represented as long-term debt capital.

(e) Insufficient provision for depreciation and bad debts: Inadequate amounts are set aside for depreciation and bad debts, leading to an artificially inflated financial position.

(f) Treating revenue expenditure as capital expenditure: Expenses that should be categorized as revenue expenditure are improperly recorded as capital expenditure, which has the effect of enhancing the financial position.

(g) Over- or undervaluation of assets and liabilities: Assets and liabilities are deliberately misstated to overstate or understate their value.

(h) Inflating profits through fictitious returns: Non-existent purchase returns and sales returns are entered to artificially inflate profits.

(i) Secret reserves during economic downturns: Utilizing undisclosed reserves to bolster financial statements during periods of economic depression, without informing shareholders.

It is the responsibility of the auditor to carefully verify the existence of assets and liabilities and ensure that the client has not resorted to window dressing practices. Sometimes, clients may only represent certain assets on paper, while they do not physically exist. Window dressing poses a challenge to the verification process, which the auditor must confront by conducting effective verification procedures.

In summary, window dressing involves the artificial manipulation of financial statements to present a more favourable financial position. The auditor's duty is to detect and prevent such practices through diligent verification work.

6.8 Verification and Valuation of Assets

1. Verification and valuation of intangible assets

A) Goodwill

Goodwill refers to an intangible fixed asset. The value of goodwill reported in the balance sheet does not represent its present value because its worth depends on various factors such as the financial position of the business, current earnings capacity, and future trends. However, in practice, goodwill is not valued at its cost.

Valuation of goodwill

Valuation of goodwill involves several methods. Nonetheless, unless goodwill is acquired through a purchase, it should not be recognized in the accounts. To accurately reflect the business's capital, an appropriate method should be employed to write down the cost of goodwill using available profits.

Auditor's duty regarding valuation:

1. The auditor must ensure that the goodwill presented in the balance sheet is not overstated compared to its cost price.
2. The auditor should verify that there is no appreciation of goodwill in the company's books.

Verification of goodwill

Verification of goodwill is not a physical process; rather, it involves carefully examining the accounting entries associated with goodwill.

Regarding the auditor's duty concerning verification:

1. The auditor should thoroughly examine the recorded goodwill in the books of account and verify it against the balance sheet.
2. If goodwill is created through the acquisition of a running business, the auditor should verify it by reviewing the contract between the client and the vendor.
3. Sometimes, management may attempt to capitalize current expenditures by inflating goodwill. The auditor should raise objections to such practices.

B) Patent

A patent is an official document that grants an inventor exclusive rights for a specified number of years to manufacture, use, and sell their invention.

Valuation of patent

Valuation of a patent involves considering its cost and depreciation. The cost includes the acquisition cost, whether through purchase or invention, as well as the cost of patent registration. However, renewal fees should be treated as revenue expenses. Depreciation should be charged based on the legal life of the patent, preferably using a fixed installments method.

The auditor's duties regarding valuation are as follows:

1. Verify that the company is registered as the owner of the patent.
2. Ensure that the patent is valued at cost less depreciation. If the commercial life of the patent is shorter than its legal life, depreciation should be spread over its commercial life only.

Verification of patent

Verification of the patent requires the physical inspection of the actual patent document. The auditor should confirm that the patent has been duly registered. In cases where the patent is jointly registered with an individual who developed the patented article, the auditor should verify that a registered assignment has been made from the individual to the entity.

The auditor's duties regarding verification are as follows:

1. Check the patent register to confirm its proper inclusion.
2. Ensure that the legal life of the patent has not expired.
3. Verify the latest renewal certificate of the patent.
4. Consider the possibility of litigation regarding the patent's title and obtain a certificate from the company's solicitors to ensure it is free from encumbrances.

C) Copyright

A copyright refers to the exclusive legal right granted to an author for the production or reproduction of a literary work, providing protection against unauthorized publication by others.

Valuation of copyright

Valuation of a copyright is generally not fixed since its value diminishes over time. In the balance sheet, it is presented at cost less any amounts written off periodically.

The auditor's duties regarding valuation are as follows:

1. Ensure that the value of the copyright is determined based on an appropriate basis, taking into account the duration of copyrights.
2. Verify that any copyrights that do not generate book sales are written off in the respective year.
3. Confirm that the legal life of the copyright has not expired.
4. Verify that copyrights without any commercial value have been completely written off.

Verification of copyright

Verification of a copyright involves inspecting the agreement between the author and the publisher. If there are multiple copyrights held by the client's business, the auditor should request a schedule of copyrights and verify them accordingly.

D) Trademark

A trademark is a distinctive mark that is attached to goods for sale in the market, serving to differentiate them from similar products and associate them with a specific trader or business.

Valuation of trademark

Valuation of trademarks can be justified by considering their renewal fees. If a trademark is purchased, the price paid for it is considered its value.

The auditor's duties regarding valuation are as follows:

1. Ensure that trademarks are correctly valued and accurately presented in the balance sheet.
2. If the trademark has been purchased, verify the payment made to the seller for its acquisition.
3. Confirm that all expenses related to acquiring the trademark have been treated as capital expenditure, while renewal fees are treated as revenue expenditure.

Verification of trademarks

Verification of trademarks involves examining the assignment deed endorsed by the office of the register of trademarks. If trademarks are purchased, the assignment of interest or assignment deed should be inspected.

The auditor's duties regarding verification are as follows:

1. Verify that trademarks are registered in the name of the client and are the property of the client.
2. Ensure that a proper distinction between capital and revenue expenditure is maintained.
3. Capitalize all research expenses related to trademarks.

2. Verification and valuation of fixed assets

A) Land and Buildings

Almost all the business or commercial undertakings have land and buildings of their own. For the purposesof verification and valuation of land and buildings, it can be classified into two types, which areas follows—

1. Freehold property.

2. Leasehold property.

1) Freehold property:

Verification:

1. The auditor should inspect the title deed to ensure its validity. A certificate from the client's legal advisor should be obtained, confirming the title's authenticity.
2. The auditor should verify that the conveyance deed has been properly registered according to the Indian Registration Act, and all necessary endorsements have been made.
3. If the property is mortgaged, the title deed would be held by the mortgagee. A certificate should be obtained to confirm this.
4. In the case of property constructed or developed by the client, the auditor should ensure that the materials, labor, and overhead costs are appropriately capitalized.

Valuation:

1. The auditor should compare the original cost and any subsequent improvements with the original deed and receipts. Additionally, all expenses related to registration, brokerage, and legal fees should be properly capitalized.
2. The cost of buildings should be depreciated based on their structure quality and current usage.
3. The auditor should review repair expenditures to exclude them from the capital cost.
4. For properties constructed by the client, the auditor should refer to contractor's bills and relevant accounts.

2) Leasehold property

Verification:

1. The auditor should review the lease or assignment documents to determine if any premium has been paid and to understand the terms and conditions of the lease.
2. The auditor should verify whether the lease has been properly registered.
3. Compliance with all lease conditions should be checked by the auditor.
4. The auditor should confirm the proper recording of legal expenses associated with acquiring the lease.

Valuation:

1. The value of the leasehold property should be verified by referring to the lease deed. Any additions or expansions should be supported by contractor's bills and relevant documents.
2. The auditor should ensure that provisions are made for potential claims arising under the dilapidation clause upon lease expiry.
3. Proper depreciation of the cost and legal expenses incurred to acquire the lease should be verified, spread over the expected term of the lease.
4. The auditor should check that the accounting for leasehold property is maintained separately.

B) Building

Verification:

1. The auditor should examine the title deed of buildings to confirm that the client holds the title as of the balance sheet date. If the building is mortgaged, a certificate should be obtained from the mortgagee.
2. If the building is leasehold, the auditor should review the appropriate lease deed to determine the cost and amortization details.
3. Compliance with all conditions specified in the lease deed should be verified by the auditor.
4. The auditor should check if relevant information about buildings is recorded in the client's fixed assets register.

Valuation:

1. The auditor should verify the original cost of the building by referring to the deed of conveyance. If the client constructed the building, the original cost should be verified using the contractor's bill.
2. The auditor should ensure that appropriate depreciation has been provided for the building. If no depreciation is recorded, a note should be included in the profit and loss account.
3. The auditor should confirm that the buildings are valued at cost less depreciation, following the requirements of Schedule III for companies.
4. If any revaluation has occurred, the auditor should review the basis of revaluation and ensure that the appropriate disclosure has been made.

C) Plant and Machinery

Verification:

1. The auditor should request the plant register or a detailed schedule of plant and machinery to identify specific items and check their details against the balance sheet.
2. In the case of a company, the management is responsible for physically verifying the plant and machinery. The auditor should examine the related working papers for verification.

3. Additions and disposals of plant and machinery during the year should be verified by comparing them with purchase invoices and relevant documents.
4. The auditor should select some important items of plant and machinery for test-checking purposes.

Valuation:

1. The cost price of each plant or machinery item, including any installation costs, should be verified by examining supplier invoices and supporting documents.
2. The auditor should ensure that proper depreciation has been provided for the plant and machinery during the year.
3. If any items have been disposed of or sold, the auditor should confirm that the authorization was appropriate and that the sale proceeds were credited to the plant and machinery account. Any capital profit should be transferred to the capital reserve.
4. The auditor should verify that the plant and machinery have been correctly categorized under fixed assets in the balance sheet.

D) Furniture and Fixtures

Verification:

1. The auditor should determine whether a register is maintained for furniture and fixtures that includes details such as the item's nature, acquisition cost, location, and code number.
2. The auditor should verify whether the furniture and fixtures bear the assigned code numbers.
3. The auditor should inquire whether the management has conducted physical verification of the furniture and fixtures. If so, the auditor should review the related working papers.
4. The auditor should physically verify some important items of furniture and fixtures on a test-check basis.

Valuation:

1. The auditor should ensure that proper depreciation has been applied to the furniture and fixtures, and that the value of damaged or unserviceable items has been written off.
2. The auditor should confirm that the cost of furniture and fixtures has been accurately determined and recorded in the books of accounts.
3. The auditor should inquire whether any items have been disposed of or sold during the year. If so, the auditor should check that the transactions were properly authorized and that the sale proceeds were credited to the furniture and fixture account. Any capital profit generated should be transferred to the capital reserve.
4. The auditor should verify that furniture and fixtures have been correctly presented as fixed assets in the balance sheet.

E) Motor Vehicles

Verification:

1. The auditor may request a schedule of motor vehicles and compare it with the motor vehicles register maintained by the company.
2. The auditor should verify the additions and disposals of motor vehicles during the year by reviewing purchase invoices and other relevant documents.
3. The auditor should conduct test-checks on important motor vehicle items to ensure their accuracy.

Valuation:

1. The auditor should verify the cost price of motor vehicles, including any installation costs, by examining supplier invoices and supporting documents.
2. The auditor should ensure that proper depreciation has been applied to motor vehicles during the year.
3. If any motor vehicle items have been disposed of or sold, the auditor should verify that the transactions were authorized and that the sale proceeds were correctly credited to the motor vehicle account. Any capital profit resulting from the sale should be transferred to the capital reserve.
4. The auditor should verify that motor vehicles have been accurately included as fixed assets in the balance sheet.

F) Bills Receivables

Verification:

1. The auditor should review the bills receivable book and prepare a schedule of all bills receivable that have not yet matured before the balance sheet date.
2. If a significant number of bills are held by banks for collection, the auditor should obtain a detailed certificate from the bank to confirm the status of those bills.
3. If any bills have been discounted or endorsed but remain outstanding at the time of the audit, the auditor should disclose any contingent liability related to those bills in a footnote to the balance sheet.
4. Bills that have been dishonored before the balance sheet date should not be included as "bills receivable in hand" since they are no longer assets of the entity.

Valuation:

1. The auditor should ensure that the bills are properly drawn, stamped, and duly accepted, and that they are not overdue. In the case of bill renewals, the auditor should compare the new bill with the old one.
2. If any bills have matured and been honored between the balance sheet date and the audit date, the auditor should verify the cash received as recorded in the subsequent year's cash book.
3. If any bills have been retired before the balance sheet date, the auditor should cross-check the proceeds received with the cash book.
4. For bills that were discounted before their maturity date, and the maturity date falls after the balance sheet date, the auditor should ensure that the discount on such bills is appropriately allocated between the periods covered by the two separate financial years.

G) Cash at Bank

Verification:

1. The auditor should compare the balances shown in the passbook with the balances shown in the cashbook to reconcile any discrepancies.
2. The auditor should prepare a bank reconciliation statement or review the statement prepared by the client to determine the correct bank balance.
3. A balance confirmation certificate should be obtained from the bank at the year-end to confirm the bank balance.
4. Separate certificates should be obtained from different banks for fixed deposit accounts, current accounts, and savings bank accounts to confirm the total deposits across different banks.

Valuation:

1. To determine the current status of checks issued but not yet presented or checks deposited but not collected, the auditor should cross-verify the figures through the cashbook and passbook.
2. If amounts are deposited in foreign banks under exchange control regulations, this information should be disclosed.
3. If amounts are kept in different reserve accounts in banks to avail deductions under the Indian Income Tax Act, this information should also be disclosed.
4. The auditor should ensure that the bank balances are accurately disclosed in the balance sheet in accordance with Schedule III of the Companies Act, 2013.

H) Prepaid Expenses

Verification:

1. The auditor should verify the receipts for prepayments, which are expenses paid in the current period for future financial periods.
2. The amount of prepaid expenses should be correctly presented on the asset side of the balance sheet under current assets. The auditor should ensure proper disclosure in the balance sheet.
3. The auditor should ensure that prepaid expenses from the previous accounting period are appropriately adjusted. Expenses paid in the last year that pertain to the current accounting year should be accounted for correctly.
4. The auditor should also review the adjustments made in the subsequent year, if possible, related to prepaid expenses incurred during the current year.

6.9 Verification and Valuation of Liabilities

Verification of liabilities is crucial for ensuring the accuracy and fairness of the balance sheet. The auditor's responsibilities include:

(a) Confirming that the liabilities presented in the balance sheet are genuinely payable.

(b) Ensuring that all liabilities are accurately recorded in the company's books.

(c) Verifying that the recorded liabilities are related to legitimate business operations.

(d) Verifying that any contingent liabilities are appropriately disclosed in the balance sheet through footnotes.

Liabilities can be categorized into three main types:

1. Fixed or long-term liabilities, such as share capital, debentures, and long-term loans from banks and financial institutions.
2. Current liabilities, including sundry creditors, bills payable, and bank overdrafts.
3. Contingent liabilities, which involve potential liabilities such as disputed income tax obligations or pending lawsuits for damages.

By applying suitable verification techniques, the auditor ensures that liabilities are accurately represented and disclosed, contributing to a reliable assessment of the company's financial position.

1.9.1.Verification and valuation of fixedor long-term liabilities

A) Debentures

Verification:

1. The auditor should review the company's memorandum and articles to determine the borrowing power and any limitations on borrowing.
2. If a prospectus has been issued, the auditor should examine it to ensure compliance with its terms.
3. The auditor should extract balances from the register of debenture-holders and reconcile them with the debenture account in the general ledger.
4. The auditor should examine a copy of the debenture bond to understand the terms and conditions, assets pledged as security, and the redemption method.
5. In the case of mortgaged debentures, the auditor should review the debenture trust deed to verify compliance with its terms by the company.

Presentation:

1. Debentures should be presented under "Non-current Liabilities" in the balance sheet.
2. Debentures subscribed by directors and managers should be shown separately.
3. Accrued and due interest on debentures should be included with the debentures, while accrued but not yet due interest should be classified as "Current Liabilities."
4. The nature of the provided security should be disclosed.
5. The terms and conditions of debenture redemption or conversion, including the earliest redemption or conversion date, should be stated.

B) Secured Long-Term Loans

A company can obtain loans from banks and other financial institutions on the basis of security provided.For the purpose of verification of long-term loans, it can be classified under two broad categories—

1. Loans against security of fixed assets.

2. Loan against security of stock.

(1) Loans against security of fixed assets:

1. The auditor should review the memorandum and articles of association to determine if the company is authorized to borrow against fixed assets.
2. The loan account in the ledger and related documents pertaining to the fixed assets should be examined by the auditor.
3. The auditor should verify the execution of the mortgage deed and ensure its proper completion.
4. Enquiries should be made to ascertain whether the lender has the right to lend money against such security.
5. Confirmation from the lender should be obtained to verify the loan amount.
6. The auditor should verify if the principal is being repaid as stipulated and if interest payments are made regularly according to the terms specified in the CARO (Companies (Auditor's Report) Order) guidelines.

(2) Loans against security of stock:

1. Inspection of go-down keeper's receipts should be conducted if the loan is secured against such receipts.
2. In the case of stocks held at dock or in a bonded warehouse, the auditor should examine the dock warrant or warehouse certificate endorsed in favor of the lender.
3. The regular payment of warehouse rent by the client should be verified by the auditor. If it has not been paid, adequate provision should be made.
4. A certificate from the lender, indicating the details of the deposited securities, should be obtained to confirm accurate disclosure and proper registration with the Registrar of Companies, as well as entry in the Register of Charges.
5. The authority under which the loan was raised should be verified by the auditor. In the case of a company, only the Board of Directors is empowered to borrow or raise a loan from a bank.
6. Compliance with Section 180 of the Companies Act, 2013, which sets the maximum limit on loan amounts a company can raise, should be confirmed by the auditor.

1.9.1.Verification and valuation of current liabilities

A) Sundry Creditors

1. The auditor should verify trade creditors by obtaining a statement of their balances, duly signed by an authorized official, and compare these balances with the purchase ledger.
2. Confirmatory statements may be obtained from the creditors to validate the amounts owed.
3. Invoices received from suppliers should be examined by the auditor. Test checking of purchases, especially those made towards the end of the year, should be performed.
4. If debts have remained unpaid for an extended period, the auditor should investigate the matter thoroughly. There could be instances where the funds intended for creditors have been misappropriated by company officials.
5. If the client has made provisions for discounts on creditors, the auditor should cross-verify these provisions against the corresponding creditor accounts.
6. The auditor should reconcile the purchase ledger with the books of original entry, such as invoices and credit notes.
7. To account for any purchase returns, the auditor should review the "Return Outward Book" and compare it with credit notes issued by the suppliers.

8. The auditor should be particularly vigilant when reviewing entries made at the beginning or end of the year, as these periods are susceptible to fictitious entries.

B) Bills Payable

1. The auditor should obtain a statement of bills payable and compare it with the bills payable book and the bills payable account.
2. If any bills payable have been paid between the date of the balance sheet and the date of the audit, the auditor should examine the cash book and bank pass book to verify the payments.
3. The auditor should check the cash book and examine the returned bills payable to confirm the payment of bills that were already due.
4. It is important for the auditor to ensure that bills that have been paid are not recorded as outstanding.
5. The auditor should seek confirmation of amounts due on bills accepted by the client from the parties holding those bills.
6. The auditor should reconcile the total of outstanding bills payable at the end of the year with the balance in the bills payable account.

C) Bank Overdraft

1. The auditor should review the overdraft agreement with the bank to understand the terms, conditions, and maximum limit of the overdraft facility.
2. In the case of a company, the auditor should examine the Memorandum of Association to determine the borrowing powers and any limitations set forth.
3. The auditor should verify the minutes of board meetings to ensure that the bank overdraft borrowing is authorized by the board of directors.
4. If the client is a company and the overdraft is secured against any assets, the auditor should verify if the charge created has been properly registered with the Registrar of Companies, if required.
5. The auditor should obtain a confirmation certificate from the bank regarding the amount of overdraft outstanding at the end of the financial year.
6. The auditor should verify that the interest on the overdraft has been appropriately accounted for.
7. It is important for the auditor to confirm that the amount overdrawn does not exceed the maximum limit sanctioned by the bank.

D) Provision for Taxation

1. The auditor should review the tax liability and carefully examine the computation of the assessable profit and loss account. Any adjustments affecting taxable profit should be thoroughly scrutinized.
2. Past completed assessments should be reviewed to understand the nature of adjustments made in previous years.
3. The amount of advance tax paid and its calculations should be verified to assess the liability for future taxation.
4. If the income tax return has already been filed before the audit date, the auditor should review a copy of the filed return.
5. The auditor should ensure that the overall provision for income tax on the balance sheet date is sufficient, taking into consideration the current year's provision, advance tax paid,

previous provisions made, assessment orders received until the audit date, pending appeals, and any potential refunds.

6. It is advisable for the auditor to obtain a certificate from a tax practitioner confirming the amount of tax payable.

E) Outstanding Liabilities for Expenses

1. The auditor should request a list of outstanding expenses from the client, categorized based on the nature of the expenses.
2. Verification of supporting documents is necessary to authenticate the existence of outstanding expenses.
3. If outstanding expenses are estimated, the basis for estimation should be examined by the auditor.
4. The auditor should review the cash book for the following year to confirm that regular outstanding expenses have been paid before the audit.
5. It is important to ensure that no outstanding expenses have been paid without being recorded in the accounts. If such payments are identified, the auditor should verify the adjustment entries made for this purpose.
6. A comparison between the list of outstanding expenses for the current year and the previous year should be conducted to identify significant deviations.
7. The auditor should ensure that all usual outstanding expenses have been accounted for and provided.
8. Verification should be made to confirm that outstanding expenses are appropriately presented as current liabilities in the balance sheet.

1.Verification and valuation of contingentliabilities

A contingent liability refers to a potential obligation that may become an actual liability in the future, contingent upon the occurrence of a certain event. It is not a current liability but has the potential to convert into one based on uncertain future events.

According to W. B. Meigs, a contingent liability is described as "potential obligations that may develop into actual liabilities or dissolve without requiring any payment." Examples of contingent liabilities include discounted bills receivables, pending lawsuits for damages or compensation, disputed income tax liabilities, and bank guarantees on behalf of a company.

During the audit process, the auditor may come across contingent liabilities while examining the company's books, correspondence, minute books, bank statements, and other relevant documents. The auditor's responsibilities regarding contingent liabilities are as follows:

1. Review the company's minute book to identify all contingent liabilities existing at the end of the year.
2. Analyze lawyers' bills to identify any unreported contingent liabilities.
3. Examine correspondence with the bank regarding bills that have been discounted but have not yet matured.
4. Review bank letters to determine guarantees issued on behalf of other companies or individuals.
5. Scrutinize correspondence with suppliers, customers, lawyers, etc., to identify any potential contingent liabilities.
6. Verify investments in shares made by the client to identify any liabilities related to partly paid-up shares.
7. Assess any arrears of preference dividend on cumulative preference shares.
8. Obtain a certificate from management stating that known contingent liabilities have been included in the accounts and properly disclosed.

By performing these procedures, the auditor ensures that contingent liabilities are identified, appropriately accounted for, and disclosed in the financial statements of the company.

Summary

- Verification means the proof of existence or confirmation of assets and liabilities on the date of balance sheet. It is a process which includes valuation of asset and liabilities, checking of ownership and title of the asset, confirmation about their existence and satisfaction about the condition that they are free from any charge.
- Valuation of assets is a crucial aspect of the audit process, involving the examination of the accuracy and appropriateness of the asset values presented in the balance sheet at the end of the financial year. It is an integral part of asset verification, which also encompasses assessing ownership rights, asset existence within the business, and absence of any encumbrances or mortgages.
- The auditor's duty is to validate the existence and value of assets and liabilities as of the balance sheet date. If the balance sheet includes non-existent assets or assets valued differently from what is reasonable, both the balance sheet and the profit and loss account would be inaccurate.
- Valuation plays a significant role in every audit, as the fairness of the balance sheet relies on accurate valuation of various assets and liabilities. The auditor ensures that the assets and liabilities reflected in the balance sheet are appropriately valued.
- Key principles for asset verification and valuation encompass the acquisition and sale of assets, depreciation, physical verification, and charges on assets.
- Proper verification and valuation of assets and liabilities are essential for the auditor to certify that the balance sheet provides a true and fair view of the business's financial status. However, the auditor cannot solely rely on their own responsibility and expertise but must perform these functions based on available knowledge and information.
- Valuation-related challenges involve factors such as the nature and use of assets, estimated asset life, potential issues, and insufficient information. These factors can impact the accuracy of asset valuation during the audit process.

Keywords

- Valuation of assets
- Verification
- Accuracy
- Balance sheet
- Ownership rights
- Charge or mortgage
- Substantiate
- Fairness
- Basic principles
- Acquisition
- Depreciation
- Physical verification

Self Assessment

1. Which of the following is true regarding the verification of assets and liabilities?

A. It is not necessary for the auditor to verify the existence of assets and liabilities.
B. Verification includes examining ownership rights and the absence of charges or mortgages.
C. Valuation is not an important part of the audit process.
D. The auditor has no responsibility for verifying assets and liabilities.

2. What is the purpose of valuation in the audit process?

A. To inflate the value of assets and liabilities for financial gain.
B. To determine the fair and accurate value of assets and liabilities.
C. To bypass the need for verification of assets and liabilities.
D. To manipulate the balance sheet for personal interests.

3. Which of the following is a basic principle to be followed for the valuation of assets?

A. Inflating the value to maximize profits.
B. Ignoring the estimated life of assets.
C. Conducting physical verification of assets.
D. Disregarding any charges on assets.

4. What is the auditor's responsibility regarding the verification and valuation of assets and liabilities?

A. The auditor has no role in verifying or valuing assets and liabilities.
B. The auditor must certify the balance sheet without performing any verification or valuation.
C. The auditor is responsible for ensuring the accuracy and propriety of asset and liability valuation.
D. The auditor relies solely on the client's assessment of asset and liability values.

5. What are some challenges or problems associated with asset valuation?

A. Lack of information and eventual problems.
B. Inflating the value of assets for personal gain.
C. Disregarding the estimated life of assets.
D. Reliance on client-provided asset values without verification.

6. Which of the following statements is true regarding the verification of assets?

A. Verification is not necessary for fixed assets, only current assets require verification.
B. Verification includes examining the ownership rights and existence of assets.
C. Verification is only relevant for liabilities, not assets.
D. Verification is solely the responsibility of the company's management, not the auditor.

7. What is the purpose of valuing assets and liabilities in an audit?

A. To manipulate the financial statements and misrepresent the company's financial position.

B. To determine the fair and accurate value of assets and liabilities.

C. To avoid the need for physical verification of assets.

D. To minimize the reported value of liabilities and maximize the reported value of assets.

8. Which of the following is a principle to be followed for the valuation of liabilities?

A. Understating the value of liabilities to reduce financial obligations.

B. Ignoring the estimated life of liabilities.

C. Ensuring that liabilities are fully disclosed in the financial statements.

D. Disregarding any charges or mortgages on liabilities.

9. What is the auditor's role in verifying and valuing assets and liabilities?

A. The auditor is responsible for setting the values of assets and liabilities.

B. The auditor should rely solely on management's assessments without further verification.

C. The auditor is responsible for ensuring the accuracy and reliability of asset and liability values.

D. The auditor has no involvement in the verification and valuation process.

10. What are some challenges in valuing assets and liabilities?

A. Lack of information and uncertainty surrounding the values.

B. Overstating the values to inflate financial performance.

C. Disregarding the physical existence of assets and liabilities.

D. Accepting management's estimates without question.

11. When verifying assets, the auditor's main focus is on:

A. Assessing the profitability of the assets.

B. Examining the physical condition and location of the assets.

C. Determining the market value of the assets.

D. Ensuring compliance with tax regulations related to the assets.

12. Which of the following is an example of a contingent liability?

A. Outstanding trade payables.

B. Long-term bank loans.

C. Pending legal claims against the company.

D. Accrued salaries and wages.

13. What is the auditor's responsibility regarding the valuation of assets?

A. To determine the selling price of the assets.

B. To ensure that the assets are recorded at their historical cost.

C. To assess the economic value of the assets.

D. To verify the accuracy and reasonableness of the asset values.

14. In the context of verification and valuation, what does "freeness from charge or mortgage" mean?
A. The assets are not encumbered by any legal claims or liens.
B. The assets are readily convertible to cash.
C. The assets have no physical restrictions on their use or transfer.
D. The assets are not subject to any depreciation.

15. Which of the following is a principle to be followed for the verification of liabilities?
A. Understating the liabilities to improve the financial position of the company.
B. Ensuring that all liabilities are properly disclosed in the financial statements.
C. Ignoring the existence of contingent liabilities.
D. Treating all liabilities as fixed and non-negotiable.

Answer for Self Assessment

1.	B	2.	B	3.	C	4.	C	5.	A
6.	B	7.	B	8.	C	9.	C	10.	A
11.	B	12.	C	13.	D	14.	A	15.	B

Review Questions

1. What is verification of assets and liabilities?
2. Distinguish between verification and valuation.
3. Discuss the importance of verification and valuation of assets.
4. What is intangible asset? Give five examples of intangible assets.
5. What do you mean by fictitious assets? Give an example.
6. What is meant by contingent liability? Discuss the auditor's duty in this regard.
7. 'An auditor is not a valuer, though he is intimately connected with values'— Discuss thestatement referring to the relevant case decisions.
8. 'It has been stated that the valuation of investment for the balance sheet purpose depends largelyupon the object for which investments are held'—Discuss the statement.
9. How do you verify the following items?
   Raw material stock
   Land
   Preliminary expenses
   Investment
   Work-in-progress
   Copyright
   Machine purchased on H.P. system
   Patterns and designs
   Freehold properties
   Loans and advances
   Debtors
   Secured loan.

10. What do you mean by 'window-dressing of balance sheet'? State the duties of an auditor in thisrespect.

Further Readings

- Auditing: Principles And Techniques By S. K. Basu, Pearsonn.S.
- A Hand Book Of Practical Auditing By B N Tandon, S Sudharsnam& S Sundharabahu, S Chand Publishing
- Auditing And Corporate Governance By Anil Kumar Jyotsna Rajan Arora Lovleen Gupta, Taxmann Publisher

Web Links

https://gacbe.ac.in/pdf/ematerial/18BCO55S-U3.pdf

https://www.tutorialspoint.com/auditing/auditing_verification.htm

https://chetanmalikclasses.com/verification-and-valuation-of-assets-and-liabilities-reviewed/

Unit 07: Auditor's Report

CONTENTS

Objectives

After studying this unit, you will be able to:

- Understand the meaning, objectives and challenges of verification and valuation
- Identify verification and valuation process of assets and liabilities

Introduction

A report is a document that presents a compilation of well-researched and carefully analyzed information, intended to provide clear and concise details to individuals who may not have access to the complete knowledge on the subject matter of the report. Joseph Lancaster defines a report as a means of conveying an informed perspective to relevant individuals, aiming to offer a succinct summary based on factual data and figures.

