TECHNIQUES AND PROCEDURES OF AUDITING

Auditing

Ahmed Ali
ca.ahmedali@gmail.com

Techniques and Procedures of Auditing

CHAPTER OUTLINE

2.1 INTRODUCTION

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

The auditor should follow the appropriate audit procedure and adopt different techniques of auditing. He should maintain the principles of auditing in conducting audit of an organisation in order to meet the following requirement:

1. 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
2. Test the accounting records and perform compliance tests on the operation of those internal controls on which the auditor wishes to place reliance
3. Compare the financial statements with the accounting records and perform substantive tests to see that they are in agreement
4. Carry out a review of the financial statements
5. 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 draw up an audit programme specifically designed for that particular audit.

2.2 PREPARATORY STEPS BEFORE COMMENCEMENT OF AUDIT

Effective execution of any audit work requires appropriate planning and a well-designed audit programme. For effective audit planning and for desiging 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. This appointment letter is formally called Audit Engagement Letter. Auditing and Assurance Standard (AAS-26) describes the purposes, applicability and contents of Audit Engagement 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 Institute of Chartered Accountants Act, 1949 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 organisation 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 Organisation

Before the auditor can determine his basic approach to an audit, he must ensure that he fully understands the enterprise. He must comprehend the nature of the business and have a detailed knowledge of its activities. He must familiarise himself with the organisation 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. AAS-20 describes how the knowledge of business is relevant to the auditors and how the auditors will obtain and use the knowledge of the business in their audit work.

6. Knowledge of the accounting system

The auditor should obtain a list of all books maintained by the organisation for recording its accounting transactions along with the information relating to the existing accounting system. He should also acquire complete information about the internal control system of the organisation. 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 organisation. 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 that he has fully grasped the technicalities peculiar to the business. Only then, he will be in a position to identify the transactions of the accounting records and 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 checkings are required and the techniques to be used to conduct his audit work effectively.

10. Instructions to the client

After completing the above-mentioned steps, the auditor should issue clear instructions to his client that the accounts should be finalised and kept ready for audit and the necessary schedules required to support the final accounts be prepared and made available to him.

2.3 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 of the financial statements, now prevail. The attitude that an audit is mainly useful for the discovery or prevention of fraud is no longer accepted. It is now more generally appreciated that an audit not only ensures the true and fair presentation of the affairs of the organisation, but also that it can be of real benefit in bringing about the establishment 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 aspects of audit.

2.3.1 Audit Planning

Audit planning is the process of deciding in advance what is to be done, who is to do it, how it is to be done and when it is to be done by the auditor in order to have an effective and efficient completion of audit.

According to AAS-8, "Audit planning refers to planning by the auditor made to enable him to conduct an effective audit in an efficient and timely manner, and includes planning about area, scope, depth of transactions to be audited, time to be devoted, persons to be deployed for audit etc."

Audit planning is necessary for efficient and effective conduct of an audit. It should be continuously followed throughout the course of audit assignment. As per AAS-8, audit planning facilitates the following:

- Appropriate attention devoted to important areas of the audit
- Prompt identification of potential problems
- Timely completion of work
- Proper utilisation of assistants
- Coordination of work done by other auditors and experts

The main objectives of audit planning are to ensure the following:

- That the auditing work is conducted efficiently and profitably
- That high standards of audit works are maintained, so that the risk of litigation against the practice for negligence is minimised

It is important that audit should be carefully planned to ensure that 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 maximum work 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 remaining at the year end is the work that could not 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 organisation and ensure that the audit firm is fully aware of the exact proposed timing of the client's own accounting procedures.

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

- Statutory requirement under the assignment
- Terms and conditions of engagement
- Nature and timings of reporting
- Significant audit areas
- Applicable legal provisions
- Reliability of accounting and internal control system
- Existing accounting practices followed
- Areas requiring special attentions

2.3.2 Audit Programme

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 comprises a set of techniques and procedures, which the auditor plans to apply to the given audit for forming an opinion about the statement of account of an organisation.

Prof. 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 and giving the estimated time required."

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

- Area or extent of work
- Allocation of work
- Time duration for the completion of the work
- Responsibility of the persons, who have been assigned the work for its' timely completion

The specimen of an audit programme is given here.

Purposes of Audit Programme

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

1. Co-ordinating the procedures of audit
2. Ascertaining the progress of audit-work
3. Recording the work done during the process of auditing. Such records can act as an evidence of work done.
4. Assigning responsibilities to the audit staff for the completion of audit work within the time limit.

TABLE A Specimen of an audit programme Name of the organisation: M/s Tiger Ltd. for the year ended on March 31, 20xx

Particular of Work	Estimated Time Required	Actual Time Taken	Completed by (Signature)	Checked by (Signature)
CASH in Hand				
Bank in Hand				
Investment				
Debtors				
Physical Verification of cash				

Types of audit programme

An audit programme can be of the following two types:

1. ***Predetermined audit programme:*** In this audit programme, all the procedures of audit must be outlined in general, even though all procedures may not be relevant in a particular type of audit. The purpose of this type of audit programme is to offer either procedural guideline or to serve as a 'check off list'. For this reason, this predetermined audit programme is also known as. Tailor-made audit programme.

2. ***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 after year.

Advantages of audit programme

Whatever may be the nature of audit programme, usually the following benefits are derived from an audit programme:

1. ***Assurance of completion of work:*** It ensures that all necessary work has been done and nothing has been omitted.

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

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

4. ***Simplification of work allocation:*** It simplifies the allocation of work to various grades of articled and audit clerks.

5. ***Guidance to the staff***: It is a kind of guidance to the audit clerk for the work he has to perform.

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

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

8. ***Final review of work***: An audit programme facilitates the final review of work before the report is signed.

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 preparing the programme for the subsequent years.

Disadvantages of audit programme

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

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

3. ***Rigidity in programme***: Each business may have a separate problem of its own and hence a rigid programme 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 small concern.

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

6. ***Concealment of incapacity of staff:*** Inefficient audit assistants may also take shelters behind the programme.

Steps to be taken to overcome the disadvantages of written audit programme

Obtaining up-to-date information and encouraging audit assistants to inform the deviations from the standard and the audit programme can avoid the aforesaid shortcomings and accordingly the principal may modify the programme.

In fact the disadvantages of written audit programme arise due to misunderstanding of its purpose. It should be taken as only a guide to audit and should not be treated as rigid and inflexible document. For this purpose, the auditor should take the following steps:

1. ***Educating the audit staff***: The audit staff should be made known about the purpose of audit programme. They must be clearly stated that they may go beyond the audit programme if the situation so warrants. The opinion of the audit staff may also be taken while drafting the audit programmes.

2. ***Revision of audit programme:*** It should be the responsibility of the audit manager to constantly review the existing audit programme and modify it in the light of experience of the previous year's audit and according to the changing circumstances. The audit staff should also be encouraged to give their suggestions in this regard.

3. ***Rotation of work***: The duty of audit staff should be rotated so that no staff does the same job year after year. This will help in reducing the monotony of work.

4. ***Overall supervision***: Proper supervision and review of work is also useful for overcoming the disadvantages of predetermined audit programme.

2.3.3 Audit Notebook

An audit notebook 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:

- For keeping a record of general information as regards the audit as a whole
- For recording special points which have been observed during the course of audit of the accounts of different years

Objectives of audit notebook

The audit notebook is an important document of audit. It serves the following purposes:

1. ***Facilitates future audit***: The audit notebook of current year helps the auditor while he starts audit in the next year. He can easily understand which areas of the organisation should deserve his special attention.

2. ***Documentary evidence***: The audit notebook provides an evidence about the extent of work done and degree of skill and care exercised by the auditor in conducting audit. By producing audit notebook in the court he can defend himself against charge of negligence.

3. ***Helps in preparing audit report***: It is not possible for the auditor to keep in memory all important matters and audit findings that are required to be considered in preparing the audit report. So, maintenance of audit notebook recording all such important matters provides him a lot of assistance in preparation of audit report.

4. ***Settlement of audit queries***: The accounting staff of the client may feel disturbed if the auditor puts audit queries before them every now and then in the course

of audit. So, for the sake of convenience of the client's staff, audit queries should be recorded in the notebook as and when they crop up and placed at a time before the staff of the client for their explanations.