7.1 Definition of An Audit Report

According to Section 143(2) of the Companies Act, 2013, an auditor is obligated to provide a report to the shareholders of a company, assessing whether the examined financial statements present a 'true and fair' view of the business's state of affairs. The auditor delivers a comprehensive report to the client, presenting clear and concise information regarding the audit findings. The content of the auditor's report is exclusive and not obtainable from any other source.

The statutory auditor of a company bears the responsibility of expressing a professional opinion on the accuracy and fairness of the company's financial position as depicted in the balance sheet, as well as the profit or loss shown in the profit and loss account. Additionally, the auditor's report encompasses various other relevant information.

Therefore, an auditor's report is a written statement wherein the auditor presents their independent professional opinion regarding the accuracy and validity of the accounts and financial statements examined, along with specific details, which the auditor submits to their client upon completing the audit."

7.2 Essentials of a Good Audit Report

The key elements of an effective audit report are as follows:

1. Simplicity: A good audit report should prioritize simplicity, ensuring clarity and ease of understanding. It should avoid the use of ambiguous terms and information that could lead to confusion.
2. Clarity: The term 'clarity' emphasizes the need for a transparent and straightforward audit report. It should not conceal any material information that is crucial for evaluating and assessing the business's performance.
3. Brevity: 'Brevity' refers to the concise nature of an audit report. Repetition of facts and figures should be avoided to maintain a reasonable length for the report.
4. Firmness: The report should clearly define the scope of work conducted and explicitly state whether the company's books of accounts present a 'true and fair' view of the business's state of affairs.
5. Objectivity: An audit report should be based on objective evidence. Opinions formed without proper quantification or measurement should not be included in the report.
6. Consistency: Consistency in presenting accounting information is fundamental to a good audit report. It should assess whether there has been adherence to consistent methods of stock valuation and depreciation charges.
7. Generally Accepted Accounting Principles (GAAP): The audit report should be based on facts and figures maintained in accordance with the universally accepted accounting principles.
8. Disclosure: An unbiased audit report should disclose all relevant facts and present the complete truth without any bias.

By incorporating these elements, an audit report can meet the standards of quality and provide accurate and reliable information to stakeholders.

7.3 Contents of Audit Report

"Under Section 143(3) of the Companies Act, 2013, the auditor's report of a company is required to include the following aspects:

(a) The auditor must confirm whether they have sought and obtained all necessary information and explanations for the purpose of the audit. If any information was not obtained, the report should specify the details and the impact of such information on the financial statements.

(b) The auditor needs to express an opinion on whether proper books of account, as required by law, have been maintained by the company based on their examination. They should also state if adequate returns from branches not visited by them have been received.

(c) If the accounts of any branch office have been audited by someone other than the company's auditor, the report should mention whether the auditor has received the report on those accounts as per the provisions and how they have considered it in preparing their report.

(d) The auditor must assess whether the company's balance sheet and profit and loss account, which are discussed in the report, are in agreement with the books of account and returns.

(e) The report should state the auditor's opinion on whether the financial statements comply with the accounting standards.

(f) The auditor should include observations or comments on any financial transactions or matters that have an adverse effect on the company's functioning.

(g) The report should indicate if any director is disqualified from being appointed as a director under Section 164(2).

(h) Any qualification, reservation, or adverse remark regarding the maintenance of accounts and other related matters should be disclosed.

(i) The auditor must express their opinion on whether the company has an adequate internal financial controls system in place and assess the operating effectiveness of such controls.

(j) Finally, the report should cover any other matters prescribed by the applicable regulations.

These provisions ensure that the auditor's report provides a comprehensive assessment of the company's financial status and adherence to legal requirements."

7.4 Basic Elements of Audit Report

As prescribed in Standard on Auditing-700, the auditor's report includes the following basic elements, ordinarily in the following layouts:

1. Title: The auditor's report should have an appropriate title.

2. Addressee: Generally, the auditor's report is addressed to the authority appointing the auditor.

3. Opening or introductory paragraph: The report should begin with an opening paragraph that includes the following elements:

(a) Identification of the financial statements that have been audited.

(b) A statement highlighting the responsibility of the entity's management for the preparation and presentation of the financial statements, as well as the responsibility of the auditor to express an opinion on those financial statementsbased on the audit.

In summary, the opening paragraph of the report should clearly state the identification of the audited financial statements and emphasize the respective responsibilities of the entity's management and the auditor.

4. Scope paragraph: The auditor's report should provide a description of the audit scope, stating that the audit was conducted in accordance with the accepted auditing standards in India. The report should explicitly mention that the audit was planned and executed to obtain reasonable assurance regarding the absence of material misstatement in the financial statements. In summary, the scope paragraph should include:

(a) Reference to the generally accepted auditing standards in India.

(b) Description of the audit procedures performed by the auditor.

5. Opinion paragraph: The opinion paragraph of the auditor's report should clearly state the financial reporting framework used for preparing the financial statements. It should express the auditor's opinion on whether the financial statements present a true and fair view in accordance with that financial reporting framework. In some cases, the auditor's report may also need to provide an opinion on whether the financial statements comply with other specified requirements under relevant statutes or laws. In short, the opinion paragraph should include:

(a) Reference to the financial reporting framework applied for the financial statements.

(b) Expression of the auditor's opinion on the financial statements.

6. Date of the report: The inclusion of the report's date informs the readers that the auditor has considered the impact of events and transactions up to that date on both the financial statements and the report.

7. Place of signature: The report should clearly state the specific location, typically the city, where the audit report is signed."

8. Auditor's signature: The report should be signed by the auditor in his personal name along with the membership number assigned by the Institute. Where the firm is appointed as the auditor, the report should be signed also in the personal name of the auditor and in the name of the audit firm.

7.5 Audit Report and Audit Certificate

When an auditor certifies a financial statement, it signifies that the contents of the statement are deemed reliable, as the auditor has verified the accuracy of the data. The term 'certificate' is used to denote the confirmation of the truth and accuracy of something after a thorough examination of specific factual information. For instance, an auditor may certify the circulation figures of a newspaper or the value of imports and exports for a company.

It is important not to confuse the term 'certificate' with the term 'report'. While a certificate asserts the truth and accuracy of a fact, figure, or statement, a report typically consists of a collection of facts or the expression of an opinion regarding the truth and fairness of those facts, figures, and statements.

7.6 Types of Auditor's Report

Auditor's report can be of the following types:

(a) Clean report: An audit report is clean, where there is no qualified or adverse opinion or disclaimer of opinion in the report. A clean report indicates that the auditor is satisfied with all the points required to be stated in his report and states them in the affirmative, adding no reservation anywhere.

(b) Qualified report: When an auditor expresses an opinion in his report with a reservation or states anything in the negative, but its nature is such that it does not materially affect the true and fair picture shown by the accounts, then the auditor's report is said to be a qualified report.

(c) Adverse report: When the auditor expresses an adverse or negative opinion in his report about the principal point in the report for which audit is mainly intended, the report is called an adverse report.

(d) Disclaimer of opinion: When an auditor is unable to express an opinion due to certain reasons and states this in his report, it becomes a report with a disclaimer of opinion. A disclaimer of opinion is always required to be supported by the justified facts.

(e) Piecemeal report: Auditor's opinion in his report may not be on the entire financial statements. Such opinion may relate to some of the items contained in the statements on which only he can satisfactorily express opinion after audit. Such an opinion as a part of the financial statement is a piecemeal opinion and the auditor's report containing such opinion is called a piecemeal report.

7.7 Types of Audit Certificate

Professional accountants are frequently required to issue various types of certificates, depending on the specific purpose they serve. The major types of certificates commonly encountered are as follows:

(a) Certificate for tax computation: Chartered accountants may be called upon to certify specific incomes and expenses for the purpose of obtaining exemptions from income tax. These certifications are based on the provisions outlined in the Income Tax Act, 1961. The precise format and content of such certificates are typically defined by the Income-Tax Rules, as the wording of the certificate needs to be tailored to the unique nature and circumstances of each case.

(b) Certificate of import and export: Import and Export Trade Control Rules and Procedures stipulate that applicants seeking import or export licenses must provide a certificate of import and/or export from a qualified practicing accountant. These certificates contain information regarding the value of goods imported or exported, goods consumed by the entity from imported goods, goods supplied by the entity for export, and the remaining value of the license.

(c) Certificate of circulation: The Audit Bureau of Circulations Ltd., an association of advertisers and publishers, provides circulation reports for the publications of its members. The association issues circulation certificates based on the audit reports submitted by its members. The auditor is responsible for certifying the circulation figures by verifying and examining the books related to newsprint consumption, distribution, and unsold stock of publications, in accordance with the guidelines established under the A.B.C.Audit Procedure."

These various types of certificates serve distinct purposes and require the expertise of professional accountants to provide accurate and reliable certifications.

7.8 Importance of Audit Report

1) The outcome of the auditing process

The final result of the auditing process is typically an audit report. This report is prepared by a qualified accountant or auditor and provides an assessment of the accuracy and reliability of a company's financial statements. It is an essential component of the company's statutory accounts, along with the balance sheet, profit and loss statement, and director's report. As per the requirements of the Companies Act, 2013 (Section 143(2), (3), & (4)), the audit report must be signed by the auditor and presented to the members at the annual general meeting of the company.

2) Auditor's opinion on financial statements

The audit report includes the auditor's opinion on the company's accounts and records that have been examined. The auditor evaluates the financial statements to determine if they are prepared in accordance with the relevant financial reporting standards or principles applicable to the company. Additionally, the auditor assesses whether the financial statements comply with the applicable statutory requirements before formulating the audit report.

3) Reflection of auditor's work

The audit report serves as a reflection of the auditor's work. It highlights the nature and extent of the audit procedures undertaken by the auditor to examine the company's accounts. The report provides insights into the methodologies and approaches used by the auditor during the audit process.

4) Measures auditor's responsibility

The audit report is a crucial instrument that measures the auditor's responsibility in evaluating the financial statements. It acknowledges that if the auditor was not provided with critical information that was deliberately withheld and had no means of knowing about its existence, the auditor should not be deemed guilty or negligent if the accounts are later found to be inaccurate as a result.

The audit report plays a vital role in providing stakeholders with an independent and professional opinion on the financial statements, thereby instilling confidence and trust in the company's financial reporting.

5) Serving as a reliable source of evidence

The audit report serves as a reliable document that reveals the accurate financial state of a company. It is widely recognized as a trustworthy source of information and assists users of financial statements in assessing the correctness and reliability of the financial data presented.

A) Use in Income Tax Return filing: Income tax authorities typically accept the certified profit and loss statement prepared by a qualified auditor as sufficient evidence, without delving into the intricate details of the accounts.

B) Facilitating Borrowing from External Sources: Audited financial statements, accompanied by audit reports, provide a solid basis for borrowing funds from external sources. Financial institutions often approve loans based on audited financial statements.

C) Supporting Insurance Claims: In the event of unforeseen incidents such as floods, fires, or other natural calamities, insurance companies may settle claims for loss or damages based on the audit reports from previous years.

D) Sales Tax Payments: GST and sales tax authorities generally accept audited books of accounts as reliable evidence for assessing sales tax liabilities.

E) Bankruptcy Proceedings: Audited accounts play a crucial role in determining the course of action in insolvency and bankruptcy cases.

6) Advisory role to management

Internal auditors provide valuable advice to the management regarding areas of improvement in business operations. They evaluate the company's internal controls, corporate governance practices, and accounting processes.

In external audits, it is possible for management to seek the auditor's advice on technical matters, although it is not the primary duty of the external auditor to provide such advice. The external auditor primarily focuses on assessing the legality and validity of the business transactions. However, if deficiencies in the internal control system are identified, the auditor should bring them to the attention of the management, as these deficiencies can impact the nature and scope of audit procedures.

7.9 Specimen of Audit Report

Specimen of a clean audit report

To

The Shareholders,

XYZ Co. Ltd., Kolkata.

Dear members,

I/we have audited the annexed balance sheet of XYZ Co. Ltd. as on 31st March 20xx and also the statement of profit and loss of the company for the year ended on that date and report that—

1. We have obtained all the information and explanations which to the best of my/our knowledge and belief were necessary for the purpose of audit.

2. In my/our opinion, proper books of accounts as required by law have been kept by the company so far as appears from my/our examination of such books and proper returns adequate for the purpose of my/our audit have been received from the branches not visited by us.

3. The accounts of Chennai branch office have been audited u/s 143 of the Companies Act by Subrata Renuka and Co. The report of the said accounts, which has been forwarded to us, has been dealt with by us, in the manner we have considered necessary, while preparing this report.

4. The balance sheet and the statement of profit and loss dealt with in this report are in agreement with the books of accounts.

5. In my/our opinion and to the best of my/our information and according to the explanations given to me/us, the said accounts, together with the notes thereon, give the information required by the Act in the manner so required and give a true and fair view:

(a) In the case of the balance sheet of the state of the affairs of the company as on 31st March 20xx and

(b) In the case of statement of profit and loss of the profit of the company for the year ended on thatdate.

For G. G. Basu& Co.

Kolkata

Chartered Accountants

Date..

Signature ....

B. B. Basu (Partner)

Specimen of a Qualified audit report

To

The Shareholders,

ABC Co. Ltd., Mumbai.

Dear members,

We have audited the annexed balance sheet of the ABC Co. Ltd. as at 31st March, 20xx and also the statement of profit and loss for the year ended on that date. We report that—

(a) We have obtained all the information and explanations, which to the best of our knowledge and belief were necessary for the purpose of audit.

(b) In our opinion, proper books of accounts as required by law have been maintained by the company, kept in accordance with the accounting standards, so far as it appears from our examination of the books except for the comments given here under:

(i) The stocks of the company have been valued at a current replacement price, which is higher than the cost price to the extent of Rs. 1,03,000.

(ii) Provisions for bad and doubtful debts have not been taken into consideration which should have been taken in view of the fact that some of the debts are quite old and time-barred.

(iii) In the absence of stock registers, adjustments relating to the balances on the register have been accepted on the basis of the decisions of the management.

(c) The balance sheet and statement of profit and loss dealt with by the report are in agreement with the books of accounts and returns.

(d) Subject to the qualifications given above, in our opinion and to the best of information available and according to the explanations given to us, the said accounts, with the notes thereon and documents attached thereto give the information required by the law and accounting standards and gives a true and fair view:

(i) In the case of the balance sheet of the state of affairs of the company as at 20xx and

(ii) In the case of the statement of profit and loss of the profit for the year ended on that date.

For B. K. Basu& Co.
Mumbai
Chartered Accountants
Date..
Signature ....
B. K. Basu (Partner)

CASE STUDY: Allen Craig & Co. (London) Ltd. (1934)

Facts of the Case:

The company made a loss in each year of its existence, and there was as deficiency of assets to meet liabilities of over £ 40,000. In submitting the accounts for 30th June 1924, the auditor sent a letter to the company drawing attention to the serious position of the company, this being quite apart from the normal audit report. In 1927, in submitting the accounts for the years to 30th June 1925 and 1926, respectively, the auditor sent further letters, showing that there was a deficiency as regards creditors of nearly £ 11,000.

The liquidator of the company took out a summon for misfeasance against the former managing director and the auditors asking for a declaration that such parties were liable for the debts of the company incurred after 30th June 1925.

Legal view:

It was held that the duty of the auditors, after having signed the report to be annexed to a balance sheet, is confined only to forwarding that report to the secretary of the company. It will be for the secretary or the directors of the company to convene a general meeting and send the balance sheet and report to members entitled to receive it. The auditor, in no way, will be held liable in this situation.

CASE STUDY: London and General Bank Ltd. (1895)

Facts of the Case:

The company, in this case, had not made adequate provision for bad debts. The auditor had discovered that the debts were doubtful and had clearly reported the situation to the directors, but when the directors failed to make provisions, instead of reporting the fact equally clearly to the shareholders, he simply made the statement that 'the value of the assets is dependent upon realization.' It was held that the auditor had failed in his duty to convey information clearly in his report and he was made liable for certain dividend improperly paid.

Legal view:

This case underlined the dangers of equivocal statements in audit report. In the course of his judgement, Justice Lindley, L. J. said, 'Information and means of information are by no means equivalent terms. An auditor who gives shareholders means of information does so at his peril and runs the very serious risk of being held, judicially, to have failed to discharge his duty'. It was held in this case that an auditor has a duty to convey facts clearly to the shareholders. The auditor whose duty it is to convey information to others does not discharge that duty by simply giving them so much information as is calculated to induce them or some of them to ask for more.

7.10 Basic Understanding on the Corporate(Auditor's Report) order, 2015

According to Section 143(11) of the Companies Act, 2013, the Central Government, in consultation with the National Financial Reporting Authority, has the authority to issue general or special orders directing certain classes or descriptions of companies to include specific statements in the auditor's report.

Therefore, in addition to the requirements stated in Section 143(3) of the Companies Act, the Companies (Auditor's Report) Order (CARO), 2015, issued by the Central Government, applies to certain types of companies. This order has been issued by the Central Government under the powers granted by Section 143(11) of the Act.

The 2003 order expanded the scope of the audit of companies by introducing new items and modifying existing ones, replacing the previous 1988 order. However, the Companies (Auditor's Report) Order, 2015, has made significant changes to the provisions in response to the amendments introduced in the new Companies Act of 2013.

7.11 Companies Auditors' Report Order (CARO), 2015

The Ministry of Company Affairs (previously known as the Department of Company Affairs) issued the Companies (Auditor's Report) Order, 2003 (CARO, 2003) in June 2003, replacing the Manufacturing and Other Companies (Auditor's Report) Order, 1988. The CARO, 2003 introduced new reporting requirements for auditors regarding specific critical issues that were not previously explicitly addressed. These critical issues included reporting on the utilization and end use of funds raised by the company, utilization of short-term funds, physical verification of fixed assets, inventories, and more.

Subsequently, on November 25, 2004, the Ministry of Corporate Affairs made certain amendments to the principal Order issued on June 12, 2003, exercising the powers conferred by Sub-section (4A) of Section 227 of the Companies Act, 1956, and after consultation with the Institute of Chartered Accountants of India (ICAI). The amended version of CARO 2003, known as the CARO (Amendment) Order 2004, came into effect from November 25, 2004, upon its publication in the Official Gazette.

In further exercise of the powers conferred by Sub-section (11) of Section 143 of the Companies Act, 2013, and superseding the Companies (Auditor's Report) Order, 2003, the Central Government, in consultation with the Institute of Chartered Accountants of India, introduced the CARO 2015. The CARO 2015 came into effect from April 1, 2015. The text of the order is provided below.

Basic structure of the order

The Order in its entirety comprises 4 paragraphs and the relevance of each of them is as follows:

Reference	Particulars

Paragraph 1 **Short title, application and commencement**

Paragraph 2 **Auditor's report to include matters specified in paragraphs 3 and 4**

Paragraph 3 **Matters to be included in auditor's report (12 Clauses)**

Paragraph 4 **Reasons to be stated for unfavourable/qualified answers**

It may be noted in this context that CARO 2003 had five paragraphs in total, which include the definitions paragraph also, but CARO 2015 excludes that definition paragraph and thereby the number of paragraphs has been reduced from five to four only.

Applicability

The Order shall apply to every company including a foreign company as defined in Section 2(42) of the Act, except the following:

- Banking Company as defined in Clause(c) of Section 5 of the Banking Regulation Act, 1949.
- Insurance Company as defined under the Insurance Act, 1938.
- Company licensed to operate under Section 8 of the Companies Act, 2013.
- One person company as defined under clause (62) of Section 2 of the Companies Act and a small company as defined under clause (85) of Section 2 of the Companies Act and
- Private limited company with a paid-up capital and reserves not more than Rs. 50 lakhs and which does not have loan outstanding exceeding ` 25 lakh from any bank or financial institution and does not have a turnover exceeding ` 5 crore at any point of time during the financial year.

Matters to be included in the auditor's report

There are 12 clauses under the Order, which detail the matters to be included in the auditor's report in respect of certain critical issues. They can be grouped and analysed, as follows for better understanding:

Serial Number	Relevant Clause	Matters Deal with
1	3 (i) (a) to (b)	Fixed assets
2	3 (ii) (a) to (c)	Inventory
3	3 (iii) (a) to (b)	Loans granted to any section 189 Companies
4	3 (iv)	Internal control system
5	3 (v)	Acceptance of deposits from public
6	3 (vi)	Maintenance of cost records
7	3 (vii) (a) to (c)	Undisputed statutory dues
8	3 (viii)	Incurrence of cash losses
9	3 (ix)	Default in repayment of dues
10	3 (x)	Guarantee given for loan taken by others
11	3 (xi)	Application of term loans
12	3 (xii)	Fraud on/by the company

Summary

- A report is a document that presents collected and carefully considered facts in a clear and concise manner, providing information to individuals who may not have full knowledge of the subject matter.

- An audit report is a written statement by an auditor expressing their independent professional opinion regarding the accuracy and fairness of the examined accounts and financial statements.
- Important attributes of a good audit report include simplicity, clarity, brevity, firmness, objectivity, consistency, relevance, and adherence to auditing and assurance standards.
- Only the appointed auditor of a company or a partner in the firm practicing in India, if a firm is appointed, is authorized to sign the audit report.
- In addition to the requirements stated in Section 143(3) of the Companies Act, 2013, certain types of companies are also subject to the provisions of the Companies (Auditor's Report) Order, 2015 issued by the central government.
- The key elements of an audit report include the title, address, identification of financial statements, reference to auditing standards, opinion on the financial statements, auditor's signature, address, and date of the report.
- It is important to distinguish between an audit certificate and an audit report. An audit certificate confirms the accuracy of the client's prepared statements, while an audit report represents the auditor's opinion on the fairness of the financial statements in reflecting the organization's financial position and results.
- Audit reports can be classified into four main types: clean report, qualified report, adverse report, and disclaimer of opinion. Each type reflects a different assessment by the auditor based on specific circumstances.
- The traditional concept of a "true and fair" view used in audit reports may not be suitable in the current dynamic and complex business environment. Therefore, audit reports should avoid using ambiguous terms like "true and fair" to ensure clear and transparent disclosure of material information.
- The audit report holds significant value not only for the company's shareholders but also for other stakeholders such as employees, investors, creditors, government, and financial institutions who are interested in the business affairs.
- The auditor's report should state whether, in their opinion and based on the information provided to them, the balance sheet presents a true and fair view of the company's financial status at the end of the financial year and whether the statement of profit and loss presents a true and fair view of the financial performance for the year.

Keywords

- Audit report
- Financial statements
- Auditing standards
- Audit certificate
- Clean report
- Qualified report
- Adverse report
- Disclaimer of opinion
- Financial position

Self Assessment

1. Which of the following statements best defines an auditor's report?
A. A report prepared by the management of a company.
B. A report summarizing the financial statements of a company.
C. A report expressing the auditor's independent opinion on the financial statements of a company.
D. A report providing recommendations for improving the internal control system of a company.

2. What are the essential attributes of a good audit report?
A. Complexity, ambiguity, brevity, subjectivity.
B. Simplicity, clarity, brevity, objectivity.
C. Complexity, verbosity, firmness, relevance.
D. Elaboration, ambiguity, brevity, objectivity.

3. Which document outlines the reporting requirements for auditors in addition to the Companies Act?
A. The Companies (Auditor's Report) Order, 2003.
B. The Financial Reporting Authority Guidelines.
C. The Auditing and Assurance Standards issued by the Institute of Chartered Accountants.
D. The Ministry of Corporate Affairs Circulars.

4. What is the purpose of an audit certificate?
A. To provide an independent opinion on the fairness of the financial statements.
B. To certify the correctness of the statements prepared by the client.
C. To highlight any fraudulent activities detected during the audit.
D. To recommend improvements in the company's financial reporting processes.

5. Which type of audit report indicates that the financial statements are free from any material misstatements?
A. Clean report.
B. Qualified report.
C. Adverse report.
D. Disclaimer of opinion.

6. Who are the stakeholders who rely on the auditor's report?
A. Shareholders, creditors, and government.
B. Auditors, managers, and employees.
C. Customers, suppliers, and competitors.
D. Regulatory authorities, media, and general public.

7. What does the auditor's report state regarding the financial position and financial results of a company?

A. Whether the financial statements comply with the applicable statutory requirements.
B. Whether the financial statements provide a true and fair view of the company's affairs.
C. Whether the financial statements have been prepared in accordance with International Financial Reporting Standards.
D. Whether the company's internal control system is effective in preventing fraud and errors.

8. Which of the following is a characteristic of a well-structured auditor's report?
A. Lengthy and complex language.
B. Inclusion of personal opinions of the auditor.
C. Clear and concise presentation of information.
D. Lack of reference to auditing standards.

9. Who has the authority to sign an auditor's report?
A. Any member of the audit team.
B. The managing director of the company.
C. The lead partner of the audit firm.
D. The auditor appointed by the company.

10. In which situation would an auditor issue a qualified report?
A. When the financial statements are free from material misstatements.
B. When the auditor is unable to obtain sufficient evidence.
C. When the auditor provides recommendations for improving internal controls.
D. When the auditor detects fraud or irregularities in the company's operations.

11. What is the purpose of the Companies (Auditor's Report) Order, 2015?
A. To define the roles and responsibilities of auditors in the Companies Act.
B. To specify the format and contents of the auditor's report for certain types of companies.
C. To provide guidelines for conducting internal audits within companies.
D. To establish the qualifications and eligibility criteria for becoming an auditor.

12. What type of opinion does an adverse report express?
A. The financial statements are presented fairly, in all material respects.
B. The financial statements are free from material misstatements.
C. The financial statements do not comply with applicable accounting standards.
D. The auditor is unable to form an opinion on the financial statements.

13. In the context of an auditor's report, what is the significance of the term "true and fair"?
A. It refers to the accuracy and completeness of the financial statements.
B. It indicates that the auditor has performed an in-depth review of the company's operations.
C. It highlights any potential risks or uncertainties in the financial statements.
D. It reflects the auditor's personal opinion on the financial performance of the company.

14. What is the primary purpose of an audit report in relation to external users?
A. To provide assurance on the future profitability of the company.
B. To evaluate the performance of the company's management.
C. To assist users in assessing the reliability of the financial statements.
D. To recommend changes in the company's strategic direction.

15. Which type of audit report indicates that the auditor is unable to express an opinion on the financial statements?
A. Clean report.
B. Qualified report.
C. Adverse report.
D. Disclaimer of opinion.

Answer for SelfAssessment

1.	C	2.	B	3.	A	4.	B	5.	A
6.	A	7.	B	8.	C	9.	C	10.	B
11.	B	12.	C	13.	A	14.	C	15.	D

Review Questions

1. What do you mean by 'auditor's report'?
2. What is piecemeal report?
3. Distinguish between auditor's report and auditor's certificate.
4. Is there any difference between an adverse and a qualified report?
5. 'Information and means of information are by no means equivalent terms'. —Explain.
6. What are the contents and format of an audit report?
7. State the matters required by the Companies Act, 2013 to be stated in auditor's report to the shareholders on the accounts of a company audited by such auditor.
8. What is a clean report? Give a specimen of a clean report of the auditor.
9. What is a qualified report? Give a specimen of a qualified report of the auditor.
10. How many types of audit report may be submitted by a company auditor and in what circumstances?— Discuss briefly.
11. Under Section 143(11) of the Companies Act 2013, some additional information is to be given by the auditor in his report to the shareholders. State those matters.
12. What are the events that may occur after the preparation of a balance sheet? Do you think that those events should be incorporated in the auditor's report?

Further Readings

- Auditing: Principles And Techniques By S. K. Basu, Pearsonn.S.
- A Hand Book Of Practical Auditing By B N Tandon, S Sudharsnam& S Sundharabahu, S Chand Publishing

- Auditing And Corporate Governance By Anil Kumar Jyotsna Rajan Arora Lovleen Gupta, Taxmann Publisher

Web links

https://gacbe.ac.in/pdf/ematerial/18BCO55S-U3.pdf

https://www.tutorialspoint.com/auditing/auditing_verification.htm

https://chetanmalikclasses.com/verification-and-valuation-of-assets-and-liabilities-reviewed/

Unit 08: Internal Control

CONTENTS

Objectives

After studying this unit, you will be able to:

- identify and illustrate objectives and basic elements of internal control.
- prepare, describe and analyze the internal control check list & internal control questionnaire

Introduction

Before an auditor determines their fundamental approach to an audit, it is essential for them to have a thorough understanding of the organization they are dealing with. This entails familiarizing themselves with the company's structure, comprehending the nature of its operations, and gaining a complete grasp of any specific technicalities associated with the business. Only then will they be adequately equipped to comprehend and identify the transactions recorded in the accounting records and evaluate the effectiveness of the internal controls in place.

In the past, businesses often implemented systems aimed at achieving work completion through the cheapest and quickest available methods. While these objectives haven't been entirely abandoned, it has become apparent that employing fragmented and uncoordinated work processes is neither cost-effective nor efficient in the long run. Comprehensive planning is necessary to establish a seamless and efficient workflow throughout the entire organization, while concurrently safeguarding its assets.

This comprehensive planning, referred to as internal control, is established by management. Although the auditor, in their role, does not have the authority to dictate specific control methods, they are inherently concerned with them. The efficiency or lack thereof in the internal control system significantly impacts the auditor's approach to their work.

8.1 Internal Control

Internal control encompasses the methods and procedures implemented to oversee the production, distribution, and overall system (financial and non-financial) of an enterprise. It ensures adherence to management policies, safeguards assets, and promotes accurate record-keeping.