5. ***Evaluation of work***: The auditor, by going through the audit notebook, can understand the progress of audit work and the level of efficiency of his staff in audit work.

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 shoreholders. In case a charge of negligence is filed against the auditor, a notebook may prove to be a 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, 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.

Contents of audit note book

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 which require further explanations
5. The particulars 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 which might be required at a subsequent audit
9. The points which 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

Advantages of audit notebook

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 a 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.

2.3.4 Audit Working Papers

Audit working papers are 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 that are under audit.

Purpose of working papers

Working papers are actually the compilation of all evidences which are collected by the auditor in the 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-ordinating and organising 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 ongoing audit work.
10. Working papers assist the auditor in forming an opinion on the financial statements.

Contents of working papers

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

AAS-3 issued by the Institute of Chartered Accountants of India 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 given below:

    1. The nature of the engagement
    2. The form of the audit report
    3. The nature and complexity of client's business
    4. The nature and conditions of the client's records and degree of reliance on internal controls
    5. The need in particular circumstances for direction, supervision and review of work performed by assistants

3. Working papers should be designed and properly organised 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 utilises schedules, analysis and other working papers prepared by the client such as analysis of important revenue accounts receivables etc.
7. In case of recurring audits, some working papers may be classified as permanent audit files as distinct from current audit files relating primarily to the audit of a single period.

Responsibility on protection and preservation of working papers

Whosoever is in the possesion of working papers should be responsible for their safe custody. These should in no case be shown to a third party except with the permission of the client. As the working papers are prepared in respect of the client's business, they should be treated as top secret and should be preserved in all circumstances and at all times.

After the audit report has been prepared and delivered to the client, these papers may be filed and preserved for a period of time sufficient to meet the needs of his practice and satisfy any pertinent legal or professional requirements of record retention.

Ownership of working papers

An important and pertinent question arises as to the ownership of these working papers. The claim of the auditor is that it is he who has collected the information for the purpose of discharging his duties. Therefore, he is entitled to the possession of these papers. On the other hand, it is the claim of the client that the auditor is his agent and hence he should surrender these papers to the client.

In fact, this question of ownership in respect to the working papers arose in the case of Sockockingky vs Bright Graham & Co. (1938) in England. The question was whether the auditor had a right to retain the working papers as if it were his own property even after the payment of the audit fees. The court gave judgement in favour of the auditors on the ground that they were independent contractors and not agents of the client.

According to the views of the Institute of Chartered Accountants of India (AAS-3), working papers are the property of the auditor. The auditor may, at his discretion, make portions of or extracts from his working papers available to his clients. Further, according to this standard of auditing practices, an auditor should adopt reasonable procedures for custody and confidentiality of his working papers and should retain them for a period of time sufficient to meet the needs of his practice and satisfy any pertitent legal and professional requirements of record retention.

2.3.5 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, viz. audit notes, audit programme, audit working papers etc. The efficient audit filing system strengthens the integrity of the audit work.

The audit file is generally of two types:

- Permanent audit file
- Temporary audit file

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 the following:

1. Information regarding the legal and organisational structure of the organisation. In case of company form of organisation, this includes the Memorandum and Articles of Association
2. Extracts or copies of important legal documents, agreements and minutes relevant to the audit
3. A record of the study and evaluation of the internal controls relating to the accounting system
4. Copies of audited financial statements for previous years
5. Analysis of significant ratios and trends
6. Copies of management letters issued by the auditor, if any
7. Record of communication with the retiring auditor, if any, before acceptence of the appointment as auditor
8. Notes regarding significant accounting policies
9. Significant audit observations of earlier years

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:

1. Draft financial statements being audited
2. Schedules supporting the financial statements
3. Extracts from relevant minutes
4. Audit programme and time budget
5. Internal control questionnaire and, where applicable, flow charts and notes on the system of internal control

6. Confirmations obtained from banks and other relevant organisations regarding items in the financial statements
7. Details of queries raised during the audit, and the answers obtained to them
8. Copy of letter of representation

2.3.6 Audit Manual

Audit manual may be defined as a "written internal auditing document". It provides different information regarding detailed auditing procedures, objects of auditing, standard of performance, time recording procedure, preparation of audit report etc. The audit manual is prepared for the general guidance of the auditors with the object of planning the procedure of audit.

Advantages

1. Different information regarding policies of the concern and procedure of audit is available in the manual.
2. Information relating to required steps to be followed for conducting different auditing work can be collected from the manual.
3. Audit manual provides answers to routine questions by 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.

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 the working 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 of the audit staff during the course of audit.

2.3.7 Audit Memorandum

An audit memorandum is a statement containing all useful information regarding the business of the client. It indicates the method of operation, policies of different aspects of the business as well as all the conditions in respect of audit.

Audit memorandum is very useful in case of first time audit by the concerned auditor in an organisation. While conducting his auditing work, the auditor requires certain information which may be directly related with the method of operation of the business.

If the auditor is not informed about the method of operation as well as the operational activities of the organisation, he will not be in a position to conduct his audit effectively. Hence audit memorandum is useful to the auditor while the auditor wants to relate the financial transactions with the business activities, with the condition of the business in which the transactions are being activated.

Contents of audit memorandum

- About the business—its early history and growth
- Nature of ownership of the organisation
- Location of its principal offices and factories
- Sources of factors of production—materials, labour etc
- Details about its manufacturing operations
- Principal products produced by the concern
- Market condition and nature of competition in the market
- Organisational structure and heirarchy
- Method of accounting and nature of books of accounts
- List of persons involved in management

2.4 PRINCIPLES AND TECHNIQUES OF AUDITING

Principles of auditing refer to fundamental consideration that sustain the function of auditing and direct its activities. Auditing has evolved in the satisfaction of a social need to see that the accounting statements on which people rely are reliable. To achieve this broad functional objective, certain techniques and procedures have been developed over the years on the basis of certain concepts and principles that are considered to be the governing forces. AAS-1 on "Basic Principles Governing an Audit" describes the basic principles which govern the auditor's professional responsibilities and which should be complied with whenever an audit is carried out. It also states that compliance with the basic principles requires the application of auditing procedures and reporting practices appropriate to the particular circumstances.

Auditing techniques refer to the methods and means adopted by an auditor for collection and evaluation of audit evidence in different auditing situations. When the audit objective is to see that debtors' balances are correctly stated in the balance sheets, the auditor would introduce confirmation and scrutiny of subsequent years' accounts as the appropriate audit technique. The method of collection of evidence to verify accounts maintained under manual system will be different from that, when accounts are computerised. In the former case, audit trial will be available and usual techniques like posting verification and casting verification would be appropriate. However, in the latter case, because of loss of audit trial and accuracy of the computer, these techniques are replaced by more intensive and extensive examination of the internal control. Also, the technique may vary according to the nature of proposition to be tested.

Thus auditing principles are fundamental in nature which underlie the conduct of the audit. These principles are not liable to change frequently while audit techniques may vary according to the nature of propositions to be tested. For instance, audit technique to test the existence of cash in hand will be different from the method to verify recoverability of sundry debtors. Further, audit techniques may vary from organisation to organisation depending upon the nature of the business but the principles of auditing will remain the same irrespective of the nature of the organisation.

2.4.1 Important Audit Techniques

The techniques or strategies, which are followed in order to collect proper evidence in support of the transactions recorded in the books of accounts, are termed as 'Techniques of Auditing'.

Important techniques usually adopted by the auditors include the following.

- Vouching (of expenses)
- Physical verification (of fixed and current assets)
- Reconciliation (of stock statement)
- Confirmation (of customers or bank balance)
- Re-computation (of depreciation and other calculations)
- Scanning (of legal formalities)
- Scrutiny (of ledger balances)
- Inquiry (of propriety aspect)

2.5 PROCEDURES FOLLOWED IN COURSE OF AUDIT

There is no fixed rule regarding the procedures the auditor would follow in the course of audit. He would fix 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 include the following:

2.5.1 Audit Evidence

It is the auditor's duty to express a professional opinion on financial statements and it must always be a matter of judgement whether the auditor has sufficient evidence on which to base such an opinion. The auditor can never be absolutely certain that the financial statements show a true and fair view; the question is, 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 judgement about the truthfulness of the propositions submitted to him for review."