The American Institute of Certified Public Accountants defines internal control as the organizational plan and coordinated measures aimed at protecting assets, verifying accounting data, enhancing operational efficiency, and aligning with managerial policies.

According to the Companies Act, 2013, internal financial controls refer to policies and procedures that ensure orderly and efficient business conduct, including adherence to company policies, asset safeguarding, fraud prevention and detection, accurate accounting records, and timely preparation of reliable financial information.

In essence, an internal control system provides management with vital information, protection, and control necessary for the successful functioning of a business organization.

8.2 Basic Elements of Internal Control

An effective system of internal control should have the following basic elements:

(a) Financial and organizational plans: These plans, which can be documented through flow charts or manuals, should clearly outline the duties and responsibilities of both management and staff. It is crucial to specify the authorization powers of various individuals to prevent potential disruptions to the correct workflow and internal control system caused by staff absence or incorrect implementation of procedures, whether intentional or unintentional.

(b) Competent personnel: The effectiveness of any internal control system heavily relies on competent and efficient employees. Even in the absence of other elements of the internal control system, capable personnel can still ensure its successful operation.

(c) Division of work: Proper division of work among organizational employees is essential. Each task should be allocated based on quality and skill, dividing the organization's workload into different stages.

(d) Separation of operational responsibility from record-keeping: To ensure reliable records and information, it is important to separate the responsibilities of each department. Allowing departments to prepare their own records and reports can lead to potential manipulation for the sake of presenting better performance. By separating record-keeping from operational responsibility, the organization can maintain the integrity of its records.

(e) Separation of asset custody from accounting: To prevent misuse or misappropriation of assets, it is necessary to assign separate individuals to handle asset custody and accounting. When one person has control over both functions, there is a risk of using the organization's assets for personal gain and adjusting records to evade accountability.

(f) Authorization: A proper authority should authorize all activities within the internal control system. The individual or group granting specific or general authority for transactions should hold a position appropriate for the nature and significance of the transactions. Top management should establish policies regarding the delegation of such authority.

(g) Managerial supervision and review: The internal control system should be implemented and maintained in line with changes in the business environment. To ensure the effectiveness of specific control systems, it is essential to evaluate and re-examine the extent to which flexible control procedures have been followed in practice.

8.3 Types of Internal Control

The various types of internal control can be classified as follows:

(a) Organization: An enterprise should establish an organizational plan that:

(i) Defines and assigns responsibilities to specific individuals, known as responsible officials, for each function.

(ii) Identifies lines of reporting, ensuring clear communication and delegation of authority.

(b) Segregation of duties:

(i) No single person should be solely responsible for recording and processing an entire transaction.

(ii) Involving multiple individuals reduces the risk of intentional manipulation or accidental errors and increases the effectiveness of checks and balances.

(iii) Functions related to a given transaction, such as initiation, authorization, execution, custody, and recording, should be separated.

(c) Physical control:

(i) Focuses on the physical custody of assets and implements procedures to restrict access to authorized personnel only.

(ii) Access can be granted directly or indirectly.

(iii) These controls are particularly crucial for valuable, portable, exchangeable, or desirable assets.

(d) Authorization and approval: All transactions should require appropriate authorization or approval from designated individuals. The specific limits for these authorizations should be clearly defined. For example, credit sales may need approval from the credit control department, or overtime must be authorized by the works manager.

(e) Arithmetical and accounting control:

(i) Ensures the recording function includes controls that verify authorized transactions, their completeness, and accurate processing.

(ii) Procedures encompass checking the mathematical accuracy of records, maintaining and verifying totals, reconciling accounts, utilizing control accounts, preparing trial balances, accounting for documents, and conducting previews. Previewing involves reviewing available documents before important actions involving the company's assets are taken to ensure all necessary steps have been taken.

(f) Personnel control:

(i) Procedures should be implemented to ensure that personnel operating the system are competent and motivated to carry out their assigned tasks. The proper functioning of a system relies on the competence and integrity of the personnel involved.

(ii) Measures include appropriate remuneration, promotion opportunities, career development prospects, selection of individuals with suitable characteristics, and training and assignment to tasks at an appropriate level.

(g) Supervision: All actions performed by staff at every level should be supervised. The responsibility for supervision should be clearly defined and communicated to the individuals being supervised.

(h) Management control:

(i) These controls, exercised by management, go beyond the day-to-day routine of the system.

(ii) They encompass overall supervisory controls, review of management accounts, comparison with budgets, internal audits, and other special review procedures.

It is important to note that implementing a combination of these internal control measures contributes to a comprehensive and effective internal control system.

8.4 Objectives of Internal Control

Internal control holds utmost significance for auditors as it guides their planning of audit tests in the audit program. Before placing reliance on the organization's internal control system, auditors must ensure that the following objectives of internal control are being achieved:

(a) Proper authorization: Transactions are executed with both general and specific authorization from management.

(b) Timely recording of transactions: All transactions are promptly and accurately recorded in the appropriate accounts, reflecting the correct amounts and within the relevant accounting period. This enables the preparation of financial information based on recognized accounting policies and ensures asset accountability.

(c) Restricted access to assets: Access to assets is granted only in accordance with management's authorization, limiting unauthorized access.

(d) Actions against deviations: The recorded accountability for assets is periodically compared with the existing assets, and appropriate action is taken to address any discrepancies.

By assessing whether these internal control objectives are being met, auditors can determine the extent to which they can rely on the internal control system during their audit procedures.

8.5 Advantages of Internal Control System

The advantages that can be obtained from an internal control system can be summarized as follows:

(1) Defect identification: The internal control system incorporates segregation of duties, enabling automatic checks between employees. This facilitates the easy detection of any defects or errors within the system.

(2) Flexibility: The system allows for year-wise comparative analysis, making it adaptable to changes in the mode of operation. This flexibility enables adjustments to accommodate evolving circumstances.

(3) Time savings: With an internal control system in place, there is no need to create separate audit programs for each engagement. As a result, significant time savings can be achieved.

(4) Reduced risk of omission: The division of work into different activities within the system ensures that each employee is assigned specific responsibilities. This minimizes the likelihood of oversight or omission of important matters.

(5) Training provision: The internal control system offers training opportunities for auditors to enhance their understanding of how to establish a close relationship between audit programs and the internal control system. This helps auditors overcome any difficulties stemming from limited experience.

Implementing an internal control system provides these advantages, enhancing the effectiveness and efficiency of audit processes.

8.6 Disadvantages of Internal Control System

It is crucial to acknowledge the inherent limitations of an internal control system, which include:

(1) Potential for human error: The system may be rendered ineffective due to human errors resulting from carelessness, errors in judgment, or misunderstandings of instructions.

(2) Cost considerations: Control procedures should ideally be cost-effective according to management's expectations. However, in some cases, the cost of implementing internal control measures may not be proportionate to the potential losses incurred from fraud and errors.

(3) Limited coverage of unusual activity: Most internal control techniques primarily address anticipated types of transactions, potentially leaving unusual transactions unaddressed.

(4) Collusion risks: Controls can be circumvented through collusion with external parties or employees within the organization, posing a threat to the effectiveness of the control system.

(5) Potential for abuse of responsibility: Individuals entrusted with control responsibilities may misuse their authority, undermining the integrity of the control system.

(6) Rigidity: Changes in conditions can render the system inadequate, leading to a deterioration in compliance with established procedures.

Recognizing these limitations is essential for understanding the boundaries and vulnerabilities of an internal control system. Organizations should actively address and mitigate these limitations to ensure the effectiveness and adaptability of their control processes.

8.7 Evaluation of Internal Control

The evaluation of internal controls is a fundamental aspect of an audit. It is through this evaluation that the auditor will:

(a) Determine the nature and scope of audit procedures, which leads to the creation of an audit program.

(b) Prepare letters identifying weaknesses in the system, informing management about any identified weaknesses.

Given its significance, it is important to differentiate evaluation from the process of understanding and documenting the system.

Prior to commencing the audit in an organization, the auditor should verify the authenticity of the existing internal control system. The auditor will evaluate the control system to determine the extent to which they can rely on it. The evaluation process will be guided by the auditor's knowledge and judgment, considering the nature and size of the audited organization.

When evaluating the internal control system, the auditor should consider the following:

(a) Whether the organization has properly adhered to the fundamental principles of internal control.

(b) Whether the theoretical procedures have been effectively implemented.

(c) Whether any changes have been made to the internal control system in response to evolving organizational circumstances.

Based on the evaluation of the internal control system's effectiveness, the external auditor will determine the degree to which they can rely on it during the audit.

8.8 Internal Control Checklist

Checklists serve as reminders for the auditor to ensure that all important aspects of the accounts have been considered. They can also be utilized to assess the internal control systems by listing essential questions for the auditor to ask. Completed checklists should be signed and included in the current working papers files as evidence of coverage.

A checklist consists of a series of instructions and/or questions that the auditor must follow and answer. Upon completing each instruction, the auditor initials the corresponding space. The answers provided on the checklist typically include 'Yes,' 'No,' or 'Not Applicable.'

Here are a few examples of checklist instructions related to sales:

1. Are sales assistants using books of serially numbered cash sales slips?
2. Is there a proper system in place to control the issue and return of the cash sales slip books?
3. Are sales assistants prohibited from accepting cash?
4. Is a copy of the cash sale slip given to:
    (a) the cashier?
    (b) the customer?
5. Are the prices and calculations on the cash sale slips subject to independent verification?
6. Does the customer present the cash sale slip to the cashier and make the payment before receiving the goods?
7. Do sales assistants only deliver goods to customers with a receipted cash sale slip?
8. Are cash collections made regularly from the cashiers during business hours?

9. Is all cash received on the day of receipt deposited intact into the bank? If not, please provide details of the system.
10. Is the total amount of cash deposited reconciled by a responsible official, other than the chief cashier, with:

    (a) the cashier's records?

    (b) the sales records?

8.9 Internal Control Questionnaire

An internal control questionnaire is a comprehensive list of questions that encompasses every aspect of the client's system. The purpose of this questionnaire is to enable the auditor to evaluate the effectiveness of the internal controls in place. The questions are designed in a manner that a "yes" response indicates a satisfactory control, while a "no" response suggests a potential weakness.

The internal control questionnaire serves as a tool for the auditor to gather relevant information and assess the controls in operation. By obtaining answers to these questions, the auditor can form a comprehensive understanding of the client's internal control environment and identify areas that may require further attention or improvement. The questionnaire aids in systematically evaluating the adequacy and reliability of the internal controls implemented by the client.

8.10 Basic Characteristics of Internal Control Questionnaire

1. The internal control questionnaires should be designed in a format that allows for simple responses such as 'yes/no/not applicable'.
2. While standardized pre-printed forms are commonly used for internal control questionnaires specific to certain types of enterprises, their application to individual clients requires the expertise of senior staff.
3. Regular review and updates of the internal control questionnaires are necessary to adapt to changing situations and make amendments to the system.
4. The staff responsible for completing or reviewing the internal control questionnaires should sign and date them. This helps establish accountability and indicates when the answers to the questions were obtained.
5. 'No' answers on the questionnaires should be carefully examined during the subsequent evaluation stage. They often necessitate cross-referencing with system notes, addressing weaknesses in a letter, and conducting further internal control assessments.

8.11 Typical Questions to Be Found in an Internal ControlQuestionnaire

(A) In respect of stocks and work-in-progress

1. Are stocks kept in proper storage accommodation which protects them against—

(a) Deterioration?

(b) Access by unauthorized persons?

(c) Other risks (e.g. fire)?

2. Is there an adequate system in operation in respect of goods received to ensure that they are:

(a) Checked as to quantity and quality?

(b) Properly recorded in the records?

3. Are all stocks issues from stores made only against properly authorized requisitions?

4. By whom can requisitions be authorized?

5. Are bin cards or equivalent records, maintained at the stores?

6. Are perpetual inventory records maintained in respect of both quantity and value for:

(a) Raw materials?

(b) Components?

(c) Finished goods?

(d) Consumable stores?

7. Are store records maintained by persons independent of—

(a) the storekeepers?

(b) the persons responsible for actually checking the physical stocks?

8. Are the physical stock quantities regularly counted and reconciled with the stores records bypersons independent of the storekeepers? State approximate frequency of reconciliation.

9. Are all material discrepancies revealed independently investigated?

10. Are stores records amended to agree with actual quantities?

11. Are there proper arrangements in operation for writing down stocks that are—

(a) Defective?

(b) Obsolete?

(c) Slow-moving?

12. Is the costing system fully integrated with the financial accounting records?

13. Is there a sound system in operation for charging direct costs to work-in-progress accounts?

14. Does the system clearly distinguish between fixed and variable overheads?

15. Does the treatment of overheads comply with the requirements of generally acceptedaccountingprinciples?

16. Does the system ensure that excess costs are written off and not included in work-in progress?

17. Has adequate insurance been taken out in respect of—

(a) theft?

(b) fire?

(c) Other risks (e.g. flood)?

(B) In respect of fixed assets

1. Are registers of fixed assets maintained, showing adequate details of all material assets?

2. Are regular physical inspection made to ensure the continued existence and to confirm, the conditionof assets, by responsible officials other than those who—

(a) maintain registers of fixed assets.

(b) have custody of fixed assets.

3. Is there a proper system for distinguishing between capital and revenue expenditure?

4. By whom is capital expenditure authorized? Give details of who may authorize capital expenditure,and the precise limits of their authority.

5. Is the authorization of capital expenditure properly evidenced?

6. By whom is the sale or scrapping of fixed assets authorized? Give details of who may authorizethe sale or scrapping of fixed assets and the precise limits of their authority.

7. Is the authorization of the sale or scrapping of fixed assets properly evidenced?

8. When fixed assets are sold or scrapped, are there controls in force to ensure that—

(a) appropriate entries are made in the accounting records and registers.

(b) receipts for sale are properly accounted for.

9. Are the rates of depreciation for the major classes of fixed assets adequate?

10. Do the rates of depreciation take due account of obsolescence?

11. Is the system adequate to ensure the correct calculation of depreciation in respect of individualassets?

12. Are the balances on the asset register regularly reconciled with the accounting records?

Note: It is difficult to draft a standardized questionnaire of different items of internal control, becausethere are a number of methods of controlling the business internally. However, the above illustrativequestionnaires have been given to give an idea about the internal control questionnaire.

CASE STUDY

Fast Move Ltd. is a listed company in the food processing industry. They have 10 factory sites and 2500workers. They have grown very rapidly in recent years under the direction of Siddharth, who is a verydynamic character. He tries to operate on the lowest possible costs and sees internal control as himselfand his factory managers. The company has recently moved into the production of mass produced. South-Indian foods and gambled that they will grab a large market share. They have an audit committee(not liked by Siddharth) but no internal audit department.

Discussion

(a) What advantages might accrue to the company if they set up an internal auditdepartment?

(b) How might the auditors approach the audit?

(c) What specific duties are imposed on the auditor regarding internal control and internal audit?

Answer:

(a) Advantages of setting up an internal audit department:

1. Enhanced Internal Control
2. Compliance and Governance
3. Risk Management
4. Performance Improvement
5. Fraud Prevention and Detection

(b) Approach to the audit:

Given the company's rapid growth and Siddharth's emphasis on cost reduction, auditors should adopt a thorough and risk-based approach to the audit. They should consider the unique risks associated with the food processing industry and the recent expansion into mass-produced South-Indian foods. The audit approach should include:

1. Understanding the Business
2. Risk Assessment
3. Internal Control Evaluation
4. Testing and Verification
5. Fraud Detection

(c) Specific duties regarding internal control and internal audit:

1. Evaluating Internal Control
2. Reporting Control Deficiencies
3. Assessing Fraud Risks
4. Coordinating with Internal Audit
5. Consideration of Internal Audit Function

Summary

- Internal control encompasses a range of methods and procedures implemented to regulate the production, distribution, and overall system (both financial and non-financial) of an enterprise. It consists of key components such as financial and organizational plans, competent personnel, division of work, segregation of operational responsibilities from record-keeping, separation of asset custody and accounting functions, and authorization and managerial oversight.
- Internal control can be classified into various categories, including organizational controls, segregation of duties, physical controls, authorization and approval controls, arithmetical and accounting controls, personnel controls, and supervision and management controls.
- The benefits of implementing internal control measures include the identification of defects in processes, increased flexibility to accommodate operational changes, time savings through streamlined procedures, reduced risk of omissions or oversights, and provision of training opportunities for auditors to enhance their understanding of the internal control system.
- However, internal control systems also have their limitations, such as the potential for human errors arising from carelessness or misinterpretation, the costliness of implementing control procedures compared to the potential losses due to fraud or errors, limitations in addressing unusual or unexpected activities, the risk of collusion with external parties or internal employees, potential abuses of responsibility by those in control, and the possibility of the system becoming inadequate in response to changing conditions.
- Evaluation of internal controls is a crucial aspect of an audit. Based on the assessment of the effectiveness of the internal control system, the external auditor determines the extent of reliance placed on the system's functioning.
- An internal control questionnaire serves as a comprehensive list of questions covering all aspects of a client's system. The answers to these questions enable auditors to evaluate and assess the effectiveness of internal controls in operation.

Keywords

- Internal audit
- Fraud prevention
- Financial reporting
- Policies and procedures
- Risk management
- IT controls
- Internal control framework
- Accountability
- Ethics and integrity
- Audit trail
- Materiality

Self Assessment

1. What is the purpose of internal control in an organization?

A. To increase profits

B. To prevent fraud and errors

C. To reduce employee workloads
D. To streamline communication channels

2. Which of the following is a characteristic of an effective internal control system?
A. Limited employee training
B. Lack of segregation of duties
C. Regular monitoring and evaluation
D. Minimal documentation requirements

3. What is the primary objective of internal control?
A. Maximizing shareholder wealth
B. Ensuring regulatory compliance
C. Enhancing employee satisfaction
D. Increasing market share

4. Which of the following is an example of an internal control procedure?
A. Conducting background checks on employees
B. Conducting market research
C. Developing marketing strategies
D. Hiring external consultants

5. Which of the following is an inherent limitation of internal control?
A. Increased operational efficiency
B. Reduced risk of fraud
C. Possibility of human error
D. Enhanced decision-making process

6. Which department is typically responsible for conducting internal audits?
A. Human Resources
B. Finance and Accounting
C. Marketing
D. Operations

7. Which of the following is a key component of internal control?
A. Employee performance appraisal
B. Product pricing strategies
C. Customer relationship management
D. Segregation of duties

8. What is the purpose of a control activity in internal control?
A. To establish organizational goals
B. To monitor employee attendance
C. To enforce management policies

D. To provide employee benefits

9. Which of the following is an example of a preventive control measure?
A. Conducting surprise audits
B. Implementing segregation of duties
C. Conducting regular performance evaluations
D. Implementing an employee rewards program

10. Who is responsible for ensuring the effectiveness of internal control in an organization?
A. External auditors
B. Top management
C. Shareholders
D. Customers

11. Which of the following is NOT a component of the COSO framework for internal control?
A. Control environment
B. Risk assessment
C. Information technology
D. Monitoring activities

12. What is the purpose of segregation of duties in internal control?
A. To increase employee workload
B. To prevent conflicts of interest
C. To decrease operational efficiency
D. To limit communication channels

13. Which of the following is an example of an internal control weakness?
A. Regular monitoring and evaluation
B. Documented policies and procedures
C. Lack of management oversight
D. Adequate employee training programs

14. What is the role of internal auditors in an organization's internal control system?
A. Implementing control activities
B. Setting organizational goals
C. Conducting independent evaluations
D. Establishing risk assessment processes

15. Which of the following is an example of an internal control monitoring activity?
A. Conducting background checks on new employees
B. Developing a code of ethics for employees
C. Reviewing financial statements for accuracy
D. Creating an organizational chart

Answer for SelfAssessment

1.	B	2.	C	3.	B	4.	A	5.	C
6.	B	7.	D	8.	C	9.	B	10.	B
11.	C	12.	B	13.	C	14.	C	15.	C

Review Questions

1. Distinguish between internal control system and internal check system.
2. What is internal control questionnaire?
3. Should the statutory auditor examine the accounts already checked by the internal auditor?
4. To what extent the internal auditor is responsible for the internal control?
5. What do you mean by the term 'Internal Control'? What are the important features of a goodsystem of internal control?
6. What is internal audit? Distinguish between internal control and internal audit. 'The modern conceptof internal audit envisages scope of internal audit much beyond financial audit'—Explain.
   (a) Distinguish between internal audit and statutory audit.
   (b) Can the statutory auditor rely upon the internal audit in carrying out his function as a statutoryauditor?

Further Readings

- Auditing: Principles And Techniques By S. K. Basu, Pearsonn.S.
- A Hand Book Of Practical Auditing By B N Tandon, S Sudharsnam & S Sundharababu, S Chand Publishing
- Auditing And Corporate Governance By Anil Kumar Jyotsna Rajan Arora Lovleen Gupta, Taxmann Publisher

Web links

https://www.investopedia.com/terms/i/internalcontrols.asp

https://www.investopedia.com/terms/i/internalcontrols.asp

https://www.taxmann.com/post/blog/auditing-internal-control-meaning-objective-duties

Dr. Arpit Sidhu, Lovely Professional University

Unit 09: Internal Control on Various Transactions

CONTENTS

Objectives

After studying this unit, you will be able to:

- identify and illustrate objectives and basic elements of internal control.
- prepare, describe and analyze the internal control check list & internal control questionnaire

Introduction

In today's complex business environment, ensuring the reliability and integrity of financial information is of utmost importance for organizations and their stakeholders. Auditing plays a vital role in this process by providing an independent and objective assessment of an organization's financial statements. Within the realm of auditing, one critical aspect that demands meticulous attention is internal control on various transactions.

Internal control refers to the systems, processes, and procedures implemented by an organization to safeguard its assets, ensure accurate financial reporting, and promote operational efficiency. It encompasses a wide range of activities, including the authorization, recording, and reporting of transactions, as well as the protection of assets from fraud, error, and misappropriation.

The effectiveness of internal control on various transactions is crucial in mitigating risks, deterring fraudulent activities, and ensuring compliance with laws, regulations, and industry standards. It provides auditors with the necessary framework to assess the reliability and accuracy of financial information, making it an essential component of the auditing process.

9.1 Internal Controland Computerized Environment

The objective and scope of an audit remain consistent in a computer information system environment, although the utilization of computers introduces changes to how financial information is processed, stored, retrieved, and communicated. These changes can have an impact on an entity's accounting practices and internal control systems. Consequently, auditors must acknowledge and consider the implications of a computer information system environment on their audit procedures.

In order to effectively plan the audit and determine which areas might be influenced by the computer information system environment, auditors are required to gain a comprehensive understanding of the significance and complexity of the computer-related activities. Additionally, they must assess the availability and reliability of data that can be used in the audit process.

According to SA-315 (Identifying and assessing the risk of material misstatement through understanding the entity and its environment), auditors must extend their understanding to encompass the computer information system environment when it holds significance. This includes evaluating whether the computer information system environment might impact the assessment of inherent risk and control risk.

The nature of the risks and the internal control characteristics in computer information system environments include the following:

*1) Lack of transaction trails:*Certain computer information systems may not maintain a comprehensive transaction trail for audit purposes, either because the trail exists for a limited period of time or only in computer-readable form. This can make it difficult for auditors to trace and verify transactions. Moreover, complex computer application systems may lack a complete transaction trail, making it challenging to detect errors embedded in the program logic in a timely manner through manual procedures.

*2) Uniform processing of transactions:*Computer processing treats similar transactions uniformly, following the same set of processing instructions. As a result, clerical errors commonly associated with manual processing are significantly reduced. However, programming errors can have a widespread impact, affecting all processed transactions.

*3) Lack of segregation of functions:*In computer information system environments, control procedures that would typically be performed by separate individuals in manual systems may become consolidated. This concentration of functions means that an individual with access to computer programs, processing, or data may be able to perform incompatible functions, creating potential conflicts of interest and increasing the risk of fraudulent activities.

*4) Potential for errors and irregularities:*Human error in the development, maintenance, and execution of computer information systems can be more pronounced compared to manual systems due to the inherent complexity and level of detail involved. Additionally, computer information systems have an increased vulnerability to unauthorized access and data manipulation without visible evidence, making it easier for individuals to perpetrate errors or irregularities without immediate detection.

These factors highlight the unique challenges and risks posed by computer information system environments for auditors. It underscores the importance of implementing robust controls, conducting thorough assessments of the system's integrity, and developing specialized audit procedures to effectively address these challenges. By understanding and addressing these risks, auditors can enhance the reliability and accuracy of financial information in computerized systems, ultimately ensuring the effectiveness of internal controls and promoting trustworthy financial reporting.

9.2 Internal Control and Corporate Governance

A) Concept

The listing agreement has recently undergone an amendment, particularly in Clause 49, which is widely recognized as the corporate governance clause. The amendment entails the following provision:

"The CEO, who is the Managing Director or Manager appointed in accordance with the Companies Act, 2013, and the CFO, who is the full-time Finance Director or any individual leading the finance function and responsible for its operations, shall provide a certification to the Board. This certification states that they accept the responsibility for establishing and managing internal controls. Additionally, they confirm that they have evaluated the effectiveness of the company's internal control systems. If they are aware of any deficiencies in the design or operation of the internal controls, they must disclose these to the auditors and audit committee. Furthermore, they are required to outline the steps they have taken or plan to take to rectify these deficiencies.

Furthermore, they are obligated to communicate the following to the auditors and Audit committee:

1. Any significant changes that have occurred in the internal control system throughout the year.
2. Any significant changes in accounting policies during the year, which have been duly disclosed in the financial statements' accompanying notes.
3. Instances of significant fraud that have come to their attention, along with any involvement of the management or an employee holding a significant role within the company's internal control system."

This amendment reinforces the importance of accountability and transparency within the organization. It places responsibility on the CEO and CFO for establishing and managing effective internal controls. It also ensures that any deficiencies or changes in internal control, accounting policies, or instances of significant fraud are promptly disclosed to the auditors and audit committee. By implementing these requirements, the amendment aims to enhance corporate governance practices and bolster the reliability of financial reporting.

B) Objectives

Internal control can be defined as a comprehensive process implemented by management and other personnel within an organization. Its primary purpose is to provide reasonable assurance concerning the achievement of objectives in the following categories:

*1) Effectiveness and efficiency of operations:*Internal control aims to ensure that the organization's operations are conducted in an effective and efficient manner. This includes achieving business objectives related to performance, profitability, and the safeguarding of assets.

*2) Reliability of financial reporting:*Another crucial objective of internal control is to ensure the reliability of financial reporting. This encompasses the accurate preparation of financial statements and the data derived from such statements, including press releases and other external communications.

3) Compliance with applicable laws and regulations: Internal control also focuses on ensuring compliance with relevant laws and regulations that apply to the organization. This involvesadhering to legal requirements, industry standards, and ethical practices.

While internal control is a continuous process, its effectiveness can be assessed at various points in time. It represents the state or condition of the control process and its ability to achieve the desired objectives.

By emphasizing these three categories, internal control encompasses the broader goals of an organization, including operational efficiency, reliable financial reporting, and legal compliance. It serves as a crucial framework for establishing accountability, mitigating risks, and enhancing overall governance within the organization.

9.3 Internal Control in Specific Areas of Business

This section is divided into the areas of activity usually found in a business. At the beginning of each area are stated the objectives of internal control in the area and some measures then follow which will achieve the objectives.

9.4 Internal Control in general

Objectives

To carry on the business in an orderly and efficient manner, to ensure adherence to management policies, safeguard its assets, and secure the accuracy and reliability of the records.

Measures

1. An appropriate and integrated system of accounts and records.

2. Internal controls over those accounts and record.

3. Financial supervision and control by the management, including budgetary control, management accounting reports and interim accounts.

4. Safeguarding and if necessary duplicating records.

5. Engaging, training, allocating to specific duties staffs who are capable of fulfilling theirresponsibilities.

6. Rotation of duties and cover for absences.

9.5 Internal control of Cash Sales and Collections

Objectives:

1. Ensure the receipt of all cash rightfully owed to the enterprise.
2. Ensure proper accounting and recording of all received cash in the company's records.
3. Ensure prompt and intact deposit of all received cash.

Measures:

1. Establishing authorized personnel who are limited in number to handle cash, such as sales assistants, cashiers, and travelers.
2. Implementing methods to provide evidence of cash receipts, such as the use of pre-numbered duplicate receipt forms or cash registers with sealed till rolls. The duplicate receipt form books should be securely stored and issued under strict control.
3. Ensuring that customers are informed that they must receive a receipt or making sure that the cash register display is clearly visible to the customer.
4. Appointing responsible officers to empty cash registers at prescribed intervals, verifying the amount with till roll totals or internal registers. These collections should be documented and initialed by both the assistant and the supervisor.
5. Ensuring immediate and intact banking of cash. Payments should be made from funds drawn from the bank through an imprest system.
6. Conducting investigations into shortages and excesses to identify and address any discrepancies.
7. Independently comparing agreed till roll totals with subsequent banking records to verify accuracy.
8. Implementing a rotation of duties and providing coverage for holidays and sickness, ensuring that multiple individuals handle cash handling responsibilities.
9. Requiring salesmen to bank their collections intact on a daily basis. Independent comparisons should be made between the amounts banked and the records of the salesmen.
10. Restricting access to other cash funds, bought ledger records, and sales ledger records for individuals responsible for handling cash.

By implementing these objectives and measures, organizations can establish effective internal controls for cash receipts and payments. These measures promote transparency, accuracy, and accountability in handling cash, reducing the risk of errors, fraud, and misappropriation. It is important for organizations to adapt these measures to their specific needs and regularly review and update them to address emerging risks and changes in the business environment.

9.6 Internal Control of Payment into Bank

Objectives:

1. Ensure that all cash and cheques received are deposited in the bank in their entirety and without any deductions.
2. Ensure that all cash and cheques received are promptly deposited at prescribed intervals, preferably on a daily basis.
3. Ensure that all cash and cheques received are accurately accounted for and recorded in the company's financial records.