Types of audit evidence

Professor R. K. Mautz in his work *Fundamentals of Auditing* has rightly observed that "the nature of financial statement assertions leads to the conclusion that the nature of the following kinds of evidences are indicative of the validity of financial statement assertions in varying degrees depending on the circumstances of the examination."

Thus professor Mautz cited nine types of audit evidences, which are as follows.

1. Physical examination by the auditor of the article represented in the accounts
2. Statement by independent third parties:
    1. oral evidence
    2. written evidence
3. Authoritative documents:
    1. prepared outside the enterprise under examination
    2. prepared inside the enterprise under examination
4. Statements by officers and employees of the concern under examination:
    1. formal statement
    2. 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 data examined

Methods of obtaining audit evidence

AAS-5 on "audit evidence" describes the method of obtaining audit evidences. According to this statement, the auditor obtains evidence in performing compliance and substantive procedures by one or more of the following methods:

1. ***Inspection***: Inspection consists of examining records, documents or tangible assets. Inspection of records and documents provides evidence of varying degree of reliability depending on their nature and source and the effectiveness of internal controls over their processing. Four major categories of documentary evidences, which provide different degrees of reliability to the auditor, are as follows:

    1. Documentary evidence originating from and held by third parties

2. Documentary evidence originating from third parties and held by the entity
3. Documentary evidence originating from the entity and held by third parties
4. Documentary evidence originating from and held by the entity

Inspection of tangible assets is one of the methods to obtain reliable evidence with respect to their existence but not necessarily as to their ownership or value.

2. ***Observation:*** Observation consists of witnessing a process or procedure being performed by others. For example, the auditor may observe the counting of inventories by client personnel or the performance of internal control procedures that leave no audit trial.

3. ***Inquiry and confirmation:*** Inquiry consists of seeking appropriate information from knowledgeable persons inside and outside the entity. Inquiries may range from formal written inquiries addressed to third parties to informal oral inquiries addressed to persons inside the entity. Responses to inquiries may provide the auditor with information which he did not previously possess or may provide him with corroborative evidence.
   Confirmation consists of the response to an inquiry to corroborate information contained in the accounting records. For example, the auditor requests confirmation of receivables by direct communication with the debtors.

4. ***Re-computation:*** Re-computation consists of checking the arithmetical accuracy of source documents and accounting records or performing independent calculations.

5. ***Analytical review***: Analytical review consists of studying significant ratios and trends and investigating unusual fluctuations and items.

2.5.2 Routine Checking

Routine checking is a total process of accounting control, which includes the following:

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 prepared with those balances
4. Overall examination of writing up the transactions properly

In short, the routine checking is concerned with ascertaining the arithmetical accuracy of casting, posting and carry forwards. For the purpose of confirming the arithmetical accuracy and detecting frauds and errors of very simple nature, this method is adopted as basic to all types of audit work. The scope of application of routine checking depends upon the nature and size of the organisation as well as the effectiveness of the internal check and control system.

Objectives

Objectives of routine checking can be described as follows:

1. To ensure the arithmetical accuracy of the books of accounts
2. To form the basis of vouching
3. To prevent alteration of figures
4. To increase reliability of financial statements
5. To detect errors and frauds

Advantages

1. It is the simplest form of audit work.
2. Errors and frauds of simple nature can be detected very easily.
3. The books of accounts can be thoroughly checked.
4. It is the basis of checking the final account as it helps in checking castings and postings.
5. Arithmetical accuracy of all the transactions can be confirmed by this method.
6. It offers an opportunity to train the new entrants to the profession.

Disadvantages

1. It is not generally considered as an important part of audit work where self-balancing system is maintained.
2. As the audit staff are engaged in same type of work the possibility of becoming monotonous may grow in this system.
3. Negligence of work, taking the advantage of internal check system, are frequent.
4. It fails to detect errors and frauds arising from the fraudulent manipulation in accounting principles.