Measures:

1. Implement a policy to bank all cash and cheques received intact, without removing any portion of the funds.
2. Establish procedures to ensure that cash and cheques are promptly deposited without unnecessary delays.
3. Assign the responsibility of preparing the bank paying-in-slip to an official who does not have access to cash collection points, as well as the bought or sales ledger.
4. Prioritize the security of cash deposits, especially for large sums, by utilizing security guards or other appropriate measures.
5. Conduct independent comparisons between the bank paying-in-slips and the collection records, post lists, and sales ledger records to verify the accuracy and completeness of deposits.

9.7 Internal Control of Cash Balances

Objectives:

1. Prevent misappropriation of cash.
2. Prevent unauthorized cash payments.

Measures:

1. Establish cash floats of predetermined amounts and designate specific locations for their custody and use.
2. Appoint responsible officials to oversee each cash transaction, ensuring accountability and transparency.
3. Implement security measures such as the use of safes and restricted access to cash handling areas to safeguard against unauthorized access or theft.
4. Utilize an imprest system that allows for reimbursement of cash expenditures only upon submission of authorized vouchers.
5. Enforce strict rules and procedures for authorizing cash payments, ensuring that only authorized personnel can approve such transactions.
6. Conduct regular and surprise independent cash counts to verify the accuracy of cash balances and identify any discrepancies.
7. Consider insurance arrangements, such as insuring cash balances and obtaining fidelity guarantees, to provide additional protection against potential losses.

8. Implement special rules regarding IOUs, ideally not permitting their use to maintain proper control over cash transactions.

9.8 Internal Control of Cheques Payments

Objectives

To prevent unauthorized payments being made from bank accounts.

Measures

1. Control over custody and issue of unused cheque books. A register should be kept if necessary.
2. Appointment of an official to be responsible for the preparation of cheques or traders credits.
3. Rules should be established for the presentation of supporting documents before cheques can be made out. Such supporting documents may include goodsreceipts note, orders, and invoices, etc.
4. All such documents should be stamped 'paid by cheque no…' with date.
5. All cheques should be signed by at least two persons, with no person being permitted to sign if he/she is a payee.
6. No cheques should be made out to bearer except for the collection of wages or reimbursement of cash funds.
7. All cheques should be strictly crossed.
8. The signing of blank cheques must be prohibited.
9. Special rules for authorizing and checking direct debits and standing orders.
10. Separation of duties: custody, recording and initiation of cheque payments.

9.9 Purchases and Trade Creditors

Objectives:

1. To ensure that goods and services are procured in an appropriate quantity, quality, and at the most favorable terms, following the necessary requisition and approval process.
2. To guarantee that only acceptable items are received by inspecting the goods and services upon delivery.
3. To verify that all invoices are cross-checked against authorized orders and receipts, ensuring that the received items are in good condition.
4. To maintain accurate records of all invoiced goods and services in the company's books.

Measures:

1. Establish procedures that specify designated personnel responsible for requisitioning goods and services. Use designated forms with space for acknowledging performance.
2. Safeguard pre-numbered order forms and keep them securely. Maintain strict control and documentation when issuing blank order form books.
3. Record all received goods either on goods received notes or in a dedicated register.
4. Inspect all goods upon receipt to verify their condition and conformity with the placed order. Acknowledge the inspection process.
5. Periodically, compile a list of outstanding orders and conduct thorough investigations into their status.

6. Thoroughly review invoices for accuracy in calculations, pricing, proper application of taxes and trade discounts, and conformity with the corresponding orders.
7. Regularly verify the accuracy of the total entries in the invoice register or day book.
8. Ensure that personnel responsible for purchase ledger entries are separate from those in charge of ordering, receiving goods, and maintaining the invoice register.
9. Conduct frequent reconciliations or independent checks of the purchase ledger by a senior official not directly involved in the process.
10. Regularly compare ledger account balances with the supplier's statements of account.
11. Implement necessary cut-off procedures at the end of the year.
12. Establish an appropriate coding system for the purchase of goods and services to ensure accurate debit entries in the correct nominal accounts.

9.10 Internal Control of Sales and Debtors

Objectives:

1. Ensure prompt execution of all customer orders.
2. Limit sales on credit to trustworthy and reliable customers with low credit risk.
3. Invoice all credit sales accurately, applying authorized prices and thoroughly checking price, trade discounts, and tax information prior to issuing invoices.
4. Record all raised invoices in the company's books.
5. Conduct thorough investigations into customer claims before issuing credit notes.
6. Make every effort to collect outstanding debts from customers.

Measures:

1. Maintain a record of incoming orders on pre-numbered forms, acknowledging them if necessary. Match orders with invoices and prepare periodic lists of outstanding orders for management to take appropriate actions. Conduct regular sequence checks under the supervision of a senior official.
2. Establish procedures for verifying the creditworthiness of individuals or businesses seeking credit for purchasing goods. Set credit limits accordingly.
3. Define selling prices, credit terms, trade and cash discounts, and special prices through established policies.
4. Assign a separate department for the invoicing process. Use pre-numbered invoices and control the custody and issuance of unused invoice blocks while maintaining proper documentation.
5. Independently verify all invoices to ensure they align with customer orders, goods dispatch records, and accurate pricing, discounts, and tax details. Require acknowledgment through signature or initials for all actions taken.
6. Segregate accounting for sales and debtors by employing separate staff for cash management, invoice register, sales ledger entries, and statement preparation.
7. Pre-list sales invoices before entering them into the invoice register or day book. Independently compare the pre-listed total with the total in the register.
8. Record and investigate customer claims, applying similar controls to credit notes. Conduct a thorough investigation and assessment of all unresolved claims at the end of the year.
9. Regularly prepare a control account that is independent and separate from other financial records.

10. Conduct regular reviews of all balances by an independent official to identify and investigate overdue accounts, debtors making instalment payments, and discrepancies between payments and invoices.
11. Write off bad debts only after conducting a thorough investigation and obtaining authorized approval from senior management.
12. Prepare an aged analysis of debtors at the end of the year to assess the necessity for a provision for doubtful debts.

Summary

- The internal audit system offers several benefits, such as the prevention and early detection of errors and frauds, continuous review of internal control systems, assurance regarding the accuracy of books and accounts, preparation of interim accounts, early completion of annual audits, periodic physical verification, and assistance to the statutory auditor. The scope of internal audit encompasses the review of the accounting system and related internal controls, examination of the management of financial and operating information, assessment of operational effectiveness, and physical verification.
- Evaluating internal controls is a crucial aspect of an audit. Based on the evaluation of the internal control system's effectiveness, the external auditor will determine the extent to which they can rely on its functioning.
- While internal controls offer significant advantages, there are also a few disadvantages to consider. These include the potential for human error, high costs associated with implementation, the possibility of overlooking unusual activities, collusion among individuals, abuse of responsibility, and inflexibility.

Keywords

- Internal audit
- Fraud prevention
- Financial reporting
- Policies and procedures
- Risk management
- IT controls
- Internal control framework
- Accountability
- Ethics and integrity
- Audit trail
- Materiality

Self Assessment

1. What is the purpose of internal control on various transactions?

A. To prevent fraud and error
B. To increase transaction volume
C. To reduce employee workload
D. To maximize profits

2. Which of the following is an example of an internal control measure for cash transactions?
A. Requiring two signatures for checks above a certain amount
B. Accepting cash payments without verifying their source
C. Allowing employees to handle cash without supervision
D. Recording cash transactions in a spreadsheet without backup documentation

3. How does segregation of duties contribute to internal control on various transactions?
A. It ensures that the same person performs all tasks related to a transaction.
B. It reduces the likelihood of collusion and unauthorized actions.
C. It speeds up the transaction processing time.
D. It eliminates the need for regular financial audits.

4. Which of the following is an example of an internal control procedure for inventory management?
A. Allowing employees to access the inventory storage area without supervision
B. Conducting inventory counts only once a year
C. Implementing a barcode scanning system to track inventory movements
D. Failing to reconcile physical inventory counts with accounting records

5. Why is documentation important for internal control on various transactions?
A. It provides a record of transactions for future reference.
B. It increases the complexity of the control system.
C. It allows employees to bypass control procedures.
D. It reduces the need for regular financial reporting.

6. How does internal control on various transactions help ensure the accuracy of financial statements?
A. It eliminates the need for financial statement preparation.
B. It ensures that financial statements are always favorable to the organization.
C. It reduces the risk of material misstatements in financial statements.
D. It allows for the manipulation of financial data.

7. What is the purpose of implementing IT controls in internal control systems for transactions?
A. To increase transaction processing time
B. To eliminate the need for manual controls
C. To prevent unauthorized access to data and systems
D. To reduce the need for financial reporting

8. Which of the following is an example of a detective control in the context of internal control on various transactions?
A. Segregating duties among different employees
B. Implementing a system to monitor and detect unusual transaction patterns
C. Requiring employees to take vacations regularly

D. Allowing employees to handle cash without supervision

9. What is the purpose of internal control on various transactions in an organization?
A. To increase the complexity of transaction processes
B. To minimize the need for financial reporting
C. To safeguard assets and ensure accurate financial records
D. To delegate control responsibilities to external auditors

10. Which of the following is an example of a preventive control in the context of internal control on purchasing transactions?
A. Requiring purchase orders for all purchases
B. Allowing employees to make purchases without approval
C. Delaying payments to suppliers indefinitely
D. Failing to review vendor invoices for accuracy

11. How does the principle of "segregation of duties" contribute to internal control on payroll transactions?
A. It allows one person to handle all aspects of payroll processing.
B. It increases the risk of payroll fraud and errors.
C. It ensures that multiple individuals are involved in different payroll functions.
D. It eliminates the need for payroll documentation.

12. Which of the following is an internal control measure to prevent unauthorized access to computer systems and data?
A. Sharing passwords among employees for convenience
B. Implementing strong password policies and regular password updates
C. Allowing unrestricted access to sensitive information
D. Disabling firewall and antivirus software

13. How does reconciliation of bank statements contribute to internal control on cash transactions?
A. It allows for discrepancies between cash balances and bank balances.
B. It ensures that cash withdrawals are made without proper authorization.
C. It verifies the accuracy of cash transactions recorded in the accounting system.
D. It eliminates the need for regular cash flow forecasting.

14. What is the purpose of conducting regular physical inventory counts as part of internal control on inventory transactions?
A. To disregard any discrepancies found during the count
B. To discourage employees from reporting inventory shortages
C. To identify theft and errors in inventory records
D. To eliminate the need for inventory valuation

15. How does internal control on various transactions contribute to compliance with legal and regulatory requirements?

A. It encourages unethical business practices.
B. It eliminates the need for financial audits.
C. It ensures that transactions are conducted in accordance with applicable laws.
D. It allows for non-disclosure of financial information.

Answers for Self Assessment

1.	A	2.	A	3.	B	4.	C	5.	A
6.	C	7.	C	8.	B	9.	C	10.	A
11.	C	12.	B	13.	C	14.	C	15.	C

Review Questions

1. Distinguish between internal control system and internal check system.
2. What is internal control questionnaire?
3. Should the statutory auditor examine the accounts already checked by the internal auditor?
4. To what extent the internal auditor is responsible for the internal control?
5. What do you mean by the term 'Internal Control'? What are the important features of a goodsystem of internal control?
6. Suggest a set of rules you would recommend for the internal control over the purchases of raw materials and stores of a large manufacturing concern.
7. Draft a form of questionnaire, which you would use for determining the effectiveness of the client'sinternal control over payrolls.
8. (a) Distinguish briefly internal control, internal check and internal audit.
   (b) Discuss the general considerations in framing a system of internal control in respect of purchaseof goods.

Further Readings

- Auditing: Principles And Techniques By S. K. Basu, Pearsonn.S.
- A Hand Book Of Practical Auditing By B N Tandon, S Sudharsnam& S Sundharabahu, S Chand Publishing
- Auditing And Corporate Governance By Anil Kumar Jyotsna Rajan Arora Lovleen Gupta, Taxmann Publisher

Web links

https://www.investopedia.com/terms/i/internalcontrols.asp

https://www.investopedia.com/terms/i/internalcontrols.asp

https://www.taxmann.com/post/blog/auditing-internal-control-meaning-objective-duties

https://www.ifac.org/system/files/publications/files/internal-control-guide-for-smes.pdf https://www.councilofnonprofits.org/sites/default/files/documents/2021-01/internal-control-financial-accountability-nonprofits.pdf

https://boardsource.org/wp-content/uploads/2017/09/Internal-Controls-A-Guide-for-Nonprofit-Boards-Web-Version.pdf

Unit 10: Internal Checking

CONTENTS

Objectives

After studying this unit, you will be able to:

- identify and illustrate objectives and basic elements of internal control.
- prepare, describe and analyze the internal control check list & internal control questionnaire

Introduction

Internal check plays a crucial role in the field of auditing, serving as an essential mechanism to ensure the accuracy, reliability, and integrity of financial information within an organization. It encompasses a system of checks and balances implemented within an organization's processes and procedures. The primary objective of internal check in auditing is to prevent and detect errors, fraud, and irregularities by dividing responsibilities and establishing independent verification processes. By implementing an effective internal check system, auditors can rely on the internal controls established by the organization to gain assurance and confidence in the financial statements and related information. This introduction highlights the significance of internal check as a fundamental component of the auditing process.

10.1 Definition

The concept of internal check involves a systematic arrangement of responsibilities within the accounting department, ensuring that the work performed by one individual is automatically verified by another. According to Spicer and Pegler, internal check is a framework of staff duties that prohibits any single person from fully executing and documenting all aspects of a transaction. This arrangement effectively prevents fraud without the need for collusion, while minimizing the potential for errors.

The Institute of Chartered Accountants of England and Wales defines internal check as an ongoing process of checks applied to day-to-day transactions within a routine system. These checks involve the independent or complementary verification of one person's work by another, with the ultimate goal of preventing or promptly detecting errors or frauds.

Based on the aforementioned definitions, it can be concluded that internal check is a system where tasks are divided among employees in a manner that prevents any one individual from overseeing the entire process from start to finish. Instead, the work of each individual is automatically cross-checked by another, ensuring a robust system of internal controls.

10.2 General Considerations in Framing a System of Internal Check

(a) Work assignment: It is important to distribute tasks among multiple individuals, ensuring that no single person is solely responsible for a specific work. All activities and transactions performed by employees should be subject to the review and oversight of others.

(b) Rotation of employees: Regular rotation of duties among staff members should be implemented without prior notice. This practice prevents any officer or subordinate from continuously performing the same function for an extended period, reducing the risk of impropriety.

(c) Compulsory leave: Encouraging all staff members to take annual leave is crucial. Experience has shown that instances of fraud, which may have been concealed by employees, often come to light when they are on leave.

(d) Separation of inter-related jobs: It is essential to ensure that individuals who have physical custody of assets do not have access to the books of accounts. This separation of responsibilities helps to maintain integrity and prevent potential conflicts of interest.

(e) Use of mechanical devices: Employing mechanical devices, such as automatic cash registers, can help prevent cash losses or misappropriation.

(f) Periodical review: The distribution of financial and administrative power should be carefully allocated among different officers, and periodic reviews of their exercised authority should be conducted.

(g) Responsibility: Clearly defining and assigning responsibilities to each individual is crucial. The allocation of tasks among staff members should be done in a manner that ensures clear and judicious division of duties and responsibilities.

(h) Safeguards: To facilitate stock-taking at the end of the year, it is advisable, if possible, to suspend trading activities temporarily. The evaluation and inventory counting should involve staff members from different sections of the organization. Depending solely on the stock section staff for these tasks could be risky, as they may be tempted to manipulate stock levels.

(i) Supervision: Strict supervision should be maintained to ensure the effective implementation of prescribed internal checks and procedures.

(j) Reliance: It is important not to overly rely on any particular staff member. The system should incorporate automatic checks, whereby the work of each employee is verified by another employee.

10.3 Objectives of Internal Check

The objectives of an internal check system can be summarized as follows:

(a) Assigning responsibility: To allocate duties and responsibilities to each employee in a manner that allows for clear identification and accountability for specific errors or frauds.

(b) Minimizing errors or frauds: To minimize the likelihood of errors or fraudulent activities committed by staff members.

(c) Detecting errors or frauds: To easily detect errors or frauds through the independent checking of one employee's work by another.

(d) Reducing clerical mistakes: To minimize the chances of any transactions being omitted from the books of accounts.

(e) Enhancing work efficiency: To enhance staff efficiency through the management of duties based on the principle of division of labor.

(f) Obtaining confirmation: To obtain confirmation of facts and entries, both physical and financial, through the proper presentation and maintenance of records.

(g) Reducing the burden of work: To lessen the workload of independent auditors by implementing an internal check system in a systematic manner.

(h) Exercising moral pressure: To exert moral pressure on employees by introducing a continuous review process of the entire system.

(i) Ensuring reliability: To ensure the reliability of accounting records and books, thereby facilitating effective business control.

(j) Obtaining supervision advantages: To gain the advantages of supervising various assets, cash inflows and outflows, and goods within the business.

10.4 Advantages of Internal Check

The advantages of an internal check system can be discussed from various perspectives:

A) From a business point of view:

(i) Proper allocation of work: Rational allocation of work among different staff members brings precision and efficiency to the work performed.

(ii) Control device: The distribution of work acts as a control device against dishonest employees, reducing the likelihood of fraudulent manipulation.

(iii) Speedy work: Specialization and continuity in job roles lead to efficient performance and increased speed of work.

(iv) Increase in efficiency and skill: A well-designed internal check system enhances staff efficiency by assigning suitable tasks to individuals based on their skills.

(v) Easy preparation of final accounts: By dividing the work among employees and ensuring regular updates, maintaining up-to-date books of accounts becomes easier, facilitating the preparation of final accounts.

(vi) Creation of moral check: The knowledge that each employee's work will be checked by others acts as a deterrent to errors and frauds.

B) From the viewpoint of the owners:

(i) Reliability on accounts: A robust internal check system enables owners to rely on the authenticity and accuracy of the accounts.

(ii) Orientation of accounting: Clearly defined and fixed responsibilities foster a system of accounting known as responsibility accounting.

(iii) Economical operation: While implementing a well-integrated internal check system may seem costly, in practice, it optimizes staff utilization without incurring additional expenses.

C) From the perspective of the auditor:

(i) Facilitation of audit work: A sound and efficient internal check system facilitates the auditor's work by allowing reliance on "test checks" rather than comprehensive verification.

(ii) Attention to other important matters: With confidence in the internal check system, auditors can allocate more attention to other critical areas instead of focusing extensively on routine checking tasks.

10.5 Shortcoming of Internal Check System

The internal check system has certain shortcomings that should be considered:

(a) Monotony: Engaging in the same type of work for an extended period can lead to a monotonous attitude among employees, potentially affecting their motivation and productivity.

(b) Carelessness: Some responsible officials may become complacent under the belief that a sound internal check system prevents any errors or wrongdoing, leading to a potential lack of diligence or attentiveness.

(c) Collusion: The effectiveness of the internal check system can be undermined if there is collusion among the staff members, rendering the intended checks and balances ineffective.

(d) Limited application: The practical application of the internal check system is often limited to larger organizations. Implementing it in smaller organizations may result in unnecessary time consumption and additional expenditure.

(e) Dependence: Statutory auditors often rely on the internal check system, which can lead to a reduced scope of their examination as they conduct test checks instead of thorough reviews.

(f) Possibility of disorder: In the absence of a well-organized internal check system, the working of a business may suffer from chaos and disorder.

It is important to recognize these shortcomings and implement measures to address them effectively.

10.6 Internal Check System as Regards to Purchase

Purchases can be classified into two types: cash purchase and credit purchase. The internal control measures for cash purchase are relatively straightforward compared to credit purchase. The internal checks for both cash and credit purchases are outlined below:

(a) Purchase requisition: No purchases should be made without a purchase requisition slip issued by the store department. The procedure for issuing purchase requisitions should be clearly specified. The requisition slip must include details such as the quantity, quality, and delivery time of the goods.

(b) Enquiry for purchase: To acquire the necessary items, the purchase department conducts inquiries about the terms and conditions of purchases from various suppliers. Typically, tenders are invited, and the tenders offering the lowest price are generally accepted.

(c) Purchase order: The purchase manager or another authorized officer of the organization should be solely responsible for issuing purchase orders. One original copy and three duplicates of the order should be prepared. The original purchase order is sent to the supplier, the first copy is sent to the store department, the second copy is sent to the accounts department, and the last copy is retained by the purchase department for reference.

(d) Receipts of goods: All goods received from the supplier must be checked against the copy of the purchase order and the supplier's delivery documents. A goods receipt register should be maintained to record the receipt of goods after proper inspection of their quantity and quality, either at the store department or a centralized warehouse. All supplier invoices should be carefully examined and entered into the purchase daybook.

(e) Payment processing: The purchase department should meticulously review the invoices and forward them to the accounts department for payment. The accounts department should compare the invoices with the purchase orders and verify the calculations. Only authorized personnel should draw a cheque for invoice payment, which should be marked as 'PAID' after the transaction is completed. All payments should be made using "A/c payee cheques."

By adhering to these internal control measures, organizations can effectively manage their purchases, ensuring proper authorization, documentation, and verification processes are followed, thereby minimizing the risk of errors, fraud, or unauthorized purchases.

10.7 Internal Check System as Regards to Sales

Sales represent the primary and often sole source of income for a business organization. Consequently, it is crucial to establish an effective system of internal checks for sales operations. The internal check system for sales should address the following aspects:

(a) Independent sales department: A separate and independent sales department should be established, consisting of various sub-departments. The department should be overseen by a sales manager or a senior competent officer.

(b) Order receipts: Upon receiving an order, it should be assigned a unique number and recorded in an orders received book, along with comprehensive order details. Verbal orders should be confirmed in writing. The despatch department should receive a copy of the order containing relevant particulars.

(c) Goods packaging: The despatch department should handle the packing of goods according to the details specified in the sales order. The department should maintain a separate statement indicating the goods that have been packed.

(d) Invoicing process: The statement of goods prepared by the despatch department should be cross-checked with the customers' orders. Based on this verification, the invoice should be prepared in triplicate.

(e) Invoice verification: A responsible official should carefully review the invoice, paying special attention to the rates charged and calculations made. They should ensure compliance with the terms and conditions specified in the order, eliminating any potential for customer complaints. The official should initial the invoice to indicate its verification.

(f) Goods dispatch: Using the invoice copies, entries should be recorded in the sales day book. The despatch of goods should be documented in the goods outward book. Two copies of the invoice may be sent to the customer, who will return one copy after signing it.

By implementing these internal check procedures, organizations can maintain a robust system to ensure accurate sales processes, minimize errors, and enhance customer satisfaction.

10.8 Internal Check as Regards Movement of Materials

Organizations are often required to maintain and manage stocks and stores of various types, including finished goods, semi-finished goods, and raw materials. It is essential to establish a proper and effective control system to safeguard these items against pilferage, theft, or misuse. An appropriate system of internal checks should be devised to ensure accurate records, prevent theft, and reduce wastage. The internal check system for stocks and stores can be outlined as follows:

(a) Receipts of materials in stores:

The process of maintaining stocks starts with the receipt of materials in stores. To implement an effective internal check system for material receipts, the following considerations should be taken into account:

(i) Store location: The store building should be conveniently located with adequate storage space and proper ventilation to prevent waste, misplacement, or misuse of materials.

(ii) Requisition: The storekeeper should submit requisitions to the purchase department based on the demand from the production department to procure the required materials.

(iii) Materials received note: Upon receipt of purchased materials, the storekeeper should prepare a materials received note in triplicate—one copy for the purchase department, one for the accounts department, and the third for the store's own records.

(iv) Recording: The accounts department should record the materials received in the materials inward book, while the stores department should record them in the bin card.

(v) Inspection: Materials should be inspected properly upon receipt before they are placed in stores.

(b) Delivery of materials from stores:

The purpose of procuring materials is to supply them to the production department based on their requirements. To monitor the delivery of materials from stores to the production departments, the following points should be considered:

(i) Requisition process: Proper requisitions should be submitted on behalf of the respective departmental authority to issue different types of stores to different departments.

(ii) Specific materials supply: Materials should only be supplied to departments upon receipt of requisitions specifically requesting those materials.

(iii) Requisition forms: Different departments should use requisition forms of different colors for the supply of specific types of materials.

(iv) Recording: Materials issued from stores should be recorded in the materials outwards book.

(v) Returns: If any materials are returned to stores, a materials return note should be prepared and recorded accordingly.

(c) Accounting of store movements:

The recording and accounting of material movements form a critical area of the internal check system. It is important to assign the responsibility of recording to a person who is separate from the physical handling of materials. To ensure proper implementation of the internal check system for accounting material movements, the following measures should be followed:

(i) Responsibility: An efficient accountant should be assigned the responsibility for accounting of stores.

(ii) Separate store ledgers: Separate store ledgers should be maintained for each type of material.

(iii) Bin cards: Separate bin cards should be used to record the movement of each item of material.

(iv) Verification: Regular verification of the store ledger with the bin card should be conducted at fixed intervals to identify any discrepancies.

(v) Reporting discrepancies: If any material discrepancies are found to be material, they should be promptly reported to management for necessary action.

By adhering to these principles of internal checks for stocks and stores, organizations can establish effective control systems to ensure accurate records, prevent theft or misuse, and reduce wastage.

(d) Counting and maintenance of stores:

The valuation of material stock in the stores at specific intervals is essential for accurate financial reporting. The inventory directly impacts both the profit and loss account and the balance sheet, which are crucial financial statements for assessing the financial performance and position of an organization. To ensure proper counting and maintenance of stores, the following considerations should be taken into account:

(i) A separate list should be prepared for each type of stores, incorporating the quantity of materials, acquisition rates, and the actual procurement value.

(ii) The task of counting the stores at regular intervals should be assigned to an employee who is not involved in the maintenance of stores.

(iii) Different employees should be engaged to count various types of stores separately.

(iv) A responsible employee should be assigned the responsibility of recording the valuation rate and the actual value of stores in the appropriate column of the stock sheet.

(v) The individuals preparing the stock sheets should sign them, and the counting and addition on the stock sheet should be verified by a separate employee.

(vi) After thorough verification, the stock sheet should be signed by higher-level officials.

(e) Preservation of stores:

Efficient preservation of procured materials is crucial to avoid wastage and misuse. The cost of production can increase due to improper maintenance of stores. To ensure proper preservation of materials, the following actions should be considered:

(i) Allocate a separate and appropriate place for each type of material.

(ii) Assign unique code numbers to different classes of materials for easy identification.

(iii) A responsible official should regularly count and check the stores, comparing the bin cards with the stores ledger.

(iv) Any discrepancies between the actual stock and the recorded stock in the books should be adjusted or written off with the approval of the appropriate authority.

(v) Conduct physical verification of the material stock at the end of the accounting period or at irregular intervals if necessary.

(vi) A responsible official should examine whether proper security measures have been implemented for the preservation of stores. If any defects or drawbacks are identified, they should be reported to the relevant authority for appropriate action.

10.9 Internal Check System as Regards to Cash Receipts

The significance of addressing the risk of cash misappropriation cannot be overstated. Cash transactions are particularly susceptible to various forms of fraud. To minimize the likelihood of fraudulent activities, an effective internal check system should be implemented for cash receipts. This system should incorporate the following principles:

(a) Separation of duties: The cashier should not have access to ledgers and other books of original entry, except for the rough cashbook used for immediate recording of cash receipts.

(b) Control over receipts book: A printed receipts book with sequential numbering should be utilized whenever cash is collected. Each receipt should be countersigned by a responsible manager. Unused receipt books must be securely stored.

(c) Handling of incoming remittances: The cashier should open all incoming correspondences, including remittances, in the presence of a responsible officer. Cheque receipts should be clearly marked with a rubber stamp indicating "A/c payee only."

(d) Depositing cash into the bank: Cash and cheque collections should be deposited into the bank on a daily basis. The clerk should complete the counterfoil portion of the paying-in slip, while the cashier fills in the portion to be retained by the bank.

(e) Reconciling bank statements: The cashier should regularly prepare bank reconciliation statements to ensure an accurate understanding of the actual bank balances.

(f) Correcting the cashbook: Cancelled or spoiled slips should be marked accordingly and not torn out or removed from the receipt book. Overwriting should be discouraged, and any necessary alterations should involve rewriting with proper initials.

By adhering to these principles of internal check for cash transactions, organizations can enhance the effectiveness of their internal control systems and mitigate the risks associated with cash misappropriation.

10.10 Internal Check System as Regards to Cash Payments

The principles of internal check for cash payments can be outlined as follows:

(a) Payments through cheques: It is advisable to make all payments through account payee cheques.

(b) Separation of duties: The individual responsible for making payments should not be involved in cash receipts.

(c) Proper authorization: All cheques should be duly signed by authorized personnel, and payments exceeding the amount of 20,000 should only be made through 'A/c payee' cheques. This requirement is in accordance with Section 40A(3) of the Income Tax Act, 1961, which states that expenses exceeding 20,000 must be paid by crossed cheques to qualify for business income deductions.

(d) Safety measures for unused cheques: All unused cheques should be securely stored.

(e) Control over payment vouchers: Measures should be implemented to prevent the presentation of payment vouchers for duplicate payments. Such vouchers should be stamped as 'paid' before the cheques are signed.

(f) Confirmation with creditors: A responsible official should verify statements received from creditors by cross-checking them with invoices and ledger accounts. Only after proper verification should cheques be issued in favor of the creditors. Direct correspondence should also be conducted to confirm accounts with creditors.

(g) Cash discount: To avail cash discounts, payments should be made on fixed dates at regular intervals, such as monthly or periodically.

(h) Reconciliation of bank balance: Bank reconciliation statements should be prepared by individuals other than the cashier to reconcile bank and cash balances periodically.

By adhering to these principles of internal check for cash payments, organizations can enhance control and minimize the risk of errors and fraudulent activities in their cash disbursement processes.

10.11 Internal check as regards to wage payments

The system of internal check for wage management should be carefully planned and implemented, particularly in manufacturing concerns where wages are often based on the time spent by each worker. Accurate recording of time is crucial for ensuring proper payment of wages. To establish an effective internal check system for wage payment, the following procedures are recommended:

A. Maintenance of wage records:

(i) Time work recording:

i. Time recording clock: A time recording clock should be placed at the factory entrance. Workers are required to insert their entry cards into the clock upon arrival and departure to record their actual working hours.
ii. Brass metal token: Each worker should be assigned a numbered brass metal token. Upon entering the factory, workers place their tokens in the designated location on a board. The timekeeper records their attendance in the register based on the tokens.
iii. Attendance card: Workers are provided with attendance cards that they deposit in a box near the gate upon entering the factory. The gatekeeper collects these cards to record the time in the attendance register.

(ii) Piecework recording:

i. Job cards: Workers who are paid based on the work performed receive job cards that contain details such as the worker's name, assigned tasks, work volume, and wage or job rate. The piecework reviewer checks these cards along with the quality and quantity of goods produced. The job cards assist in preparing the wage sheet.

(iii) Overtime recording:

i. Overtime slips: Overtime payments are made when authorized. Each worker allowed to work overtime should receive an overtime slip containing information such as the worker's name, job details, and the applicable wage rate. The slip should be reviewed and approved by a foreman or the works manager. It is then sent to the accounts department for inclusion in the wage sheet.

(iv) Pass-out recording:

i. Pass-out slips: Workers generally cannot leave the factory during working hours. However, in exceptional cases, such as for personal reasons, pass-out slips are issued. Two copies of the slip are prepared, with the original given to the worker to be handed over to the gatekeeper upon leaving the factory. The other copy is sent to the wage department for wage sheet preparation.

B. Preparation of wage sheets:

A dedicated wage department should be responsible for preparing wage sheets.The assignment of preparing wage sheets should be divided among multiple employees in the wage department to minimize irregularities.Attendance data from registers, job cards, overtime slips, pass-out slips, etc., should be utilized.Separate wage sheets should be prepared for time workers and pieceworkers.

Wage sheets should include essential details such as worker names, identification numbers, departments, total time worked, work details, applicable wage rates, total wages payable, bonus entitlement (if applicable), overtime wages (if any), deductions, and net wages payable.

The wage sheet preparation process can be divided into different stages, each handled by designated staff members within the wage department.Employees involved in the process should initial the wage sheets, which are then forwarded to the cash department for payment by a responsible official.

C. Payment of wages:

i. Employees involved in wage sheet preparation should not be assigned to make wage payments to prevent collusion.
ii. Upon receiving wage sheets from the wage department, the chief cashier should make arrangements with the bank for withdrawing the necessary cash.
iii. Each worker should be present in person to receive their wages, and their thumb impression may be taken as proof of receipt.
iv. Foremen or departmental officers should be present during payment to identify the workers.
v. Appropriate measures should be in place for handling unclaimed wages.
vi. Advances to workers should be discouraged, and if necessary, they should be given with subsequent deductions from their wages.

By implementing these internal check procedures for wage management, manufacturing concerns can ensure accurate recording of time, prevent fraud and errors, and promote efficient payment of wages to workers.

Summary

- Internal check is a system designed to organize the duties of accounting staff in a manner that enables the work of one person to be automatically verified by another. When establishing a system of internal check, several factors should be considered, including work assignment, employee rotation, mandatory leave, supervision of interconnected tasks, use of mechanical devices, periodic review, responsibility, safeguards, supervision, and reliance.
- The objectives of implementing an internal check system are as follows: assigning responsibility, minimizing errors and fraud, detecting errors and fraud, reducing clerical mistakes, enhancing work efficiency, obtaining confirmation, reducing workload, exerting moral pressure, ensuring reliability, and benefiting from supervisory advantages.
- There are several advantages associated with internal check from different perspectives. From a business standpoint, the advantages include proper allocation of work, a control mechanism, increased efficiency and skill, streamlined preparation of final accounts, and the establishment of a moral check. Owners benefit from internal check through increased reliance on accurate accounts, improved orientation of accounting practices, and cost-effective operations. For auditors, the advantages include facilitating the audit process and allowing them to focus on other critical matters.

- However, it is important to recognize the shortcomings of an internal check system, which may include monotony, carelessness, collusion, limited applicability, dependency, and the potential for disorder. Auditors must exercise proper judgment, demonstrating reasonable care and skill, to evaluate the effectiveness of the internal check system. They need to determine the extent to which they can rely on the internal check system since it does not absolve the auditor of their liability.

Keywords

- Internal check
- Work assignment
- Rotation of employees
- Auditor's judgment.
- Fraud prevention

Self Assessment

1. Which of the following is not a characteristic of effective internal checking procedures?

A. Independence and objectivity
B. Adequate documentation
C. Flexibility and adaptability
D. Involvement of external auditors

2. What is the purpose of segregation of duties in internal checking?

A. To prevent errors and fraud by having multiple individuals involved in critical processes
B. To streamline the workflow and improve operational efficiency
C. To centralize decision-making authority and responsibility
D. To ensure consistent application of accounting policies

3. Which of the following is an example of a preventive internal checking control?

A. Periodic reconciliation of accounts receivable balances
B. Conducting surprise audits on employees' workstations
C. Implementing password protection for financial systems
D. Reviewing financial statements for accuracy and completeness

4. What is the role of management in internal checking?

A. To perform the actual internal checking procedures
B. To establish and maintain effective internal control systems
C. To report internal checking findings to external stakeholders
D. To conduct risk assessments and determine materiality thresholds

5. Which of the following is an example of a detective internal checking control?

A. Requiring management approval for significant transactions
B. Conducting surprise cash counts in the company's cash office
C. Implementing firewalls and antivirus software for IT systems
D. Segregating the duties of cash handling and record keeping

6. How does internal checking differ from external auditing?
A. Internal checking is performed by internal auditors, while external auditing is conducted by independent external auditors.
B. Internal checking focuses on compliance with laws and regulations, while external auditing assesses the financial statements' fairness.
C. Internal checking is an ongoing process, while external auditing is conducted at the end of the financial year.
D. Internal checking primarily involves reviewing financial records, while external auditing includes physical inspections of company assets.

7. Which of the following is a limitation of internal checking?
A. Reliance on external auditors for accurate and reliable financial reporting
B. Lack of objectivity and independence of internal auditors
C. Inability to detect errors or fraud due to collusion among employees
D. Focus on compliance rather than financial performance evaluation

8. What is the purpose of conducting internal checking in an organization?
A. To identify and correct financial statement errors and misstatements
B. To provide assurance to shareholders and investors about the company's financial health
C. To ensure compliance with laws, regulations, and internal policies
D. To evaluate the performance and effectiveness of top-level management

9. Which of the following is an example of an internal checking technique used to assess the effectiveness of internal controls?
A. Analyzing financial ratios to identify potential fraud indicators
B. Testing a sample of transactions to verify accuracy and completeness
C. Conducting background checks on new employees during the hiring process
D. Reviewing the organizational structure to ensure appropriate segregation of duties

10. Which of the following best describes internal checking in auditing?
A. A process of verifying financial statements for accuracy
B. A system of internal controls to ensure compliance with laws and regulations
C. A method of ensuring that company assets are properly safeguarded
D. A technique used to detect fraud and errors in financial records

11. What is the primary objective of internal checking in auditing?
A. To detect and prevent fraud within an organization
B. To ensure the accuracy and reliability of financial statements
C. To evaluate the efficiency and effectiveness of internal controls
D. To assess the overall financial health of a company

12. Which of the following is an example of an internal checking procedure?
A. Reviewing bank reconciliations and comparing them to financial records
B. Conducting interviews with company employees to gather information
C. Inspecting physical inventory and reconciling it with recorded quantities
D. Analyzing market trends and competitor performance to assess business risks

13. What is the significance of internal checking in auditing?
A. It helps identify weaknesses in internal controls and suggests improvements
B. It ensures that all transactions are accurately recorded in the general ledger
C. It determines the fair value of assets and liabilities for financial reporting
D. It validates the compliance of management with ethical standards

14. Which of the following statements is true regarding internal checking?
A. Internal checking is solely the responsibility of external auditors.
B. Internal checking is a one-time process performed at the end of the financial year.
C. Internal checking is performed by internal auditors within the organization.
D. Internal checking is optional and not necessary for audit assurance.

15. Final audit implies
A. Audit of accounts at the end of the year.
B. Finally checking of accounts to reveal frauds.
C. Audit for submitting report immediately at the end of the year.
D. Audit of banking companies.

Answer for SelfAssessment

1.	D	2.	A	3.	C	4.	B	5.	B
6.	A	7.	B	8.	C	9.	B	10.	B
11.	B	12.	A	13.	A	14.	C	15.	A

Review Questions

1. Distinguish between internal control system and internal check system.
2. What is internal control questionnaire?
3. Should the statutory auditor examine the accounts already checked by the internal auditor?
4. To what extent the internal auditor is responsible for the internal control?
5. What do you mean by the term 'Internal Control'? What are the important features of a goodsystem of internal control?
6. Suggest a set of rules you would recommend for the internal control over the purchases of raw materials and stores of a large manufacturing concern.
7. Draft a form of questionnaire, which you would use for determining the effectiveness of the client'sinternal control over payrolls.
8. (a) Distinguish briefly internal control, internal check and internal audit.
   (b) Discuss the general considerations in framing a system of internal control in respect of purchaseof goods.

Further Readings

- Auditing: Principles And Techniques By S. K. Basu, Pearsonn.S.
- A Hand Book Of Practical Auditing By B N Tandon, S Sudharsnam& S Sundharabahu, S Chand Publishing
- Auditing And Corporate Governance By Anil Kumar Jyotsna Rajan Arora Lovleen Gupta, Taxmann Publisher

Web links

https://www.tutorialspoint.com/auditing/auditing_internal_check.htm

https://www.tutorialspoint.com/auditing/auditing_internal_check.htm

https://www.taxmann.com/post/blog/auditing-internal-control-meaning-objective-duties

https://finlawportal.com/internal-check-in-auditing-a-complete-outlook/

http://www.rdscollege.ac.in/studymaterial/1594136363.pdf?uid=

Unit 11: Recent Trends in Auditing

CONTENTS

Objectives

After studying this unit, you will be able to:

- identify and illustratethe computer assisted auditing techniques.
- analyze impact of computerization on auditing approach.

Introduction

Technology never fails to change the way we do things. It has transformed how we think, how we interact, and how we do business. No one can deny that technology has made a remarkable impact in the finance and accounting industry. Accounting and finance professionals can now perform tasks faster and with greater precision. With these developments in the industry, auditors have also utilized the latest technological advancements to improve their service offerings.

As we begin the second half of 2020, here are the audit trends that are continuously shaping the audit industry.

11.1 Recent Trends in Auditing

1. **Artificial Intelligence and Robotic Process Automation**

The adoption of smart automation and machine-learning artificial intelligence in accounting has led to a tremendous overall improvement in the accounting process. Accountants can now shift to more complex tasks by automating time-consuming tasks, tighten controls with the aid of advanced software, and eventually produce high-end results. As more tasks are performed with these innovative tools, internal audit should be able to identify, monitor, and evaluate the risks that come with these tools. Audit professionals need to have an understanding of how these systems are designed and how they affect business operations, administration, and the structure of the organization as a whole.

2. **Cyber and Data Security**

Even before the Facebook-Cambridge Analytica Scandal, the world has been moving towards better data and cybersecurity. Businesses have been working on regulatory compliance with different countries on varying cybersecurity requirements and data management directives. The roll-out of the European Union's GDPR has signaled sweeping changes in the way businesses handle data and information.

Auditors must keep up with these updates to ensure that the company's cyber data are well protected and secure, at the same time, monitor that data collection, processing, and management by the company are in accordance with data privacy regulations such as the EU's GDPR.

3. **Data Analytics**

Modern business operations are now heavily relying on data to optimize product and/or service lines. From time to time, data are collected by companies to identify process bottlenecks and reduce unnecessary costs. To help them in the audit process, audit professionals also harness the capabilities of data analytics software. Data analysis helps auditors to check irregularities in data trends or patterns and identify errors that the company may have made during their processes.

Data analytics tools are also of tremendous help for auditors, especially when it is necessary for them to look at the bulk of data collected and processed by their organization. Finally, like other professionals in different industries, auditors have been able to produce smarter, faster, and better results.

4. **Technology and Talent Development**

All these technological trends have led to the necessity for professionals to develop proficiency and have a keen understanding of the latest technological tools and software. The top audit firms have invested in the skills development of their people to catch up with the new trends in auditing, with new but competitive audit players following this practice

As we continue with the second stretch of 2018, we can only expect to see more technological trends dictating the future of the audit industry. Audit firms around the world are innovating on how the practice adjusts to the adoption of sophisticated business processes such as robotic process automation, artificial intelligence, and blockchain technology. If anything, the recent audit trends above only show the increasing importance of technology in audit and the necessity for firms to ensure that their people are up to the tasks.

5. **Organizational structure for accountability and transparency**

Today's environment calls for greater collaboration and strong relationship between the auditor and the auditee at all levels. The trend therefore is moving towards developing a structure that facilitates healthy environment. This will encourage free flow of information regarding any issues or concern between the auditee and the auditor. The organization has to be structured in a way that facilitates accountability i.e. not limited to only the Audit Committee.

6. **Shift away from SOX compliance towards risk-based auditing**

Out of necessity, internal auditors have been devoting their time, energy and resources in recent years primarily to SOX compliance activities. Now, it is time for internal auditors to reevaluate its activities and sharpen its focus on stakeholder expectations and risk-based auditing. Enterprise-wide risk management and fraud are also gaining precedence. Moreover, the modern day, technology savvy companies require additional focus on risk assessment, particularly because these risks have the potential to impact organizations more rapidly. Activities relating to fraud detection and auditing IT security are also generating more responsibility for internal audit.

7. **Upgrading audit infrastructure and technological advancement**

Large companies, specially with complex auditing requirements that span not just financial audits but also audits, assessments and inspections related to operations, quality, safety, suppliers and IT are upgrading the technology infrastructure used to carry out auditing from risk assessments and audit universe creating and planning to audit data collection, reporting and remediation. Companies are migrating from their legacy systems, point applications and paper-based procedures to a web-based integrated audit management system. The technological advancement allows the CAE to streamline and strengthen the internal audit function enabling it to deliver more strategic value while lowering its costs of operation. Expected benefits are better enterprise wide visibility, a transparent and collaborative environment and data-driven decision making. Solution and tools available today provide a reliable means to monitor access controls, observe the closed-loop processes and analyze important data and KRIs.

8. Sustainable and ESG Auditing

The growing emphasis on sustainability and Environmental, Social, and Governance (ESG) factors has led to the emergence of sustainable and ESG auditing. Auditors are now being called upon to assess organizations' environmental and social impact, as well as the effectiveness of their governance practices. This includes evaluating carbon emissions, resource usage, supply chain sustainability, diversity and inclusion initiatives, and ethical business practices.

Sustainable and ESG auditing goes beyond financial reporting to provide stakeholders with a comprehensive view of an organization's long-term value creation and its impact on society and the environment. This trend reflects the increasing recognition that financial performance alone is insufficient to gauge the overall health and sustainability of an organization.

11.2 Computer Assisted Auditing Techniques (CAATs)

Computer Assisted Auditing Techniques (CAATs) have become an integral part of modern auditing practices, leveraging technology to enhance audit efficiency, effectiveness, and accuracy. CAATs encompass a range of tools and techniques that enable auditors to access, analyze, and validate large volumes of data, thereby improving the quality and reliability of audit procedures. CAATs involve the use of computers in the process of an audit rather than limiting it to an entirely manual approach. CAATs are defined as computer-based tools and techniques, which facilitate auditors to increase their personal productivity as well as that of audit function. CAATs are software tools for auditors to access, analyses and interpret data and to draw an opinion for an audit objective.

11.3 Need for CAATs

Effectiveness and efficiency of audit procedures may be improved through the use of CAATs. CAATs may be used in performing various auditing procedures, including the following—

- Tests of details of transactions and balances;
- Analytical procedures;
- Tests for general controls;
- Sampling programmes to extract data for audit testing;
- Tests of application controls; and
- Re-performing calculations performed by the entity’s accounting system.

Guidance note on CAAT issued by the Institute of Chartered Accountants of India (ICAI) describes CAATs as important tools for the auditor in performing audits. During the course of an audit, the auditor is to obtain sufficient, relevant and useful evidence to achieve the audit objectives effectively. Audit findings and conclusions are to be supported by appropriate analysis and interpretation of the evidence.

In auditing a computerized environment where all significant operations are computerized, it may be impractical to perform audit completely and with assurance unless the auditor uses CAATs for collection and evaluation of audit evidence by performing both compliance and substantive tests. By using CAATs, it is possible for the auditor to perform audit more effectively and efficiently and also have greater assurance on the audit process.

11.4 Considerations in the Use of CAATs

When planning an audit, the auditor may consider an appropriate combination of manual and CAATs.In determining whether to use CAATs, the factors to consider include:

- The IT knowledge, expertise and experience of the audit team;
- The availability of CAATs and suitable computer facilities and data;
- The impracticability of manual tests;
- Effectiveness and efficiency; and
- Time constraints.

Before using CAATs, the auditor considers the controls incorporated in the design of the entity'scomputer system towhich CAAT would be applied in order to determine whether, and if so, CAATshould be used.

11.5 Types of CAATs

CAATs can be broadly categorized into the following three types:

1. Generalized audit software:

These are also referred as package programmes. Generalized auditsoftware (GAS) refers to generalized computer programmes designed to perform data processing functionssuch as reading data, selecting and analysing information, performing calculations, creating datafiles and reporting in a format specified by the auditor. GAS is standard off-the-shelf audit software,which can be used across enterprises and platforms.

2. Specialized audit software:

Specialized audit software (SAS) are also referred to as purpose-writtenprogrammes. They perform audit tasks in specific circumstances. These are specifically written for performingaudit tests for specific type of applications. These programmes may be developed by the auditor,the entity being audited or an outside programmer hired by the auditor. In some cases, the auditor mayuse an entity's existing programmes in their original or modified state because it may be more efficientthan developing independent programmes.

3. Utility software:

These are used by an entity to perform common data processing functions, suchas sorting, creating and printing files. Utility software also includes utility programmes available insystem programmes for performing debugging or analysis of various aspects of usage/access. Theseprogrammes are generally not designed for audit purposes but can be used for performing specific tests.

CAATs and more specifically audit software have the potential to enable auditors to recognize computeras a tool to assist them in the audit process. Audit software give auditor's access to data in themedium in which it is stored, eliminating the boundaries of how it can be audited. Once the auditorsaccept and learn how to use audit software, they will be in a better position to create value addition intheir audit. The greatest barrier in promoting use of audit software is failure to recognize opportunitiesto use audit software for audit. Understanding and recognizing how CAATs can be used and knowinghow to use audit software is most critical to its effective use.

Using audit software enhances the effectiveness of audit and enables auditor to provide better assuranceto their clients. In an increasingly computerized environment, it is critical for the auditor to movefrom ticks to clicks and learn to harness the power of computers for audit. Using audit software as theirtool for auditing digitized data, auditor can shift focus from time-consuming manual verification auditprocedures to intelligent analysis of data to provide assurance to clients and manage audit risks.

11.6 Key Aspects of CAATs and Their Impact on The Auditing Profession

a) Data Extraction and Analysis: CAATs enable auditors to extract data from various sources, including accounting systems, databases, spreadsheets, and electronic documents. By automating data extraction, auditors can save significant time and effort, reducing the reliance on manual data entry and minimizing the risk of errors. Moreover, CAATs facilitate sophisticated data analysis techniques, such as data mining, trend analysis, and outlier detection, allowing auditors to identify patterns, anomalies, and potential risks.

b) Audit Trail and Documentation: CAATs help auditors establish a comprehensive audit trail and maintain detailed documentation of audit procedures. Through the use of specialized software, auditors can track changes to financial data, record their testing procedures, and document the rationale behind their audit conclusions. This not only enhances audit transparency and accountability but also facilitates the review process and provides evidence of the audit work performed.

c) Testing and Validation: CAATs offer auditors advanced testing capabilities, enabling them to perform a wide range of audit procedures with greater efficiency and accuracy. For example, auditors can use CAATs to conduct substantive testing, including sampling, reconciliations, and analytical procedures, on large datasets. These tools also support the validation of complex calculations and simulations, ensuring the integrity and accuracy of financial models and projections.

d) Continuous Monitoring: CAATs enable auditors to implement continuous monitoring techniques, allowing for real-time evaluation of financial transactions and controls. By utilizing automated scripts and data analytics tools, auditors can monitor key control points, identify control failures or weaknesses, and provide timely feedback to management. This proactive approach to monitoring helps organizations improve their internal controls and risk management processes.

e) Data Visualization and Reporting: CAATs provide auditors with data visualization tools that facilitate the communication of audit findings and insights to stakeholders. Through interactive dashboards, charts, and graphs, auditors can present complex financial information in a visually appealing and easily understandable format. This enhances the effectiveness of audit reporting, enabling stakeholders to grasp key findings and trends quickly.

f) Challenges and Considerations: While CAATs offer numerous benefits, their implementation may present certain challenges. Auditors need to acquire the necessary technical skills to effectively use CAATs and interpret the results generated. Moreover, data privacy and security concerns must be addressed to ensure the confidentiality and integrity of sensitive financial information. Auditors also need to exercise professional skepticism when relying on CAATs, understanding their limitations and conducting appropriate validation and verification procedures.

11.7 Impact of Computerization on Auditing Approach

The widespread computerization of business processes and the increasing reliance on information technology (IT) systems have had a profound impact on the auditing approach. As organizations have transitioned from manual record-keeping to automated systems, auditors have had to adapt their methodologies and techniques to effectively address the unique challenges and risks associated with computerized environments. Here are key considerations regarding the impact of computerization on the auditing approach:

a) Understanding IT Systems: Auditors must possess a solid understanding of the IT systems and infrastructure used by their clients. This includes knowledge of the software applications, databases, networks, and security measures in place. Understanding IT systems helps auditors identify the relevant controls and assess the integrity, reliability, and security of the electronic information being audited. Auditors must also consider the impact of IT on business processes and the associated risks.

b) Assessing Internal Controls: Computerized environments introduce new risks and control challenges. Auditors need to evaluate the design and effectiveness of IT general controls (such as user access controls, change management, and segregation of duties) and application controls (such as input validation, processing controls, and output verification). Testing these controls often involves reviewing system configurations, assessing user access rights, and examining audit trails and logs to detect anomalies or unauthorized activities.

c) Data Extraction and Analysis: With computerization, auditors have access to large volumes of electronic data. They can use computer-assisted auditing techniques (CAATs) to extract, analyze, and validate this data. By employing data analytics tools and techniques, auditors can identify trends, anomalies, and potential risks more efficiently and effectively. Data extraction and analysis enable auditors to perform substantive testing and gain deeper insights into the financial and operational aspects of an organization.

d) Considerations for IT-Dependent Audits: Some audits heavily rely on IT systems, such as IT audits, cybersecurity audits, and privacy audits. In these cases, auditors must possess specialized IT knowledge and skills to assess and evaluate IT-related risks, controls, and compliance requirements. IT-dependent audits require auditors to understand specific regulatory frameworks, industry standards, and best practices related to IT governance, cybersecurity, and data protection.

e) Continuous Monitoring and Auditing: Computerization enables auditors to implement continuous monitoring and auditing practices. By utilizing automated tools and monitoring systems, auditors can review transactions and controls in real-time, identify exceptions, and promptly address potential issues. Continuous monitoring allows auditors to provide more timely insights and recommendations to management, enhancing risk management and control effectiveness.

f) Ethical Considerations: As auditors rely on computerized data and systems, ethical considerations related to data privacy, confidentiality, and integrity become paramount. Auditors must ensure that they adhere to professional and legal requirements related to data protection and maintain the utmost confidentiality when accessing and handling electronic information.

Summary

- Auditing around the computer involves arriving at a conclusion through examining the internal controlsystem for computer installation and the input and output only for application systems. Underthis approach, the auditor considers the computer as a black box and as a result the application systemprocessing is not examined directly.
- Under auditing through the computer, the auditor can use the computer to test the logic and controls existing within the system and the records produced by the system. By examining the system's processing, the auditor can assess the system's ability to cope with the environment change.
- CAATs involve the use of computers in the process of an audit rather than limiting it to an entirely manual approach. CAATs are defined as computer-based tools and techniques, which facilitate auditors to increase their personal productivity as well that of audit functions. These are software tools for auditors to access, analyse and interpret data and to draw an opinion for an audit objective.
- CAATs can be broadly categorized into three groups, which include generalized audit software (GAS), specialized audit software (SAS) and utility software. Using audit software enhances the effectiveness of audit and enables the auditor to provide better assurance to the clients.

Keywords

- Data analytics
- Automation
- Continuous auditing
- Real-time reporting
- Cybersecurity
- Data privacy
- Sustainable auditing
- ESG (Environmental, Social, and Governance) auditing
- Regulatory changes
- Increased accountability
- Computer Assisted Auditing Techniques (CAATs)

Self Assessment

1. What is one of the recent trends in auditing that leverages technology to enhance audit efficiency and accuracy?

A. Increased regulatory compliance

B. Traditional manual audit procedures

C. Continuous auditing

D. Exclusive focus on financial reporting

2. Which of the following is an emerging area in auditing that focuses on assessing an organization's environmental and social impact?

A. Cybersecurity auditing

B. Sustainable auditing

C. Internal control auditing

D. Financial statement auditing

3. What technology-driven approach allows auditors to extract, analyze, and validate large volumes of data efficiently?

A. Manual data entry

B. Traditional auditing methods

C. Computer Assisted Auditing Techniques (CAATs)

D. Manual reconciliations

4. Which aspect of auditing has gained increased attention due to the growing threat of cyberattacks and data breaches?

A. Financial statement preparation

B. Data privacy compliance

C. Internal control testing

D. Asset valuation

5. What is one of the recent trends in auditing that emphasizes real-time reporting to provide up-to-date financial information to stakeholders?

A. Annual auditing

B. Periodic financial reporting

C. Real-time auditing

D. Traditional risk assessment

6. Which of the following trends in auditing focuses on the use of advanced analytics tools and techniques to identify patterns, anomalies, and potential risks in large datasets?

A. Data privacy compliance

B. Sustainable auditing

C. Continuous monitoring

D. Data analytics

7. What is the term used to describe the auditing approach that involves conducting audits on an ongoing basis, utilizing automated tools to monitor transactions and provide immediate feedback?
A. Traditional auditing
B. Periodic auditing
C. Continuous auditing
D. Risk-based auditing

8. Which area of auditing has gained prominence due to the increasing emphasis on organizations' environmental impact, social responsibility, and corporate governance practices?
A. Financial statement auditing
B. Internal control auditing
C. Cybersecurity auditing
D. ESG auditing

9. Which of the following auditing trends has been influenced by advancements in technology, such as Robotic Process Automation (RPA) and Artificial Intelligence (AI)?
A. Manual auditing techniques
B. Increased reliance on paper-based records
C. Automation of repetitive tasks
D. Exclusive focus on financial reporting

10. Which regulatory change has prompted auditors to focus on assessing organizations' data handling practices, consent management, and data protection measures?
A. International Financial Reporting Standards (IFRS)
B. General Data Protection Regulation (GDPR)
C. Sarbanes-Oxley Act (SOX)
D. Basel III

11. What recent trend in auditing involves the integration of environmental, social, and governance factors into the audit process to assess an organization's overall performance?
A. Risk-based auditing
B. Sustainable auditing
C. Compliance auditing
D. Financial statement auditing

12. Which of the following is a key component of computer-assisted auditing techniques (CAATs) that enables auditors to identify control failures and weaknesses in real-time?
A. Data extraction
B. Data visualization
C. Continuous monitoring
D. Sampling techniques

13. What aspect of auditing has seen an increased focus as auditors utilize technology to analyze large volumes of data and identify unusual trends or patterns?

A. Compliance testing
B. Internal control testing
C. Analytical procedures
D. Audit planning

14. Which of the following is a recent trend in auditing that involves auditors utilizing advanced cybersecurity techniques and tools to assess an organization's information security controls?

A. Financial statement auditing
B. Cybersecurity auditing
C. Compliance auditing
D. Operational auditing

15. Which auditing trend emphasizes the use of key performance indicators (KPIs) and other metrics to assess an organization's performance and align it with its strategic objectives?

A. Risk-based auditing
B. ESG auditing
C. Performance auditing
D. Compliance auditing

Answers for SelfAssessment

1.	C	2.	B	3.	C	4.	B	5.	C
6.	D	7.	C	8.	D	9.	C	10.	B
11.	B	12.	C	13.	C	14.	B	15.	C

Review Questions

1. What do you mean by the term ‘computer-assisted audit techniques’? State the factors to be consideredbefore using these techniques.
2. Describe briefly the common types of CAATs.
3. State the primary purpose of generalized audit software.
4. You have been appointed as the auditor of a company, which maintains its accounts on computers.Write in detail the audit approach that you would follow in the case of the company.
5. Describe the similarities and differences in the approach of an auditor to conduct audit of accountsmaintained manually and those maintained on computers.

Further Readings

- AUDITING: PRINCIPLES AND TECHNIQUES by S. K. BASU, PEARSONN.S.

- A HAND BOOK OF PRACTICAL AUDITING by B N TANDON, S SUDHARSNAM & S SUNDHARABAHU, S Chand Publishing
- AUDITING AND CORPORATE GOVERNANCE by ANIL KUMAR JYOTSNA RAJAN ARORA LOVLEEN GUPTA, TAXMANN PUBLISHER

Web Links

https://global.theiia.org/Pages/IIAHome.aspx

https://www.iaasb.org/

https://www.aicpa.org/

https://www.journalofaccountancy.com/

Unit 12: EDP Environment

CONTENTS

Objectives

After studying this unit, you will be able to:

- Ability to understand the role of audit in EDP (Electronic data processing) based environment
- Ability to understand the **problems and control of audit** in EDP based environment

Introduction

In recent times, the utilization of computers for generating financial information has witnessed significant growth. While this advancement has not altered general auditing principles, it has introduced specific challenges for auditors. In certain cases, auditors must employ specialized auditing procedures and techniques to effectively assess the financial data produced through computer systems.

Consequently, a new group of experts known as electronic data processing (EDP) audit specialists has emerged within the accounting profession. Equipped with technical expertise, these professionals can intelligently analyze complex computer audit situations.

The purpose of this chapter is to highlight the various factors that must be considered when evaluating internal control within EDP systems. Additionally, it aims to draw attention to potential modifications in audit procedures that may be necessary under certain circumstances.

It is important to note that the fundamental objective and nature of an audit remain unchanged in a computer information system environment. Nevertheless, the integration of computers in bookkeeping and record-keeping processes significantly impacts the processing, storage, retrieval, and communication of financial information. As a result, it may require adjustments in the accounting and internal control systems employed by the organization.

In conclusion, the growing reliance on computers to handle financial information has led to the development of specialized audit practices. Auditors must adapt to the changing landscape by understanding the intricacies of EDP systems and considering their implications on internal controls. By doing so, they can ensure effective and accurate financial reporting for businesses operating in this technologically advanced environment.

The auditor must possess sufficient knowledge of computer information systems to effectively plan, direct, supervise, control, and review the audit work. Additionally, the auditor should assess whether specialized skills are necessary to conduct an audit in a computer information system environment. During the planning phase of the audit, the auditor should gain an understanding of the significance and complexity of the computer information system activities and ascertain the availability of data for use in the audit. If the computer information systems play a significant role, the auditor should also comprehend the overall computer information system environment and its potential impact on assessing inherent and control risks.

To ensure a comprehensive and well-documented audit process, the auditor should record the audit plan, including the nature, timing, and extent of the audit procedures conducted, as well as the conclusions drawn from the evidence obtained. In an audit conducted in a computer information system environment, some of the audit evidence may exist in electronic form. The auditor must verify that such electronic evidence is adequately and securely stored and can be retrieved in its entirety whenever needed.

By adhering to these practices, the auditor can effectively navigate the complexities of auditing in a computer information system environment and maintain the integrity of the audit process. Additionally, careful documentation and secure storage of electronic evidence contribute to the overall accuracy and reliability of the audit findings.

12.1 Meaning

Use of computers in maintaining the books of accounts and records affect the processing, storage, retrieval and communication of financial information.It has emerged as a challenge for the auditors.Auditor need to have the sufficient knowledge of computer information systems to plan, direct, supervise, control and review the work performed.EDP Audit term has emerged from this.EDP Audit is an analysis of an organization's computer information systems in order to:

- evaluate the integrity of its production systems, as well as
- To identify the potential security cracks.

12.2 General Approach to an EDP-Based Audit

It is usual for the auditor to base his approach to an EDP-based audit upon two completely separate types of review:

a. organizational review
b. system review

a) Organizational Review

The organizational review involves examining the internal controls within the computer installation itself to ensure that certain essential criteria are met:

(a) Maintenance of an acceptable standard of discipline and efficiency.

(b) Existence of an adequate division of duties to prevent undue concentration of functions. Weaknesses in internal control within the EDP department could cast doubt on the validity of all data produced by the system.

b) System Review

The system review entails conducting a detailed assessment of the controls operating within each computer-based accounting system. The objective is to verify that these controls ensure:

(a) Complete and accurate processing of all data.

(b) Adequate protection of permanent data.

(c) The presence of a satisfactory 'audit trail' that enables traceability and accountability.

Both types of reviews are conducted through the use of questionnaires, which are structured based on the 'key question' principle. It is essential to evaluate both general and computer-specific questionnaires together to gain a comprehensive understanding of the system and to assess the significance of individual controls.

12.3 Computer Installation Review

The organizational review seeks to establish that there are no serious internal control weaknesses within the installation, which could throw doubt on the validity of the information produced. Adopting this approach, the auditor should seek to establish that six key controls operate within the installation. These controls are—

a. Controls by the management over the activities of the EDP Function
b. Controls to ensure the continuing existence of EDP Facilities
c. Safeguarding of the client's records
d. Control over the data passing through the EDP department
e. Controls over the operation of the computer

12.4 Controls by The Management Over The Activities of the EDP Function

The extent of control exercised by general management over the EDP (Electronic Data Processing) department depends on the complexity of the business and the computer installation. However, certain minimum standards should be adhered to:

(a) The EDP Manager should directly report to senior management.

(b) All significant aspects of EDP activity should be regularly reported.

It is essential to ensure that the person to whom the EDP Manager reports is a member of the senior management team and possesses the authority to provide adequate support and effective management to the department.

The auditor should also inquire about the reporting mechanism of the department's activities to senior management. Ideally, a monthly control report should be prepared, including the following information:

(a) An analysis of computer usage, distinguishing between productive and non-productive time.

(b) A report on manpower allocation.

(c) Details of projects under development.

(d) An analysis of expenditure compared to the budget.

12.5 Controls to ensure the continuing existence of EDP Facilities

Arrangements should be in place within every EDP (Electronic Data Processing) installation to either eliminate or minimize the possibility of EDP facilities being completely destroyed due to any reason. These arrangements are of great significance, as the loss of vital information could severely disrupt an organization's business operations and profitability. The auditor should inquire about the existence of the following controls:

(a) Insurance cover: The following risks should be insured:

(i) Loss of equipment

(ii) Loss of file devices

(iii) Reconstruction of files (i.e., the cost of reconstituting the data from external sources)

(iv) Consequential loss

(v) Employee fidelity.

(b) Emergency precautions: The operating area should be equipped with fire-detection and fire-fighting equipment. Computer operators should be fully aware of the emergency procedures to be followed in the event of a fire. Adequate security measures should also be in place to prevent unauthorized access to key areas within the department.

(c) Standby facilities: Contingency plans should exist to process data at another installation in the event of machine failure, particularly for time-critical systems such as payrolls. The auditor should thoroughly inquire into the standby arrangements, focusing on aspects such as the nature of the arrangements (verbal, written, or contractual), compatibility of the standby equipment, and the availability of significant running time if extended use of the standby facility becomes necessary.

(d) Back-up copies of files, programs, and documentation: Adequate processing arrangements should ensure that recent copies of all master files and programs are available in case the current copies are lost, corrupted, or destroyed. Additionally, copies of system-flow charts and program listings should be maintained to preserve evidence of program details.

Minimum standards for back-up arrangements should include:

(i) Maintaining secure, remote storage for back-up copies of each program and system documentation, with regular updates for amendments.

(ii) Ensuring at least one recent copy of each master file is stored off-premises under secure conditions, with processing files on a generation basis to create copies before updating with current transaction data.

(e) Equipment maintenance: The equipment should undergo maintenance as recommended by the manufacturer. The auditor should inquire about the maintenance arrangements to ensure they comply with the manufacturer's recommendations.

By enforcing these controls and arrangements, EDP installations can mitigate the risks of catastrophic data loss and ensure continuity in business operations. Regular auditing of these measures ensures the organization's preparedness to address potential threats effectively.

12.6 Safeguarding of the Client’s Records

The division of duties within the EDP (Electronic Data Processing) department, along with general procedural arrangements, must ensure that the client's records are not exposed to any undue risk of loss or corruption, whether accidental or intentional.

The auditor should pay particular attention to the following aspects of internal control:

(a) Division of duties within the EDP department:

Similar to other departments in the organization, the extent to which duties can be divided among EDP department staff depends largely on the department's size. Ideally, the following duties should be assigned to separate individuals:

(i) Data initiation (outside the EDP department)

(ii) Data control (within the EDP department)

(iii) Data preparation (entering and verifying)

(iv) Job scheduling

(v) Operation of the computer

(vi) Maintenance of programs and the file library

(vii) Systems development

(viii) Programming of new systems.

It should be noted that the complete division of duties as listed above may only be found in very large institutions. Smaller institutions, for instance, often do not employ a file librarian and may combine the activities of systems development and programming.

By ensuring a clear division of duties, the EDP department can establish checks and balances to reduce the risk of errors, fraud, and unauthorized access to sensitive data. This segregation of duties contributes to a more robust internal control environment, enhancing the integrity and security of the client's records and data.

(b) Storage of Information, Files, and Programs: Procedural controls should be implemented to restrict access to files, input, and output data to authorized personnel only. The following points require special attention:

(i) Files should be securely stored, preferably in a separate file library.

(ii) Access to files should be limited and granted only to authorized personnel.

(iii) Output should not be accessible to visitors to the department.

(iv) Systems and program documentation should be stored securely.

(c) Processing of Files: Files should be processed on a generation basis, ensuring that a copy can always be recreated if the current edition of the file is lost or destroyed. The auditor should inquire about the number of generations of master files kept and evaluate the adequacy of storage arrangements for each generation.

(d) Procedures to Prevent Accidental Overwriting of Files: Operating procedures should incorporate controls to prevent accidental overwriting of files. The auditor would typically expect to find the following procedures in place:

(i) Files should be subject to retention period checks upon setup, with the file label containing a date before which the file may not be overwritten or erased.

(ii) Files should be written both internally and externally.

(iii) Files should be stored in an organized manner to prevent accidental selection of the wrong file.

(iv) Operators should be provided with file labels before processing to resolve any operating problems.

(e) Amendments to Programs: Strict control should be exercised over amendments made to existing programs. This is essential not only to safeguard against fraudulent manipulation or data suppression but also to ensure that costly amendments are made only after confirming their desirability and necessity.

By adhering to these controls and procedures, the EDP department can enhance the security and integrity of its data and programs, protecting against unauthorized access, accidental errors, and fraudulent activities. The auditor's assessment of these measures ensures that the organization's data is handled appropriately and that changes to programs are made with due diligence and authorization.

12.7 Control Over the Data PassingThrough the EDPDepartment

Control over data submitted for processing is a critical concern for the auditor. It is essential to examine the controls established within each system, such as control total checks and validation checks, through separate audit reviews of individual systems. Additionally, during the installation review, the auditor should assess the general standard of controls operating within the EDP (Electronic Data Processing) department, especially within the data control section.

The auditor should focus on three main areas of control:

(a) Controls Maintained by User Departments: In all batch-processing installations, it is crucial for user departments to maintain strict input controls over the data they submit for processing. The specific type of control will vary depending on the nature of the business and individual system requirements. During the installation review, the auditor should ascertain whether:

(i) All data is batched before being submitted for processing.

(ii) User departments are required to maintain input/output controls in the form of batch total summaries.

(iii) There are indications that these user controls are effective.

(b) Data Control Function within the EDP Department: Almost all installations have a data control section responsible for receiving data from user departments, assembling it for processing, and monitoring its progress through various stages. During the review, the auditor should ensure that:

(i) A data control section exists within the EDP department.

(ii) Staff within the data control section does not have other duties that may lead to internal control weaknesses.

(iii) Authorization controls are in place to ensure the receipt of authorized data from users and that only authorized data is accepted for processing.

(iv) A record is maintained of all data received and its progress through processing.

(v) Control totals are balanced to output after processing.

(vi) The data control section exercises anticipatory control over the receipt of data from users.

(c) Storage Arrangements within the EDP Department: Secure storage arrangements must be in place both during and outside normal working hours for:

(i) Unprocessed data in the data control section.

(ii) Data in the record room.

(iii) Data in the job assembly area (if any).

(iv) Input documents after processing.

(v) Output documents after processing.

(vi) Undistributed output.

By thoroughly examining these areas of control, the auditor can ensure that data processing activities are safeguarded against errors, unauthorized access, and data loss, thereby enhancing the reliability and integrity of the EDP systems.

12.8 Controls Over TheOperation of The Computer

The procedural controls relating to the operation of the computer must be reviewed to ensure there are no internal control weaknesses that could lead to the misprocessing of data. The following points should be considered during this aspect of the review:

(a) Number of Operators Present During Processing: Ideally, there should always be at least two operators present during processing to prevent collusion and deliberate data manipulation or destruction. In case multiple operators are employed, the auditor should ensure adequate cover arrangements are in place for holidays, sickness, extended shifts, and breaks. The rotation of operators' duties is also significant in this regard. If the standard practice does not include two operators during processing, the auditor should assess other compensatory controls that may exist.

(b) 'Hands-on' Testing: System analysts and programmers should not be allowed access to the computer operating area, except for 'hands-on testing.' During hands-on testing, at least one operator should be present, solely responsible for operating the computer. Special precautions should be in place to prevent unauthorized access to live files and programs during such testing.

(c) File Library: It is preferable from an internal control perspective to have files and programs stored in a separate file library. If such a library exists, it should be under the control of a file librarian, and operators should not have access to it. The auditor should ensure that all files are stored in this library when not in use and verify compliance with this requirement in other areas within the operations suite.

(d) Review of Operators' Activities: There should be a standard practice within the installation to record and review operators' activities. The manner in which this review is carried out may vary depending on the nature of the installation.

(e) Access to the Operating Area: Strict security measures should be in place to control access to the operating area. The auditor should ensure that:

(i) Unauthorized individuals cannot gain access to the operating area during or outside normal working hours.

(ii) Checks exist to prevent operators from bringing unauthorized files or work into the operating area.

(iii) Operators cannot remove files or work from the operating area without authorization.

12.9 Computer system review

After concluding the review of the EDP installation and ensuring the adequacy of the design and effectiveness of various procedural controls, the auditor can proceed to conduct a detailed review of each individual system within the EDP environment. The approach to this task will be akin to any other system-based audit and will encompass the following steps:

1. Documenting the system

The process of documenting a computer system is similar to that of documenting any other accounting system. In most cases, the auditor is assisted by well-documented systems prepared by the analysts who designed the system.

The extent of available documentation may vary from one installation to another. Sometimes, the auditor may need to complement the existing documentation with their own notes and flow charts, while in other cases, the client's provided notes and flowcharts may be sufficient.

To facilitate the evaluation of the system based on the 'key question' principle, the documentation needs to be organized appropriately. The outline system flow chart typically serves as the primary record of the system, supplemented by the following four main schedules:

(a) Schedule of input types

(b) Schedule of master files

(c) Schedule of intermediary files

(d) Schedule of reports printed.

By combining the outline system flow chart with these four supporting schedules, the auditor can gather the necessary information for their evaluation of the system. The level of detail and organization in the documentation aids in conducting a comprehensive and effective audit of the computer system.

2. Evaluating the system

After completing the system documentation, the auditor proceeds with the evaluation of internal controls within the system, utilizing an internal control questionnaire. The questionnaire is designed to assess the effectiveness of seven key controls operating within the system:

(a) Audit Trail: The auditor verifies that transactions can be traced through each stage of processing, ensuring the existence of a satisfactory audit trail.

(b) Data Processing Controls: The questionnaire seeks to confirm the presence of controls that demonstrate prima facie evidence that transaction data is processed accurately.

(c) Protection of Standing Data: The auditor assesses the presence of adequate controls to safeguard standing data, such as customer information or fixed asset details.

(d) Authorization Controls: The questionnaire aims to establish the existence of controls to ensure that only authorized data is processed within the system, preventing unauthorized access or data manipulation.

(e) Control over Data Rejections and Resubmissions: The auditor checks whether adequate controls are in place to handle data rejections and resubmissions of corrected data for reprocessing, ensuring data integrity and accuracy.

(f) Management Information: The questionnaire evaluates whether the system provides adequate management information, enabling decision-makers to have timely and relevant insights into the organization's operations and performance.

By utilizing the internal control questionnaire to evaluate these seven key controls, the auditor gains a comprehensive understanding of the effectiveness and reliability of internal controls operating within the system. This evaluation is crucial for ensuring data accuracy, preventing errors or fraud, and providing valuable management information for informed decision-making.

3. Designing the audit programme

After completing the documentation of the system and evaluating the internal controls, the auditor is now ready to design the audit program. The principles involved in this process are the same as in any other system-based audit, where the auditor aims to assess and test the system's operation to ensure reliance on the information it produces.

However, it is essential to emphasize that even if the auditor is satisfied with the reliability of the computer systems, it does not eliminate the need for balance sheet verification work. Therefore, the auditor must still conduct verification procedures, such as comparing purchase ledger balances against circulars and statements and reconciling stock ledger balances against physical stock counts.

In summary, the audit program is designed to complement the evaluation of the system's reliability and to ensure that the financial information produced by the computer system is accurate and dependable. Verification procedures are an integral part of the overall audit process, providing additional assurance regarding the accuracy and completeness of financial data.

12.10 Approaches to EDPAuditing

The rapid advancements in hardware and software have brought about significant changes in the conceptual approach to auditing in an EDP (Electronic Data Processing) environment. In the past, the audit approach involved treating the computer as a black box, ignoring its existence, and conducting the audit around the computer.

However, with the increasing development of computers, they are now used in two distinct ways during the audit process:

1. As a Tool: Computers are used as tools by auditors to aid in conducting the audit. For example, auditors may use computers to print confirmation requests or perform certain data analysis tasks.
2. As the Target: In some cases, computers become the target of the audit itself. This involves submitting data to the computer system and analyzing the results to assess the reliability and accuracy of the computer system.

Before proceeding with the audit, the auditor must carefully plan whether to use the computer as an assisting tool or to conduct the audit without relying on the computer's assistance. These two approaches are commonly referred to as 'auditing around the computer' and 'auditing through the computer.'

In 'auditing around the computer,' the auditor focuses on traditional auditing methods without extensively using the computer system. On the other hand, in 'auditing through the computer,' the auditor heavily relies on the computer system, submitting data and analyzing outputs to gain insights into the system's performance and accuracy.

The choice between these two approaches depends on the complexity of the computer system, the availability of appropriate audit tools and resources, and the specific audit objectives. By carefully considering the best approach, auditors can effectively adapt to the changing technological landscape and conduct thorough and reliable audits in an EDP environment.

1. Auditing around the computer

Auditing around the computer involves reaching conclusions by examining the internal control system of the computer installation and focusing on the input and output of application systems. Based on the quality of input and output in the application system, auditors make decisions regarding the processing's reliability. In this approach, the computer is viewed as a black box, and the application system processing is not directly examined.

This approach is typically adopted by auditors under the following conditions:

1. **Simplicity of the System***:* When the computer system is straightforward and uncomplicated, auditors may choose to audit around the computer, as the risk and complexity are relatively low.
2. **Batch-Oriented System:** In batch-oriented systems, data is processed in batches, and transactions are grouped together for processing. If the system operates in this manner, auditors may find it sufficient to focus on the input and output controls.
3. **Generalized Software Usage***:* When the system uses widely-used and well-tested generalized software that is employed by many organizations, auditors may rely on the overall integrity of the software to audit around the computer.

2. Auditing through computer

The auditor can utilize a computer to conduct testing in two main areas: (a) examining the logic and controls within the system, and (b) analyzing the records produced by the system. The choice of approach, whether simple or requiring advanced technical competence, depends on the complexity of the application system being audited.

Auditing through the computer becomes necessary in the following situations:

1. **Complexity of the System:** When the application system's logic is intricate, and there are substantial portions that contribute to system usability or efficient processing, auditors may need to employ auditing through the computer to gain deeper insights into the system's operations.
2. **High Volume of Transactions***:* In cases where the application system processes large volumes of inputs and generates significant volumes of output, conducting extensive direct examination of input and output validity becomes challenging. Auditing through the computer can be more efficient and effective in such scenarios.
3. ***Incomplete Audit Trail:*** If there are substantial gaps in the visible audit trail due to cost-benefit considerations, auditors may need to resort to auditing through the computer to obtain comprehensive audit evidence.
4. **Internal Control Embedded in the Computer System:** When significant components of the internal control system are incorporated into the computer system, auditing through the computer becomes essential to assess the effectiveness of these controls.

Summary

- The discussion focuses on the role of audit in an EDP (Electronic Data Processing) based environment and the various aspects that auditors need to consider to ensure effective auditing in such technologically advanced settings.
- The rapid development of computer usage for financial information production has presented challenges for auditors. While general auditing principles remain unchanged, specialized auditing procedures and techniques may be required in an EDP environment. To address these challenges, a group of electronic data processing (EDP) audit specialists has emerged within the accounting profession.
- Auditors play a critical role in evaluating internal controls within EDP systems to ensure the accuracy, integrity, and security of financial information. They assess the knowledge and skills of EDP personnel, review the audit plan and procedures, and ensure the adequacy of audit evidence, including electronic forms.
- The audit in an EDP environment involves verifying the reliability of controls, detecting fraud and errors, and ensuring compliance with relevant laws and regulations. Auditors also assess

disaster recovery plans and provide assurance to stakeholders regarding the accuracy of financial information produced by computer systems.

- Procedural controls related to data storage, processing, and access are vital considerations for auditors. They review the division of duties, 'hands-on' testing, file library management, review of operator activities, and access security to minimize the risk of misprocessing or unauthorized access.
- To address the unique challenges of an EDP environment, auditors employ various audit approaches, such as risk-based, systems-based, data analytics, continuous auditing, IT general controls, and automated audit techniques. The integrated audit approach involves collaboration between financial and IT auditors to comprehensively evaluate the system's impact on financial reporting.
- By employing these comprehensive audit approaches and addressing specific challenges, auditors can ensure the accuracy, reliability, and security of financial information processed through computerized systems in an EDP environment.

Keywords

- Data analytics
- Automation
- Continuous auditing
- Real-time reporting
- EDP (Electronic Data Processing)
- Financial information
- Specialized auditing procedures
- EDP audits specialists
- Internal control
- Auditor expertise
- Audit plan
- Audit evidence
- Electronic forms
- Reliability of controls
- Fraud detection
- Disaster recovery plans
- Compliance
- Procedural controls

Self Assessment

1. Which of the following best defines "EDP environment" in auditing?

A. Economic Development Progress environment
B. Electronic Data Processing environment
C. Enterprise Data Protection environment
D. External Data Provisioning environment

2. In the context of auditing, what does EDP stand for?

A. Electronic Data Provision

B. Efficient Data Processing
C. External Document Production
D. Electronic Data Processing

3. Why is the EDP environment crucial in auditing?
A. It reduces the need for auditors' expertise.
B. It enhances communication with external stakeholders.
C. It allows auditors to automate testing procedures.
D. It eliminates the need for financial statement analysis.

4. What technology is commonly used in an EDP environment to process financial transactions?
A. Spreadsheet software
B. Manual bookkeeping registers
C. Typewriters and calculators
D. Handwritten ledgers

5. In an EDP environment, what role does data integrity play in auditing?
A. Data integrity ensures physical security of audit files.
B. Data integrity ensures compliance with tax regulations.
C. Data integrity ensures that data is accurate and reliable.
D. Data integrity automates the audit planning process.

6. Which of the following statements is true about the EDP environment's impact on audit efficiency?
A. The EDP environment always slows down the audit process due to complexity.
B. EDP environment does not affect audit efficiency.
C. In an EDP environment, audit procedures can be performed more efficiently.
D. The EDP environment only impacts financial audits, not operational audits.

7. What is the primary purpose of using Computer-Assisted Audit Techniques (CAATs) in the EDP environment?
A. To eliminate the need for an audit opinion.
B. To minimize interaction with audit clients.
C. To assess the physical security of IT infrastructure.
D. To analyze large volumes of data effectively.

8. How does the EDP environment impact the audit trail?
A. EDP environment has no effect on the audit trail.
B. The audit trail becomes shorter and less informative.
C. The audit trail becomes longer and more detailed.
D. EDP environment eliminates the need for an audit trail.
9. What is a potential risk associated with the EDP environment in auditing?

A. Reduced reliance on technology for audit evidence.
B. Increased accuracy of financial records.
C. Inadequate data backup and recovery procedures.
D. Simplified analysis of complex financial transactions.

10. Which type of audit testing is particularly enhanced by the EDP environment?
A. Non-compliance testing
B. Sample-based testing
C. Judgmental testing
D. Manual testing

11. In an EDP environment, what is the purpose of an audit trail?
a) To track auditors' travel expenses during the audit process.
b) To provide a record of all audit findings for regulatory purposes.
c) To monitor and document changes made to financial data.
d) To store physical copies of financial statements and invoices.

12. When conducting an audit in an EDP environment, what is "data analytics" primarily used for?
A. To replace traditional audit procedures entirely.
B. To identify potential fraud or unusual patterns in data.
C. To enhance data security and protect sensitive information.
D. To generate financial reports for the audit committee.

13. How does the use of data extraction tools benefit auditors in an EDP environment?
A. It automates the entire audit process, eliminating the need for auditors.
B. It converts physical documents into digital format for easy storage.
C. It allows auditors to extract relevant data from various electronic sources.
D. It provides auditors with pre-written audit reports for quick submission.

14. What role does the IT department typically play in the audit of an EDP environment?
A. They are responsible for interpreting financial data.
B. They act as external auditors for IT-related matters.
C. They provide technical support during the audit process.
D. They are not involved in the audit of the EDP environment.

15. Which of the following is a potential limitation of an EDP environment in auditing?
A. Increased efficiency in the review of audit documentation.
B. Limited availability of electronic records for audit testing.
C. Reduced need for communication with the audit client.
D. Enhanced accuracy of financial data due to automation.

Answers for SelfAssessment

1.	B	2.	D	3.	C	4.	A	5.	C
6.	C	7.	D	8.	C	9.	C	10.	B
11.	C	12.	D	13.	C	14.	C	15.	B

Review Questions

1. What are the features of an EDP environment that affect the nature, timing or extent of auditprocedures?
2. You have been appointed as the auditor of a company, which maintains its accounts on computers.Write in detail the audit approach that you would follow in the case of the company.
3. Describe the similarities and differences in the approach of an auditor to conduct audit of accountsmaintained manually and those maintained on computers
4. You have been appointed as the auditor of a company, which maintains its accounts on computers.Write in detail the audit approach that you would follow in the case of the company.
5. Describe the similarities and differences in the approach of an auditor to conduct audit of accountsmaintained manually and those maintained on computers.
6. How has computer usage impacted auditors and what specialized procedures are required in EDP environments?
7. What factors should auditors consider in evaluating internal control in EDP systems, and how do EDP audits specialists assist in complex computer audit situations?
8. How do computers affect accounting and internal control systems, and what challenges does this pose for auditors?
9. What arrangements should exist to protect EDP facilities from destruction, and how can auditors assess controls like insurance, emergency precautions, and backup copies?
10. How can auditors enhance data security by reviewing procedural controls, such as having two operators during processing and 'hands-on' testing?
11. When is auditing around the computer suitable, and what conditions favor this approach?
12. When is auditing through the computer more appropriate, and what benefits and challenges does it present?
13. How can auditors strike a balance between using the computer as an audit tool and conducting procedures without heavy reliance on the computer?
14. What considerations are important for auditors when evaluating system complexity, transaction volume, audit trail gaps, and internal control integration in EDP environments?
15. How do auditors plan their audit program in EDP environments and ensure accurate and reliable audit outcomes?

Further Readings

- AUDITING: PRINCIPLES AND TECHNIQUES by S. K. BASU, PEARSONN.S.
- A HAND BOOK OF PRACTICAL AUDITING by B N TANDON, S SUDHARSNAM

& S SUNDHARABAHU, S Chand Publishing

- AUDITING AND CORPORATE GOVERNANCE by ANIL KUMAR JYOTSNA RAJAN ARORA LOVLEEN GUPTA, TAXMANN PUBLISHER

Web links

https://smallbusiness.chron.com/explain-audit-procedures-electronic-data-processing-audit-14715.html

https://www.ojp.gov/ncjrs/virtual-library/abstracts/evaluating-internal-control-edp-electronic-data-processing-audits

https://www.aicpa.org/

Unit 13: Special Areas

CONTENTS

Objectives

After studying this unit, you will be able to:

- To enhance the knowledge of special areas of auditing
- To Identify and illustrate the procedure of verifying the tax of the company
- Identify and illustrate the procedure of verifying the social activities of the company.

Introduction

Auditing in its contemporary form has embraced a multidimensional approach. Currently, auditing goes beyond the confines of solely financial audits under the Companies Act; it now encompasses various aspects such as cost accounts, managerial policies, operational efficiencies, system applications, social implications of business organizations, and environmental considerations. Moreover, non-business organizations also seek the services of qualified auditors to have their accounts audited. The field of audit now includes the following areas:

1. Verification of cost accounting records and examination of the cost accounting principles used in preparing and presenting cost accounting data, commonly referred to as cost audit.
2. Thorough examination and review of managerial policies and operational efficiency, known as management audit.
3. Assessment of the organization's performance and comparison with the overall industry performance to identify areas of improvement, termed performance audit.
4. Critical analysis of the organization's contributions to society's welfare, denoted as social audit.

5. Evaluation and measurement of the efficiency of human resources within the organization, compared to the expected utilization of human resources as a whole, known as human resource audit.

This broader scope of auditing reflects the growing complexity and diversity of organizational structures, as auditors play a crucial role in ensuring transparency, accountability, and responsible practices across various sectors.

13.1 Cost Audit

Cost audit was first introduced in India in 1965 with the addition of clause (d) to Sections 209 and 233B of Section 233 of the Companies Act. The primary motive behind incorporating this provision was to ensure that companies engaged in manufacturing and related activities maintain and utilize scientific cost records efficiently.

As per Section 148(1) of the Companies Act, 2013, the Central Government has the authority to issue an order directing certain classes of companies engaged in the production of specific goods or services to include particulars related to material or labor utilization, along with other cost items, in their books of account. The specific goods or services subject to this provision are prescribed by the government. In cases where the companies regulated under a special Act fall under the specified class, the Central Government must consult the regulatory body established under that special Act before issuing the order.

Under the mandate of the Central Government, cost audit for such designated companies is to be performed by a qualified cost accountant. This cost audit is independent of the financial audit conducted by an auditor appointed under Section 139 of the Companies Act. Section 148(4) clarifies that the cost audit conducted under this section is in addition to the audit performed under Section 143. Furthermore, if the Central Government orders a cost audit, the concerned company must conduct the cost audit annually until further notice.

According to Section 148(2) of the Companies Act, 2013, the Central Government has the discretion to direct, through an order, that the audit of cost records for a class of companies covered under Subsection (1) and meeting prescribed criteria of net worth or turnover should be conducted as specified in the order. This provision allows the government to ensure that cost-related information is accurately maintained and utilized for companies falling under the specified criteria.

It is important to note that the introduction of cost audit serves to enhance transparency, efficiency, and accountability in the operations of manufacturing and service-oriented companies, thus promoting responsible business practices and better economic management.

Definition

Cost audit serves as a potent tool for management control and acts as a safeguard on behalf of shareholders, consumers, and the government.

In essence, cost audit is an audit process that involves verifying the cost of manufacturing or producing any article based on the company's accounts concerning the utilization of materials, labor, and other cost items.

According to the Institute of Costs & Works Accountants of London, cost audit entails verifying the accuracy of cost accounts and adherence to the cost accounting plans. In the words of Smith and Day, cost audit refers to the thorough examination of costing systems, techniques, and accounts to ensure their correctness and alignment with the objectives of cost accounting.

In simpler terms, cost audit entails detailed scrutiny and verification of the accuracy of costing techniques, systems, and cost accounts. This process ensures that companies adhere to sound cost accounting practices, contributing to improved financial transparency, efficiency, and compliance with set objectives. By conducting cost audits, companies can maintain better control over their operations, and stakeholders can gain confidence in the reliability of the company's cost-related information.

Objectives

1. To identify and detect any potential errors or fraudulent activities, whether intentional or accidental, within the organization's financial and cost records.
2. To ensure strict adherence to the cost accounting procedures established by the management, promoting consistency and accuracy in cost-related practices.
3. To verify the accuracy of costing data by meticulously checking the mathematical correctness of cost accounting entries recorded in the books of accounts.
4. To exercise comprehensive control over the functioning of the organization's costing department and to provide recommendations for its efficient and seamless operation.
5. To implement an effective internal cost-audit system, thereby alleviating the burden of detailed checking work for external auditors.
6. To assist the management in making well-informed and timely decisions concerning the cost of production and cost variations.
7. To validate the adequacy of the books of account and records pertaining to cost, ensuring they meet the required standards and comply with relevant regulations.
8. To accurately assess the value of work-in-progress and closing stock, providing a precise representation of the organization's inventory.
9. To advise the management on adopting alternative courses of action through the preparation of cost plans and analyses.
10. To report the state of cost affairs of the organization to the appropriate authorities, promoting transparency and accountability within the company's cost management practices.

Advantages

The objectives of cost audit extend beyond the management and shareholders to encompass consumers, society, and the government, offering several advantages:

(a) To the management:

1. Facilitates control over various cost elements.
2. Assesses organizational profitability.
3. Enables inter-firm comparison.
4. Provides a basis for evaluating inter-divisional performance.
5. Helps obtain licenses for expansion or diversification.
6. Controls high inflationary trends in costs.
7. Determines the correct cost of production.
8. Increases productivity by identifying weaker cost areas.
9. Reveals inefficiencies in the cost department.
10. Detects errors and fraud through efficient auditing.

(b) To the shareholders:

1. Provides assurance of proper maintenance of cost records.
2. Prevents capital erosion by monitoring plant utilization, discontinuing uneconomic product lines, and eliminating wastage.
3. Enables timely and informed decision-making, leading to improved organizational performance.
4. Ensures fair returns to shareholders on their investments.

(c) To the consumers:

1. Facilitates the fixation of fair prices.
2. Indirectly contributes to improving consumers' standard of living.

(d) To the Government:

1. Serves as a basis for income tax assessment.
2. Assists in price regulation and fixing.
3. Offers guidance to improve the functioning of uneconomic industrial units.
4. Provides information about fraudulent intentions of companies.

(e) To the society:

1. Provides guidelines to industries for enhancing their operations, benefiting society as a whole.
2. Protects customers from exploitation by revealing actual costs and assessing fair market prices.
3. Promotes industry efficiency, increased production, and reduced product prices for the benefit of society.

Disadvantages

Cost audit, despite its intended objectives, is subject to certain limitations. These limitations primarily arise from its narrow scope of application within the related field of operation. However, criticisms of cost audit often revolve around the following points:

1. Unnecessary Interference: Some argue that cost audit introduces unnecessary interference in the regular operations of companies, potentially hindering their autonomy and decision-making processes.
2. Duplication of Work: Since significant areas of financial and cost audit processes overlap, cost audit may lead to duplication of work, which could be perceived as inefficient.
3. Burden on Companies: Critics contend that cost audit imposes an additional financial burden on companies due to the costs associated with conducting the audit.
4. Secrecy Concerns: Conducting cost audit through external auditors may raise concerns about maintaining the confidentiality of cost accounts, potentially posing risks to the company's interests.
5. Increased Government Restrictions: In certain industries, the introduction of cost audit may lead to increased government restrictions on the functioning of organizations, which some view as a limitation on business operations.

Qualification

As per the provisions of Section 148, the audit of cost records must be conducted by a cost accountant as defined in the Cost and Works Accountants Act, 1959. Section 148(5) states that the qualifications, disqualifications, rights, duties, and obligations applicable to auditors under Section 139 shall, to the extent applicable, also apply to a cost auditor appointed under this section. The company is obligated to provide all necessary assistance and facilities to the cost auditor appointed under this section to enable them to audit the cost records of the company effectively.

It is stipulated that the report on the audit of cost records shall be submitted by the practicing cost accountant directly to the Board of Directors of the company. This report serves as a critical element in assessing the cost management practices and ensuring compliance with relevant regulations.

Disqualification

A person will be deemed disqualified to be appointed as a cost auditor under the following circumstances:

(i) If the individual is disqualified according to the provisions of Section 141 of the Companies Act, as applicable for the appointment of a company auditor.

(ii) If the person currently holds the position of statutory auditor under Section 139 of the Companies Act.

(iii) If the person becomes subject to any of the disqualifications mentioned in (i) and (ii) above after being appointed as a cost auditor.

Phases or Stages of Cost Audit

The stages or phases of the cost audit may be classified under two broad categories. These include—

1. Efficiency or performance audit
2. Propriety audit

1. Efficiency or performance audit

Definition: Efficiency audit involves assessing the performance of a business enterprise and identifying its weaknesses. It is a component of cost audit that evaluates whether resources are being channeled into profitable areas. Efficiency audit encompasses reviewing the organization's environment, measuring return on investment, cash flow performance, and comparing these with standards. It aims to diagnose shortcomings and prescribe remedies for inefficiencies, making it synonymous with "performance audit."

Objectives: The main objectives of efficiency audit include identifying operational weaknesses, evaluating essential facts in each function analyzed, assessing and comparing the optimal return on capital, ensuring effective investment techniques, and enhancing overall organizational efficiency. It provides insights to the management for taking appropriate corrective actions.

Steps: Efficiency audit follows these steps:

1. Diagnosing weak areas of the business.
2. Studying the business environment for product marketability.
3. Evaluating the profitable utilization of physical assets.
4. Ensuring effective utilization of human resources.
5. Reviewing functional and operational efficiency.

Scope: Performance audit appraises the efficiency of an enterprise, analyzing the effectiveness of various plans and their alignment with target performance. It examines deviations between actual and budgeted expenditures, evaluates the results of capital investments, and assesses overall organizational efficiency. Key aspects evaluated include sales value and quantity, production costs, inventory management, capital utilization, profitability, solvency, and liquidity position. Performance audit uses comparisons with budgets, standards, historical data, and inter-firm benchmarks to evaluate the organization's performance.

2. Propriety audit

Definition: Propriety audit pertains to the assessment of the "rightness" or "justness" of various financial events or transactions conducted by an organization. It involves appraising the appropriateness of executive actions and plans. The cost auditor's role in propriety audit is more advisory than executive, focusing on evaluating the soundness of management's plans and policies.

Functions: In the context of propriety audit, the cost auditor's functions include:

1. Ensuring that incurred expenditures are planned.
2. Appraising whether these expenditures are likely to yield optimal results.
3. Verifying that the size and allocation of expenditures are appropriate and expected to produce optimum outcomes.

4. Assessing alternative plans of action to enhance current operations and returns from capital expenditure.

Importance: Propriety audit is especially relevant in companies where management personnel change regularly, and there is a separation of ownership from management. It acts as a check on transactions conducted for personal benefit, providing a safeguard against misuse of resources and conflicts of interest. The Company's Act has been amended to require auditors to report not only on financial statements' fairness but also on the propriety of specific transactions.

Objectives: The main objectives of propriety audit are to ensure the following:

(i) Absence of revenue leakage.

(ii) Prevention of funds misappropriation.

(iii) Elimination of wastage or misuse of resources.

(iv) Compliance with legal and financial regulations in managing the company's affairs.

(v) Adequate safeguarding of assets.

(vi) Transactions conducted in the best interest of the entity.

13.2 Management Audit

In recent times, there has been a growing argument for accountants to shift their focus from solely scrutinizing the accuracy of accounting records and past financial statements of their clients. Instead, it is suggested that they should also show concern for their clients' efficiency. This may involve professional firms undertaking what is commonly known as a management, operations, or efficiency audit, in addition to fulfilling their fundamental statutory responsibilities.

A management audit aims to identify irregularities and shortcomings within the management processes and offers recommendations to enhance overall efficiency. It places emphasis on evaluating outcomes rather than solely assessing whether established procedures have been adhered to. By adopting this approach, accountants can play a more proactive role in assisting their clients in optimizing their operations and achieving improved results.

Definition

Management audit is a thorough assessment and evaluation of an organization's policies and functions, measured against specific standards. Its primary objective is to analyze the performance of various management processes within the organization.

According to Taylor and Perry, management audit involves a comprehensive examination of the enterprise to assess its organizational structure, policies, and procedures. The aim is to determine the presence of effective management practices at all levels and to ensure positive external relationships.

The Institute of Internal Auditors defines management audit as a forward-looking, independent, and systematic evaluation of all levels of management activities. Its purpose is to enhance organizational profitability and achieve other organizational objectives.

In summary, management audit can be defined as an audit type that scrutinizes, reviews, and assesses the management's policies and actions, based on established norms and standards. It aims to improve organizational efficiency and effectiveness in achieving its goals.

Objectives

The primary objectives of management audit include:

1. Identifying and addressing any irregularities or deficiencies in the management process to facilitate improvements and achieve optimal outcomes.

2. Providing support and guidance to all levels of management within the organization by closely monitoring and evaluating its operations.
3. Conducting a thorough assessment of the management's performance through a comprehensive examination of inputs and outputs.
4. Assisting the management in promoting coordination and synergy among different departments.
5. Facilitating the establishment of positive relationships between the management and employees, while also clarifying the duties, rights, and responsibilities of the entire staff.
6. Recommending necessary changes in policies and procedures to ensure a better future for the organization.
7. Ensuring effective relationships with external stakeholders and enhancing the internal organizational structure for improved efficiency.
8. Proposing strategies for better human relations, new management development, and overall organizational plans and objectives.

Importance

Management audit focuses on evaluating the efficiency and effectiveness of an organization's management in achieving its objectives. It critically reviews all aspects of management performance and provides recommendations for improvement. The importance and various aspects of management audit are outlined as follows:

1. Reviewing plans and policies: The management periodically conducts meetings to assess their performance and operations in alignment with adopted plans and policies. However, an independent review of these plans and policies by management auditors is essential to ensure their effectiveness.
2. Identifying management weaknesses: Management audit identifies inefficiencies and weaknesses in the management. It evaluates the soundness of adopted plans and the adequacy of the control system to ensure successful execution.
3. Providing advice to the management: Management audit goes beyond identifying issues; it also offers valuable recommendations for resolving identified problems, thus aiding in improving overall management effectiveness.
4. Assisting prospective investors: Prospective investors can benefit from management audit reports when considering significant investments in an organization. The insights provided by management auditors help in evaluating investment decisions.
5. Facilitating takeover of sick industries: When the government contemplates taking over a struggling organization, management audit can be ordered to identify the actual causes of its sickness. The government can then take appropriate steps based on the recommendations from management auditors.
6. Supporting foreign collaboration: In cases of industrial collaboration, foreign partners can gather valuable information about the management and the future prospects of the collaborating unit through management audit, which helps them make informed decisions.
7. Guiding banks in loan sanctioning: Banks and financial institutions may conduct management audits before granting loans or participating in the equity capital of a company. This ensures that their investment would be secure and well-managed by the organization's management.

Scope

The management audit encompasses various important areas within its normal terms of reference:

1. Assessment of Aims and Objectives: Evaluating whether the enterprise is effectively fulfilling its fundamental aims and objectives in practice.

2. Adaptation to Technological Change: Determining whether the enterprise is successfully adapting to technological advancements and changes in its industry.
3. Suitability of Management Structure: Examining the management structure to assess its appropriateness and effectiveness.
4. Efficiency of Management: Assessing the efficiency of management at all levels and identifying opportunities for possible cost savings and improvements.
5. Staff Recruitment and Training Policies: Reviewing the policies related to staff recruitment and training to ensure adequacy and identifying the level of staff morale.
6. Communication System: Evaluating the presence of a proper communication system that facilitates smooth information flow both upward and downward throughout the organization, including an efficient management information system.
7. Market Share and Competition: Analyzing whether the enterprise's share of the market is growing or declining and how it compares to its main competitors.
8. Return on Capital Employed: Assessing the level of satisfaction regarding the return on capital employed and comparing it with other companies in the same industry.
9. Employee Relations: Evaluating the management's ability to establish positive relations with employees and comparing this aspect with other companies.
10. Relationship with the Outside World: Examining the effectiveness of the enterprise's relationship with external stakeholders and assessing its corporate image from the perspective of outsiders.

Advantages

The importance of management audit becomes evident when considering its various advantages, which include:

1. Assisting in Planning: Management audit helps the management in preparing plans, objectives, and policies, and it suggests effective ways and means to implement them.
2. Identifying Inefficiencies: Through management audit, any inefficiencies and ineffectiveness on the part of the management can be brought to light, allowing for corrective measures to be taken.
3. Applicability to All Factors: The techniques of management audit are not limited to specific factors of production but can be applied to all elements of cost, making it comprehensive in its approach.
4. Preventing Capital Erosion: By employing proper management audit techniques, businesses can prevent capital erosion and safeguard their financial resources.
5. Enhancing Profitability: Management audit contributes to the overall profitability of a concern by constantly reviewing its solvency, profitability, and efficiency position, leading to informed decision-making.
6. Facilitating Quick Decision-Making: Top management benefits from management audit as it aids in arriving at correct management decisions without unnecessary delays.
7. Strengthening Communication: Management audit helps improve the communication system both within and outside the business, enhancing information flow and coordination.
8. Supporting Budget Preparation: Management audit can assist the management in the preparation of budgets and formulating effective resource management policies.
9. Aiding in Personnel Training and Marketing Policies: Through management audit, the management can gain valuable insights for personnel training and the formulation of effective marketing policies.

Disadvantages

The drawbacks of management audit can be summarized as follows:

1. High Expenditure: Implementing the management audit technique requires substantial financial investment, which might not be feasible for all organizations, especially smaller ones.
2. Inhibition of Managerial Initiative: Managers may become hesitant to take initiatives because they fear that the management auditor will consistently point out shortcomings in their actions, leading to a reluctance to innovate and take risks.
3. Focus on Keeping Records: Managers may prioritize keeping records up to date rather than focusing on improving efficiency and reducing costs. This could lead to a compliance-oriented approach rather than a proactive one.
4. Ineffectiveness of Management Auditor: The effectiveness and efficiency of management auditors can vary, leading to situations where management audit fails to provide the expected result-oriented service.
5. Detrimental Activities: In some instances, management auditors may engage in activities that conflict with the social objectives of auditing, such as tax evasion or unethical practices.

Appointment

To conduct an effective management audit, it is advisable to appoint a group of auditors instead of relying on an individual auditor. This is because management audit requires expertise in various fields of management, and it is unlikely that one auditor possesses all the necessary skills. By forming a group, experts from different areas of management can contribute their specialized knowledge.

Internal auditors should be part of this group as they are familiar with the internal affairs of the organization and its management practices. Their insight can provide valuable context and enhance the effectiveness of the audit.

Management audit involves a comprehensive appraisal of the organization's management activities. To conduct such an audit successfully, auditors must thoroughly study the organization's activities and its plan of action. Full cooperation from the top-level management is crucial to facilitate the audit process effectively. This cooperation ensures that auditors have access to the necessary information and resources.

The effectiveness of the management audit will depend on the scope of the audit, which is determined by the management. Management must decide on the areas and aspects to be covered in the audit to ensure it aligns with their specific objectives and concerns.

Qualities of Management Auditors

The task of conducting a management audit requires an individual with specialized expertise and knowledge in the field of management. The management auditor must possess sufficient experience and a comprehensive understanding of various management functions within the organization. These functions include internal control systems, production planning and control, personnel management techniques, among others. The essential qualities that a competent management auditor should possess are as follows:

1. Comprehensive Understanding: The management auditor must have the ability to comprehend the organization's challenges and intricacies fully.
2. Clarity on Organizational Objectives: It is crucial for the management auditor to have a clear understanding of the organization's nature, purposes, and objectives.
3. Progress Evaluation: The management auditor should possess the skills to assess and determine the progress of the organization.

4. Interpersonal Skills: Being tactful in dealing with various employees and officers of the organization is a vital aspect of the management auditor's role.
5. Personal Demeanor: The management auditor's personality should be pleasing and dynamic to effectively communicate and interact with stakeholders.
6. Legal Knowledge: Familiarity with different types of laws, particularly the Income Tax Act and the Companies Act, is essential for the management auditor.
7. Report Preparation: The management auditor should have a sound knowledge of preparing various reports that are presented to the management.
8. Internal Control Assessment: The ability to assess and examine the internal control system of the organization is a critical aspect of the management auditor's expertise.
9. Understanding Management Principles: A proficient management auditor should be well-versed in various management principles, such as planning, control, and management by exceptions.
10. Financial Analysis Proficiency: Good knowledge of financial statement analysis techniques, such as fund flow analysis, ratio analysis, and standard costing, is vital for the management auditor's role."

Management Auditor's Report

Following the management audit, management auditors are responsible for preparing a comprehensive report to be submitted to the organization's management. The report is based on the auditors' findings and concrete information, aiming to provide recommendations for enhancing the management's functionality. It is crucial for the management auditor to present an objective evaluation, even if it involves critiquing the management's practices. The recommendations put forth by the auditor should be constructive and aimed at improving the overall efficiency of the management.

The report should be transparent and straightforward, either affirming that the efficiency is sufficient, and no changes are required, or proposing reorganization when deemed necessary. In such cases, the management auditor must have the confidence in their ability to assess the situation and provide appropriate proposals that lead to improvement and increased profitability. The primary goal of the report is to assist the management in making informed decisions for the betterment of the organization's performance and overall effectiveness.

13.3 Human Resource Audit

Concept of Human Resource

Amongst the various components contributing to an organization's profitability, the paramount element is the human resource factor. The advancement and progress of the organization, encompassing heightened productivity, enhanced profitability, and overall expansion, hinge upon the effectiveness and efficiency displayed by all personnel within the organization. This includes not only the collective efforts of workers and employees but also the proactive approach demonstrated by upper management. These collective human aspects, playing either a direct or indirect role in bolstering business growth and enlargement, can be appropriately referred to as 'human assets' or 'human resources.'

Concept of Human Resource Accounting

Touché Ross and Co., a Canadian CPA firm, has pioneered the introduction of the concept of human resource accounting as an integral component of its management information system. This pioneering initiative stems from the firm's conviction that a robust human resource accounting system can furnish critical insights essential for both short-term and long-term decision-making and performance evaluation.

According to Eric Flamholtz, the notion of 'Accounting for people as an organizational resource' encompasses the quantification of expenses borne by business enterprises and other institutions in areas such as recruitment, selection, hiring, training, and the development of human assets.

Dr. B. K. Basu defines Human Resource Accounting as 'an accounting methodology that encompasses the recording of costs associated with the nurturing and well-being of the human resources within an organization, while also encompassing the projection of anticipated future earnings attributable to each employee.

Steps for Human Resource Audit

To facilitate the audit of human resources, the following steps are recommended:

1. Conduct a comprehensive analysis of the organization's nature, distinguishing between professional and general business entities.
2. Engage in interviews with senior management to gather insights into the assessment of human resource valuation.
3. Verify the adequacy of provisions made for the depreciation of human assets.
4. Confirm the accuracy of the human resource valuation presented in the balance sheet.
5. Evaluate the effectiveness of the internal control system governing various human resource information.
6. Ensure that all potential contingencies influencing human resource valuation are appropriately factored into the measurement process.

Problems of Human Resource Audit

While the auditor does not possess specialized expertise in human resource valuation, their involvement in the evaluation of human resources is essential. The auditor must assess the values recorded in the balance sheet, whether as investments in human resources or as the net value of human assets. However, several challenges could arise for the auditor during the verification of human resource valuation:

1. The precise valuation of an individual is inherently elusive, leading to potential inaccuracies in the audit process.
2. Auditors face difficulty in quantifying the worth of employees trained through methods recommended by accountants or valuers.
3. Subjective judgment in resource valuation introduces uncertainty into the audit procedure, impacting data reliability.
4. The auditor may encounter challenges in gathering accurate information upon which human resource valuation is based.
5. Given that the concept of 'human resource audit' has not gained widespread traction, auditors may grapple with uncertainty about the appropriate audit approach.

Navigating these complexities underscores the intricate nature of human resource valuation within the audit context, demanding careful consideration and adept handling by the auditor.

1.3.5. Advantages of Human Resource Audit

Despite the challenges inherent in conducting a comprehensive human resource audit, the adopted audit procedure offers several benefits:

1. Management can view the audited figures as dependable, guiding decisions with confidence.
2. The audit process enhances the auditor's ability to provide an accurate and unbiased assessment of the business's overall state.

3. Increased investor confidence may result from a credible audit, potentially attracting additional investments.
4. A meticulous analysis of resource allocation among competing opportunities within the company becomes feasible through this audit approach.
5. Justifiability of expenditures in human assets can be substantiated through the audit of human resources.
6. The audited human resource data serves as a valuable foundation for the preparation of social accounts, enhancing transparency and accountability.

These advantages highlight the meaningful contributions that a well-executed human resource audit can make to organizational decision-making, financial reporting, investor relations, resource management, and social accountability.

13.4 Social Audit

Concept of Social Responsibility

Modern corporate entities are recognized as significant agents of social influence, extending beyond mere profit generation and shareholder dividend distribution. Their role encompasses a broader societal well-being, carrying substantial responsibilities toward the community. These responsibilities can be categorized into two distinct directions.

Concept of Social Accounting

Internal Social Responsibility encompasses:

(a) Offering employee benefits encompassing indirect financial perks such as provident fund, gratuity, bonuses, insurance, medical coverage, leave compensation, housing provisions, recreational and entertainment facilities for both workers and employees, and other relevant advantages.

(b) Maintaining a clean and hazard-free environment within the factory premises and its adjacent areas.

(c) Timely fulfillment of statutory obligations.

(d) Providing high-quality products at equitable prices.

(e) Ensuring equitable returns to investors considering associated risks.

External Social Responsibility entails:

(a) Contributing to community development through the establishment and upkeep of infrastructure such as roads, parks, playgrounds, and access to clean drinking water.

(b) Undertaking tree planting initiatives to enhance environmental conditions.

(c) Facilitating business growth and expansion to foster the creation of fresh employment opportunities.

(d) Establishing operational units in economically disadvantaged regions.

Concept of Social Audit

The terms "social accounting" and "social audit" are at times used interchangeably in literature, although they carry distinct meanings. Social accounting pertains to the establishment of a measurement framework aimed at monitoring an organization's social performance. Conversely, social audit involves an independent auditing process to verify an enterprise's social performance records. John Crowhurst, in his work "Auditing – a Guide to Principles and Practice," offers a clear elucidation of these terms. He defines social accounting as the process of evaluating an organization's social performance, while social audit is characterized as an external investigation into a company's social accounting records by an impartial entity, with the intent of attesting and authenticating the outcomes and reports.

Consequently, social audit can be delineated as the evaluation of an industry's overall performance concerning its collective responsibility. However, in contemporary times, social responsibility is no longer a comprehensive concept confined to an entire industry. Each constituent organization within an industry is attributed specific social responsibilities. Thus, social audit is aptly defined as the appraisal of an organization's social performance.

Objectives of Social Audit

Numerous methodologies and strategies have been devised to facilitate the proficient execution of social audits. These techniques are developed by accounting professionals with careful consideration of the following objectives intrinsic to social audit:

1. Assessment of Social Performance: The primary aim is to gauge an organization's societal contributions.
2. Accuracy and Fairness Assurance: Social audit serves to inform organizational management about the integrity and accuracy of their social accounts.
3. Evaluation of Socio-Economic Contributions: An industry's socio-economic impact is meticulously evaluated.
4. Transparency in Responsibility: Social audit endeavors to illuminate an organization's fulfillment of its societal obligations for public awareness.
5. Guidance in Social Account Preparation: It advises management in the meticulous creation of social accounts.
6. Financial Data Evaluation: Social actions of an organization are scrutinized and systematically presented, even in the absence of a socio-economic performance statement.
7. Categorized Evaluation: Social audit ensures that diverse social endeavors are correctly categorized, encompassing aspects like products, employees, local community, environment, and public, within the social income statement.
8. Value-Added Statement Verification: The accuracy of 'value-added statements,' used to depict an enterprise's contribution to the national economy, is meticulously examined.
9. Social Asset Validation: The assets depicted in the social balance sheet are validated, and their valuation is subject to scrutiny.
10. Social Equity Validation: The accuracy of social equity representation on the liability side of the social balance sheet is thoroughly reviewed.

Importance

The concept of social audit has emerged as a response to the increasing recognition of businesses' societal obligations. Within the evolving socio-economic landscape, the significance of social audit has become notably pronounced. This development reflects an expanded role expected of the auditing profession by society. Beyond its conventional responsibilities of ensuring the accuracy and integrity of financial records, auditing is now called upon to adopt a socially oriented stance, safeguarding diverse societal interests. Consequently, social audit has become a pivotal component in the contemporary business environment. Its importance can be elucidated as follows:

1. Assessment of Societal Contributions: Social audit serves as a means to evaluate the social performance of business enterprises. It offers a comprehensive view of the contributions an enterprise makes to society, thereby providing an accurate portrayal of its societal impact.
2. Preparation of Annual Social Accounts: The implementation of social audit necessitates the creation of social accounts. Presently, efforts are directed towards developing appropriate social accounting systems with standardized measures for social performance evaluation and the presentation of annual social accounts.

3. Guidance for Management: Social auditors assume a role in guiding management by aiding in the measurement of social performance, proper maintenance of social accounting records, and the presentation of social statements. Their specialized expertise offers valuable insights to management.
4. Industry Contributions: Social audit extends its significance to industries by effectively assessing their overall societal and national economic contributions.
5. Effective Resource Allocation: Social audit plays a pivotal role in evaluating different social projects from the perspective of their social costs and benefits. This assessment is instrumental in ensuring the optimal allocation of limited resources.

13.5 Tax Audit

Definition

The statutory audit primarily focuses on fulfilling the informational needs of the shareholders. However, there exist other stakeholders with a vested interest in the financial affairs of the organization. Among these stakeholders, the Tax Authority stands out as a significant party that seeks accurate information regarding the taxpayer's income in alignment with taxation regulations. To serve this purpose, the Income Tax Act of 1961 incorporates several provisions mandating the audit of financial statements for tax-related considerations.

Consequently, the term 'tax audit' pertains to the comprehensive examination of income, expenditures, and specific claims for deductions and exemptions, all of which must adhere to the stipulations outlined in the Income Tax Act. Unlike the financial audit, which primarily addresses general financial transparency, tax audit is a distinct requirement established under the Income Tax Act. This specialized audit is indispensable for meeting the specific demands of the tax authority and ensuring compliance with the relevant taxation framework.

Types of Tax Audit

There are three types of tax audit under the Income tax Act. These are as follows:

1. Compulsory tax audit under Section 44AB.

2. Tax audit for claiming exemptions or deductions.

3. Selective tax audit under Section 142(2A).

Tax Auditor

Only an individual fitting the description outlined in the elucidation of Section 288(2) of the Income Tax Act possesses the authority to carry out a tax audit under any of the provisions delineated within the Act. Furthermore, an individual qualified for the role of an auditor for a company as per Section 141(2) of the Companies Act, 2013, is also encompassed within the ambit of the term "accountant."

For a chartered accountant to undertake the task of conducting a tax audit, it is imperative that they maintain the status of a practicing chartered accountant, holding a valid certificate of practice as stipulated by the Chartered Accountants Act, 1949.

When considering corporations, the responsibility of performing a tax audit can be assigned to either the statutory auditor or any other practicing chartered accountant. The decision regarding the appointment of a tax auditor lies within the purview of the organization's management. In the case of a company, this authority rests with the Board of Directors or an officially authorized officer. Likewise, a sole proprietor, a partner of a firm, or any other duly authorized individual holds the prerogative to select and designate the tax auditor.

Compulsory Tax Audit Under Section 44AB

Starting from the assessment year 1985–86, specific provisions within Section 44AB of the Income Tax Act, 1961 were introduced to mandate compulsory tax audits for certain individuals. This section stipulates that individuals must undergo a tax audit if they meet the following criteria:

(a) Engaged in business with total sales or gross receipts exceeding 1 crore in the previous year.

(b) Engaged in a profession with gross receipts exceeding 25 lakh in the previous year.

Under this provision, individuals meeting the aforementioned conditions are required to have their previous year's accounts audited by an 'accountant' before the 'specified date.' They must also obtain an audit report in the prescribed format, duly signed and verified by the accountant. The term 'specified date' refers to the 31st day of December of the assessment year for companies and the 31st day of October for other cases.

Unlike statutory audits, tax audits mandated by this section are not limited to companies alone. The approach taken by the tax auditor mirrors that of the statutory auditor, utilizing generally accepted principles for conducting audits and potentially employing selective verification techniques. However, the tax auditor must also remain mindful of the requirements stipulated in the Income Tax Act and various legal decisions relevant to this field of application.

Tax Audit Report

The tax auditor holds the responsibility of providing their opinion on the chosen tax computation method employed by the enterprise. Their report must address the following aspects:

1. Confirming the accuracy and fairness of the financial statements' portrayal of profit or loss and the overall financial state, especially when the assessee's accounts aren't subject to audit under any other legislation.
2. Validating the accuracy and authenticity of the prescribed details included in the statement appended to the audit report.

Rule 6G of the Income Tax Rules prescribes the specific formats in which the auditor must furnish their audit report. These formats include:

A. Form 3CA + 3CD: Applicable for individuals engaged in business or a profession who are obligated by other laws to conduct an audit of their accounts. The tax auditor submits their report in Form 3CA and attaches a detailed statement in Form 3CD.

B. Form 3CB + 3CD: Relevant for individuals engaged in business without the requirement for accounts to be audited under other laws. The tax auditor submits their report in Form 3CB along with an appended statement in Form 3CD.

13.6 FORENSIC AUDIT

The 2015 Companies (Auditors' Report) Order mandates auditors to report on any observed or reported company fraud during the year, specifying its nature and amount. This requirement underscores the rising importance of forensic auditing.

Forensic auditing is a specialized practice focused on engagements arising from disputes or potential litigation. Forensic accountants adhere to court standards, gather evidence, and employ custom techniques tailored to each case. Their role often involves providing expert testimony during trials.

Components of Forensic Accounting

Forensic accounting blends accounting, auditing, and investigative expertise to support legal cases. It comprises two key aspects: litigation services, where accountants serve as expert consultants, and investigative services, involving a forensic accountant's skills and potential courtroom testimony. These professionals are commonly sought after for legal investigations related to theft and misuse of corporate and personal assets. They utilize their knowledge and background to analyze theft patterns and misappropriation. Additionally, forensic accountants assess business accounting systems and draw on their experience to suggest enhancements to internal controls and checks, aimed at deterring theft and fraud.

Objectives

The fundamental goal of a forensic audit is to determine the occurrence of fraud. The forensic auditor must thoroughly analyze extensive records and, when legally permissible, interview witnesses. Comprehensive documentation is crucial to validate the findings. In cases of fraud, the audit outcome centers on the following aspects:

1. Establishing the occurrence of a financial loss.
2. Identifying those accountable for the loss.
3. Revealing the method and motive behind the fraud.
4. Establishing awareness of the wrongdoing.
5. Identifying any other parties benefiting from the fraud.

Application

Forensic accounting and audit may be applied in the following areas besides fraud detection:

(a) Conducting due-diligence especially for segment-wise profitability analysis

(b) Business valuation

(c) Management auditing

(d) Assessing loss before settling insurance claims.

Role of Forensic Accountant

A forensic accountant has to analyses, interpret, summarize and present complex, financial and business-related issues for investigation. Forensic accountant carries out investigative accounting and provides litigation support. The services of forensic accountants are in great demand in the following areas:

(a) Detection of fraud committed by employees

(b) Criminal investigation

(c) Settlement for outgoing partner

(d) Cases relating to professional negligence

(e) Arbitration service

(f) Facilitating settlement regarding motor vehicle accident

(g) Settlement of insurance claim

(h) Dispute settlement

(i) Matrimonial dispute cases

13.7 Green (Environmental) Audit

The environmental audit serves as a valuable managerial instrument that establishes a connection between productivity and environmental impact. Mandated by the Environment (Protection) Act of 1986, Rule 14 stipulates the obligation for industries to submit an annual environmental statement by September 30th each year, starting from 1993. This requirement is directed towards pertinent industries or organizations that hold or necessitate consent or authorization under the Water (Prevention and Control of Pollution) Act of 1974, the Air (Prevention and Control of Pollution) Act of 1981, and/or the Hazardous Waste (Management & Handling) Rules of 1989 to be in compliance with environmental regulations.

Definition

An environmental audit involves the verification of the accuracy of environmental records. In a broader context, it encompasses the scrutiny of financial records related to environmental and natural resources, including their assessment, depreciation, and recorded values in financial documents.

As articulated by N. Rajaraman, 'Environmental auditing encompasses a series of proactive measures undertaken by an organization's leadership to assess its environmental performance.'

The International Chamber of Commerce defines 'Environmental auditing as a fundamental managerial instrument involving a structured, documented, regular, and objective assessment of the effectiveness of an organization's environmental systems, management practices, and equipment, all aimed at the preservation of the environment.'

Hence, the environmental audit stands as an exceptional managerial instrument for evaluating an industry's operations from an environmental standpoint, gauging the efficacy and sufficiency of pollution control measures in place.

Objectives

The subsequent points outline the aims of environmental auditing:

1. Ensuring appropriate and responsible utilization of natural resources.
2. Managing and monitoring expenditures related to the acquisition of natural resources, and verifying their accurate categorization.
3. Confirming accurate representation of natural resources in a nation's balance sheet, acknowledging their significance as valuable national assets.
4. Addressing the repercussions of adverse environmental impacts and pollution resulting from the utilization of natural resources in production processes. The primary objective of such an audit is to oversee the implementation of effective measures to control or prevent such adverse effects.
5. Promoting the utilization of natural resources for industrial development and overall national advancement.
6. Verifying the implementation of necessary measures to safeguard the well-being and prosperity of the community, while also ensuring proper disposal of hazardous waste and mitigation of social risks.

Approach

Developing an effective environmental audit program necessitates meticulous planning and careful attention to the objectives established for the audit initiative within each company.

The requisites for conducting an environmental audit will inherently differ from one facility to another, and a uniform approach may not be universally applicable. In essence, these audits are executed by a competent, independent team of specialists who visit specific plant sites to assess environmental management and operational performance. Additionally, industries can engage in self-analysis by conducting these audits with expert guidance. Alternatively, the utilization of environmental audit software can aid industries in executing this task.

The subsequent guidelines outline the steps to be adhered to when embarking on an environmental audit:

Step 1: Preparatory activities

The initial phase involves the establishment of a multidisciplinary audit team proficient in both overarching environmental matters such as policies, regulations, and environmental management, as well as specific environmental subjects including ecology, environmental toxicology, potential contaminant behavior, abatement technologies, and operational intricacies.

Subsequent to the constitution of the audit team, the subsequent task is to facilitate the acquisition of pre-visit data. Pertinent information can be found within industry records, encompassing details about operational nature, pertinent environmental concerns, production specifics, water cess obligations, energy consumption, and raw material-related insights. Based on this data, the audit team will pinpoint key areas for focus, construct a visit schedule, and assign specific responsibilities to individual team members.

The preparatory activities encompass the following tasks:

1. **Educational Outreach on Environmental Audit**: Primarily, educating management and plant personnel about the principles of environmental audit is essential. Securing the endorsement and commitment of senior management is critical for the effectiveness of the audit program. Management should recognize the significance of environmental auditing as a vital pragmatic instrument.
2. **Background Information Review:** Comprehensive gathering and examination of background information concerning the broader corporate environment is imperative. This entails a thorough understanding of relevant Acts and Rules, adherence to permits, evaluation of pollution control system performance, solid waste management practices, safety protocols, and more. In essence, the objectives and scope of the environmental audit should be unequivocally delineated.
3. **Audit Team Composition:** Given its multidisciplinary nature, the success of an environmental audit hinges on involving suitable experts. The audit team might encompass engineers, technologists, biologists, and personnel experienced in analogous activities from other industries. An adept environmental engineer should fulfill the role of a coordinator.
4. **Timeline Deliberation:** Crafting a well-defined timeline for the audit is essential to ensure the timely completion of all essential activities.
5. **Questionnaire Preparation:** To facilitate the audit, designing pertinent questionnaires and other tools is crucial for collecting and evaluating pertinent information. Essentially, suitable audit instruments must be devised and subjected to testing before the commencement of the actual audit process.

Step 2: On-site visit

The primary components of the site visit encompass an assessment of the facilities through thorough inspections and engaging in interviews with personnel. These interviews span across senior, middle, and junior levels within relevant departments. Conducting these interviews with a flexible checklist, following a predefined protocol, has proven advantageous. The audit further entails a comprehensive analysis of the process flow diagram, coupled with the establishment of a material balance for both water and raw materials employed. Each process is dissected into distinct sub-processes. The quantities of water and materials entering and exiting the process are estimated via:

1. Chemical process engineering computations,
2. Records maintained by the plant, or
3. On-site measurements.

The principal aim of constructing a material balance is to correlate water and raw material consumption with production per unit. Similarly, estimates are generated for air, solid, and hazardous waste produced within individual processes. Aggregating the quantities of diverse pollutants estimated across all processes yields a metric for pollution generated per unit of each product. This approach facilitates the identification of production inefficiencies and unnecessary depletion of resources, thus establishing a link between industrial productivity, pollution generation, and resource utilization.

Hence, on-site activities encompass the following tasks:

(a) Conducting interviews with personnel stationed at different sites

(b) Conducting comprehensive inspections of the site, operations, and equipment

(c) Evaluating safety protocols

(d) Scrutinizing operational and administrative records, along with relevant documents.

Analogous to statutory and cost audits, effective environmental management necessitates a well-functioning internal control system. This system is inherently embedded within a facility's environmental management framework, encompassing organizational monitoring, meticulous record-keeping procedures, formalized preventive and control strategies for inadvertent releases, internal inspection initiatives, physical containment measures for released materials, and an array of other control system components. The audit team acquires pertinent information concerning these pivotal control system elements through diverse avenues, including formal questionnaires, observations, and interviews.

Step-3: Post-visit activities

Subsequent to the site visit, post-visit activities encompass the following tasks:

(a) Identifying and assessing options for waste reduction, followed by the formulation of a comprehensive waste reduction action plan.

(b) Evaluating potential solutions and crafting recommendations based on the identified issues.

(c) Compiling the interim audit report.

(d) Allocating responsibilities for implementing corrective actions and establishing corresponding timelines.

(e) Executing the corrective actions.

(f) Undertaking follow-up procedures to monitor the effectiveness of the implemented corrective actions.

Building upon the insights gathered during the plant visit, an interim audit report is generated. A typical environmental audit report encompasses the subsequent components:

General industry-related information.

1. Water budget analysis, including quantities used in production processes, cooling systems, domestic consumption, and more.
2. Material balance for raw materials across various processes, including consumption per unit of production.
3. Assessment of air and water pollution stemming from diverse processes.
4. Analysis of solid and hazardous waste generation across processes, along with the employed disposal techniques.
5. Financial breakdown of pollution prevention costs.
6. Projection of future investments targeted at environmental protection and pollution mitigation.

Step-4: Final report preparation

In a brief timeframe, the audit team generates an interim report, intended for review and input from the site management. The suggestions and discoveries are subject to thorough deliberation during a collaborative discussion. Subsequently, the conclusive report is meticulously compiled and subsequently presented to the respective industry.

Stages of Environmental Audit

With the burgeoning growth of environmental awareness, an increasing number of companies are now taking the initiative to assess both the business implications and the consequences of their operations. The environmental audit serves as a pivotal managerial instrument, signifying that companies should proactively embrace change without waiting for restrictive legislation to enforce it.

The environmental audit encompasses the following stages:

• Analysis of prevailing legal requisites, health and safety protocols, and upcoming regulatory advancements.

• Scrutiny, comparison, and construction of internal protocols vis-à-vis external mandates. The ramifications of external obligations on production procedures and equipment are evaluated, with a focus on waste generation and emissions.

• Thorough examination of the company's organizational structure, administration, and communication processes to ascertain the degree to which management is apprised of the environmental impact resulting from the company's activities. Discrepancies are identified, and potential solutions are proposed.

Summary

- Auditing encompasses a diverse spectrum. Its scope extends beyond financial audits mandated by the Companies Act. Auditing now encompasses areas such as cost accounts, managerial policies, operational efficiencies, system applications, social impacts of business, and environmental considerations.
- Cost audit involves verifying the production cost of articles, relying on accounts that detail the use of materials, labor, and other cost elements maintained by the company. Its core aim is to detect intentional errors or fraud and report on the organization's cost status. However, it can lead to duplicated efforts since financial and cost audit areas significantly overlap, and maintaining cost secrecy becomes challenging.
- Efficiency audit evaluates enterprise performance, identifying weaknesses, particularly in operational and financial aspects. Often referred to as performance audit, it aims to assess overall business performance.
- Propriety audit assesses the appropriateness of executive actions and plans. It detects waste, misuse of assets, and frauds, potentially leading to appropriate consequences for those responsible.
- Management audit examines, reviews, and evaluates management policies and functions against established standards. It offers insights to improve management processes and procedures across all organizational levels.
- Human resource audit scrutinizes the human asset value listed in the balance sheet by inspecting and appraising various data points based on estimated human asset values. While this type of audit isn't widely adopted, auditors may face uncertainty about the approach to take for this specific audit due to its limited popularity and usage in organizations.

Keywords

- Special Areas
- Auditing Focus
- Niche Auditing
- Unique Auditing Fields
- Specialized Auditing Sectors
- Distinct Audit Emphases
- Targeted Auditing Domains
- Specific Auditing Zones
- Unconventional Audit Areas
- Non-traditional Auditing Aspects

Self Assessment

1. Which of the following areas of auditing involves examining the utilization of materials, labor, and other cost elements maintained by a company?
   A. Financial audit
   B. Efficiency audit
   C. Cost audit
   D. Management audit

2. Propriety audit focuses on:
   A. Evaluating management policies
   B. Reviewing financial statements
   C. Appraising operational efficiencies
   D. Assessing the appropriateness of executive actions

3. Human resource audit primarily involves:
   A. Evaluating financial performance
   B. Inspecting physical assets
   C. Scrutinizing human asset value in the balance sheet
   D. Reviewing cost accounts

4. Which type of audit aims to appraise the overall performance of an enterprise, including operational and financial aspects?
   a) Efficiency audit
   b) Management audit
   c) Propriety audit
   d) Cost audit
5. Auditing that focuses on areas such as managerial policies, social impacts of business, and environmental considerations falls under:
   A. Financial audit
   B. Environmental audit
   C. Efficiency audit
   D. Special areas audit

6. Specialized audit fields that go beyond financial aspects may include:
   A. Analyzing stock prices
   B. Evaluating marketing strategies
   C. Reviewing employee salaries
   D. Assessing environmental impact

7. Which type of audit involves detecting waste, misuse of assets, and frauds within an organization?
   A. Financial audit
   B. Efficiency audit
   C. Propriety audit
   D. Management audit

8. The type of audit that assists in recommending changes in management policies and procedures is:

A. Efficiency audit
B. Cost audit
C. Management audit
D. Financial audit

9. Which type of audit focuses on assessing the social implications and environmental impact of a business's operations?
   A. Financial audit
   B. Efficiency audit
   C. Environmental audit
   D. Cost audit

10. A cost audit is primarily concerned with:
    A. Reviewing financial statements
    B. Analyzing marketing strategies
    C. Verifying employee salaries
    D. Verifying the cost of production

11. What does an efficiency audit primarily aim to identify?
    A. Fraudulent financial transactions
    B. Compliance with legal requirements
    C. Weaknesses in operational performance
    D. Accuracy of financial statements

12. Propriety audit is focused on:
    A. Analyzing market trends
    B. Verifying inventory levels
    C. Assessing the appropriateness of executive actions
    D. Reviewing internal control procedures

13. Which audit area involves evaluating the utilization of human assets within an organization?
    A. Financial audit
    B. Efficiency audit
    C. Human resource audit
    D. Cost audit

14. The main purpose of a management audit is to:
    A. Calculate production costs
    B. Detect financial fraud
    C. Evaluate the performance of management processes
    D. Verify compliance with tax regulations

15. Special areas of auditing can encompass which of the following?
    A. Financial analysis only
    B. Regulatory compliance only
    C. Non-financial aspects such as social impact and environmental responsibility

D. External marketing strategies

Answer for SelfAssessment

1.	C	2.	D	3.	C	4.	A	5.	D
6.	D	7.	C	8.	C	9.	C	10.	D
11.	C	12.	C	13.	C	14.	C	15.	C

Review Questions

1. Define 'propriety' audit. What are its objectives?
2. Define 'efficiency' audit. What are its objectives?
3. Who can conduct cost audit under the Companies Act, 2013?
4. Do you justify the introduction of social audit in India?
5. What is tax audit? Who can be appointed as a tax auditor?
6. Write short notes on 'compulsory tax audit'.
7. What do you mean by human resource audit?
8. Define performance audit. What is its importance?
9. What are the contents of cost audit report?
10. Define operational audit. What are its objectives?
11. What is social audit? Give your views on the objectives of social audit. Discuss the position ofsocial audit in Indian scenario?
12. Define 'propriety audit'. Distinguish between traditional audit and propriety audit. What are thebenefits of propriety audit? Is there any provision for such audit in case of companies under theCompanies Act, 2013?
13. Discuss the concept and objective of cost audit. What are the advantages of cost audit from theviewpoint of the management? Distinguish between cost audit and management audit.
14. What is management audit? State the uses, limitations and importance of management audit.
15. Define human resource audit. State its advantages and limitations. How it differs from humanresource accounting?

Further Readings

- Auditing: Principles And Techniques By S. K. Basu, Pearsonn.S.
- A Hand Book Of Practical Auditing By B N Tandon, S Sudharsnam & S Sundharabahu, S Chand Publishing
- Auditing And Corporate Governance By Anil Kumar Jyotsna Rajan Arora Lovleen Gupta, Taxmann Publisher

Web links

https://smallbusiness.chron.com/explain-audit-procedures-electronic-data-processing-audit-14715.html https://www.ojp.gov/ncjrs/virtual-library/abstracts/evaluating-internal-control-edp-electronic-data-processing-audits

https://www.aicpa.org/

Unit 14: Code of Ethics in Auditing

CONTENTS

Objectives

After studying this unit, you will be able to:

- To comply with the code of ethics of auditing
- To Identify and illustrate the fundamental principles of code of ethics of auditing.

Introduction

In a world where financial systems and business environments continue to evolve, the ethical foundation of auditing plays a pivotal role in upholding the credibility of financial information.

As we embark on this journey of exploration, we'll delve into the principles that guide auditors in India to conduct their work with the utmost professionalism, independence, and accountability. The Code of Ethics isn't just a set of rules; it's a framework that outlines the moral compass for auditors, ensuring that their actions resonate with the highest standards of conduct.

Auditing, as we know it, is a critical function that provides assurance to stakeholders—investors, regulators, creditors, and the public—that the financial information presented by entities accurately reflects their financial health and operational performance. This function comes with great responsibility, and it's the ethical principles within the Code of Ethics that empower auditors to meet these responsibilities head-on.

In this session, we will journey through the historical context that led to the formulation of ethical guidelines in auditing, understand the regulatory framework in India that supports these guidelines, and explore the core principles that constitute the Code of Ethics. Through real-world case studies and examples, we will see how these principles come to life in practical scenarios, illustrating the challenges and decisions auditors face as they navigate complex ethical terrain.

At the end of our session, you'll have a clearer understanding of the critical role the Code of Ethics plays in shaping the auditing profession and maintaining the integrity of financial reporting. Whether you're a student beginning your journey in the world of accounting or a seasoned professional, this topic is relevant to each one of us, as it lays the foundation for our collective pursuit of accuracy, transparency, and ethical excellence.

So, without further ado, let's dive into the world of ethical principles that guide auditing in India— the principles that ensure that numbers don't merely remain digits on paper, but rather, they tell a story of trust and accountability.

14.1 Complying with the Code

A distinguishing mark of the accountancy profession is itsacceptance of the responsibility to act in the public interest. Aprofessional accountant’s responsibility is not exclusively tosatisfy the needs of an individual client or employingorganization. Therefore, the Code contains requirements andapplication material to enable professional accountants to meettheir responsibility to act in the public interest.

A professional accountant shall comply with the Code. There might be circumstances where laws or regulations preclude an accountant from complying with certain parts of the Code. In such circumstances, those laws and regulations prevail, and the accountant shall comply with all other parts of the Code.

The principle of professional behaviour requires a professional accountant to comply with relevant laws and regulations. Accountants need to be aware of differences in local regulations from the provisions as set out in the Code, and comply with the more stringent provisions unless prohibited by law or regulation.

14.2 Breaches of the Code

A professional accountant who identifies a breach of any other provision of the Code shall evaluate the significance of the breach and its impact on the accountant‟s ability to comply with the fundamental principles. The accountant shall also:

(a) Take whatever actions might be available, as soon as possible, to address the consequences of the breach satisfactorily; and

(b) Determine whether to report the breach to the relevant parties.

Relevant parties to whom such a breach might be reported include those who might have been affected by it.

14.3 The Fundamental Principles

1. General

There are five fundamental principles of ethics for professional accountants:

(a) Integrity – to be straightforward and honest in all professional and business relationships.

(b) Objectivity – not to compromise professional or business judgments because of bias, conflict of interest or undue influence of others.

(c) Professional Competence and Due Care – to:

(i) Attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organization receives competent professional service, based on current technical and professional standards and relevant legislation; and

(ii) Act diligently and in accordance with applicable technical and professional standards.

(d) Confidentiality – to respect the confidentiality of information acquired as a result of professional and business relationships.

(e) Professional Behaviour – to comply with relevant laws and regulations and avoid any conduct that the professional accountant knows or should know might discredit the profession.

A professional accountant shall comply with each of the fundamental principles. The fundamental principles of ethics establish the standard of behaviour expected of a professional accountant. The conceptual framework establishes the approach which an accountant is required to apply to assist in complying with those fundamental principles.

A professional accountant might face a situation in which complying with one fundamental principle conflicts with complying with one or more other fundamental principles. In such a situation, the accountant might consider consulting, with:

Others within the firm or employing organization.

Those charged with governance.

Institute

Legal counsel.

However, such consultation does not relieve the accountant from the responsibility to exercise professional judgment to resolve the conflict or, if necessary, and unless prohibited by law or regulation, disassociate from the matter creating the conflict.

The professional accountant is encouraged to document the substance of the issue, the details of any discussions, the decisions made and the rationale for those decisions.

2. Integrity

A professional accountant shall comply with the principle of integrity, which requires an accountant to be straightforward and honest in all professional and business relationships. A professional accountant shall not knowingly be associated with reports, returns, communications or other information where the accountant believes that the information:

- Contains a materially false or misleading statement;
- Contains statements or information provided negligently; or
- Omits or obscures required information where such omission or obscurity would be misleading

3. Objectivity

A professional accountant shall comply with the principle of objectivity, which requires an accountant not to compromise professional or business judgment because of bias, conflict of interest or undue influence of others. A professional accountant shall not undertake a professional activity if a circumstance or relationship unduly influences the accountant"s professional judgment regarding that activity.

4. Professional Competence and Due Care

A professional accountant shall comply with the principle of professional competence and due care, which requires an accountant to:

1) Attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organization receives competent professional service, based on current technical and professional standards and relevant legislation; and

2) Act diligently and in accordance with applicable technical and professional standards.

5. Confidentiality

Auditors should respect the confidentiality of information obtained during the course of their work and should not disclose such information without proper authorization, unless there is a legal or professional duty to do so.

6. Professional Behavior:

Auditors should act diligently, professionally, and in accordance with relevant laws and regulations.

14.4 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 theletter 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 arenow 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 requiredto 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 efficiencypresent in the production process of a business, the efficient use of labour and other resourcesassociated with the business, and the veracity of the financial records of the business. Along withevaluating a project or aspect of a company, an auditor is often expected to make recommendationsregarding the correction of negative conditions that currently impact the organization. Auditorsare also to conduct themselves in a manner consistent with the promotion of cooperation andgood relations between auditors and the sector. As promulgated by Auditors, Auditing shouldadopt and uphold the Code of Ethics. The Code of Ethics states principles and expectationsgoverning behaviour of individuals and organizations in the conduct of auditing. It describesthe minimum requirements for conduct, and behavioural expectations rather than specificactivities.Recent high-profile corporate collapses, such as Enron and WorldCom, have brought intoquestion the status and credibility of the accounting profession, especially auditors, "withallegations of accountants' violations of public trust"

Auditing standards require the auditor to verify that the information provided in the operationaland financial review is consistent with the audit report and the other information contained inthe annual report.Ethical auditing is a process which measures the internal and external consistency of anorganisation's values base. The key points are that it is value-linked, and that it incorporates astakeholder approach.

Its objectives are two-fold:

1. It is intended for accountability and transparency towards stakeholders
2. It is intended for internal control, to meet the ethical objectives of the organisation

14.5 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.

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.

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.

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.

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.

14.6 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:

1. Reading professional journals.
2. Attending seminars, workshops and symposia

1. Matters Influencing Auditing

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.

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 auditorclient 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.

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.

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.

Keywords

- Professional Bodies
- Ethical Codes
- Enforcement Mechanisms
- Spirit and Letter
- Non-Compliance

- Acts of Omission
- Acts of Commission
- Contrary to Laws
- Section 211(3A)
- Companies Act, 1956
- Accounting Standards
- Fast Changing Discipline
- Current Issues
- E-Commerce
- Electronic Data Interchange (EDI)
- Financial Statements
- Web Alterations
- Forensic Accounting
- Forensic Auditing
- Legal Consequences
- Evidences
- Normal Phenomena
- Abnormal Phenomena
- Accounting System
- Information System
- Complex Components
- Business Solution
- IT Audit
- Overall Audit Process
- Corporate Governance

Self Assessment

1: What is the primary purpose of the "Code of Ethics" in auditing in India?

A. To make auditing procedures more complex.
B. To increase audit fees for clients.
C. To ensure auditors follow ethical principles in their work.
D. To provide guidelines for financial statement preparation.

2: In the context of auditing, what does "independence" mean?

A. Auditors can work closely with company management.
B. Auditors can own shares in the audited company.
C. Auditors maintain unbiased judgment and avoid conflicts of interest.
D. Auditors can accept gifts from the company being audited.

3: Which regulatory body is responsible for setting auditing and ethical standards in India?

A. Securities and Exchange Board of India (SEBI)
B. Reserve Bank of India (RBI)
C. Institute of Chartered Accountants of India (ICAI)
D. Ministry of Corporate Affairs (MCA)

4: What is the significance of professional skepticism in auditing ethics?

A. Auditors should be skeptical about their clients' honesty.
B. Auditors should never trust financial statements.
C. Auditors should exercise critical judgment and question evidence.
D. Auditors should avoid communication with clients.

5: According to the "Code of Ethics," what is the importance of confidentiality for auditors?

A. Auditors should share audit findings with the public.
B. Auditors should disclose sensitive information without authorization.
C. Auditors should maintain the confidentiality of obtained information.
D. Auditors should only communicate with competitors.

6: Which provision of the Companies Act, 1956 requires compliance with accounting standards?

A. Section 211(2A)
B. Section 211(3B)
C. Section 211(4A)
D. Section 211(3A)

7: What does the term "forensic accounting/auditing" refer to?

A. The process of preparing financial statements.
B. The process of analyzing financial statements for investment purposes.
C. Applying accounting/auditing skills to situations with legal consequences.
D. Applying accounting principles in everyday business transactions.

8: In the context of E-commerce, what is Electronic Data Interchange (EDI)?

A. A method of conducting business using paper-based documents.
B. A process of conducting business without financial statements.
C. A standard method for exchanging documents over the internet.
D. A type of financial statement used in E-commerce.

9: How does IT audit contribute to good corporate governance?

A. It increases corporate profits.
B. It ensures the financial statements are flawless.
C. It helps in preventing fraud and ensuring IT systems' integrity.
D. It eliminates the need for external audits.

10: Why are ethical codes often not followed "in the spirit as well as the letter"?

A. Auditors lack knowledge about ethical codes.
B. Ethical codes are not relevant in auditing.
C. Ethical dilemmas often require difficult decisions.
D. Ethical codes are too lenient in their requirements.

11: What is the role of the "Code of Ethics" in auditing in India?

A. It ensures auditors receive higher salaries.
B. It makes audits more complicated.
C. It provides guidelines for ethical conduct in auditing.
D. It replaces financial reporting standards.

12: What is the purpose of maintaining independence as an auditor?

A. To allow auditors to collaborate with management.
B. To prevent auditors from questioning financial data.
C. To ensure unbiased evaluation of financial information.
D. To encourage auditors to invest in the audited company.

13: Which regulatory body oversees the accounting and auditing profession in India?

A. Reserve Bank of India (RBI)
B. Ministry of Corporate Affairs (MCA)
C. Institute of Chartered Accountants of India (ICAI)
D. Securities and Exchange Board of India (SEBI)

14: What does "professional skepticism" mean in auditing ethics?

A. Auditors should approach audits with doubt and negativity.
B. Auditors should trust all information provided by clients.
C. Auditors should critically assess evidence and question anomalies.
D. Auditors should avoid asking questions during the audit process.

15: How does the "Code of Ethics" address the issue of confidentiality?

A. Auditors should share audit findings with competitors.
B. Auditors should disclose sensitive information without authorization.
C. Auditors should maintain the confidentiality of client information.
D. Auditors should only communicate with the public.

Answers for SelfAssessment

1.	C	2.	C	3.	C	4.	C	5.	C
6.	D	7.	C	8.	C	9.	C	10.	C
11.	C	12.	C	13.	C	14.	C	15.	C

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 financialstatements?

4. Describe the regulations in auditing
5. What audit procedures are necessary to be applied by the auditor when non-compliance isidentified 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.

Further Readings

- Auditing: Principles And Techniques By S. K. Basu, Pearsonn.S.
- A Hand Book Of Practical Auditing By B N Tandon, S Sudharsnam & S Sundharabahu, S Chand Publishing
- Auditing And Corporate Governance By Anil Kumar Jyotsna Rajan Arora Lovleen Gupta, Taxmann Publisher

Web Links

https://smallbusiness.chron.com/explain-audit-procedures-electronic-data-processing-audit-14715.html

https://www.ojp.gov/ncjrs/virtual-library/abstracts/evaluating-internal-control-edp-electronic-data-processing-audits

https://www.aicpa.org/

LOVELY PROFESSIONAL UNIVERSITY
Jalandhar-Delhi G.T. Road (NH-1)
Phagwara, Punjab (India)-144411
For Enquiry: +91-1824-521360
Fax.: +91-1824-506111
Email: odl@lpu.co.in

9 788119 929313