Auditor's duty regarding routine checking

Although routine checking is a monotonous and time consuming process and is not very effective in detecting planned fraud, the auditor cannot skip it. It is an important part of audit. It should deserve equal emphasis from auditor as other techniques of audit. His duties in connection with routine checking are as follows:

1. The auditor will first evaluate the internal control and internal check system existing in the organisation. Based upon his evaluation, he will determine the extent of routine checking to be adopted.
2. In a small firm it is possible for the auditor to undertake thorough routine checking. So, it is advisable that he should undertake thorough routine checking in such cases.
3. In case of audit of large organisations, it is not possible for him to undertake thorough routine checking. So, in such cases, he will apply his judgment, experience and knowledge in determining the extent of routine checking.
4. The auditor should frequently supervise the work of routine checking being done by his subordinates and ensure the adherence to his instructions in this regard.
5. Computerisation of accounting system obviates the necessity of casting carry forward, posting from journal to ledger etc. So, the auditor will determine his duty after examining the degree of computerisation.

2.5.3 Test Checking

The term 'test checking' stands for the method of auditing, where instead of a complete examination of all the transactions recorded in the books of accounts only some of the transactions are selected and verified. The underlying intention is to test some of the transactions to form an opinion for the whole. According to Prof. Meig "test checking means to select and examine a representative sample from a large number of similar items".

The justification of test checking lies on the theory of probability which states in effect that a sample selected from a series of items will tend to show the same characteristics present in the full series of items, which is commonly referred to as "population" or "universe".

Objectives of test checking

Accounts of large organisations usually include an enormous number of transactions. But the auditor is not in a position to check each and every transaction within the limited time and due to the constraint of resources available to him. So, he has to depend on selective verification of the transactions. The selection of transactions will be made in such a way that the auditor will verify a small but representative number of transactions and he can draw conclusions about the transactions as a whole. So, the basic objective of test checking is to draw a valid conclusion by undertaking examination of some transactions from the large number of transactions and thereby save time and cost.

Factors to be considered before resorting to test checking

The auditor should consider the following factors before starting test checking.

1. ***Nature of transactions***: The nature of transactions should be carefully considered for determining the extent of test checking. If the transactions of a particular category are of repetitive nature, the size of sample may be small. However, if the transactions of a particular category are of divergent nature, sample size of test checking should be large.
2. ***Effectiveness of internal control:*** The internal control system existing in the organisation should be evaluated. If the internal control system is found to be sound, the auditor may adopt test checking determining the suitable sample size. But if the internal control system is found ineffective, the reliance on test checking should be minimum.
3. ***Materiality of items***: An item becomes material when any mis-statement regarding it is likely to influence the decisions of the users of financial statements. The extent of checking to be adopted should depend upon the materiality of the items.
4. ***Previous experience:*** Previous experience should also be considered while determining the extent of test checking. For example, the auditor might have noticed in the last audit that the management had the tendency to inflate the value of work-in-progress, but the cashier had honestly and sincerely recorded all the cash transactions. Based on this experience, the auditor may undertake exhaustive checking of the details of valuation of work-in-progress while restricting his checking to few transactions in the cashbook.

Advantages

1. It is one of the best techniques of auditing through which cost of audit can be reduced.
2. It can ensure the speed of audit work.
3. It can easily locate the deficient areas and thus help to come to the conclusion as to the acceptability of financial records.
4. It is a labour saving device.
5. It acts as a guide to the auditor to arrive at a conclusion regarding the true and fair view of the state of affairs of the business.

Disadvantages

1. It will prove inefficient where internal check and control system are not operating or found ineffective.
2. It is not suitable for small concerns.
3. It will show incorrect results if the samples are not proper representatives of the population.

4. It does not offer any consistency in selecting the percentage of check that will be adopted by all concerns.
5. It is not applicable in case of diversified transactions.

Precautions to be taken before taking test-checking technique

In order to apply test checking technique effectively in the audit work of an organisation, an auditor has to take certain precautionary measures. These measures include the following:

1. The auditor should review the existing internal control in order to ascertain its effectiveness.
2. The transactions to be selected for test checking must be homogenous.
3. The transactions to be test checked must form an adequate sample.
4. As far as possible the transactions to be selected for test checking should be on the basis of random number tables.
5. The results of the test checks themselves should be examined, particularly the nature of errors.

Transactions not suitable for the adoption of test checking

If the number of transactions in any area is sufficiently large, the auditors usually adopt test-check technique. However, as a practical measure, usually the following types of transactions and records are kept outside the purview of test checking :

1. In those industries, where the activities are based on seasonal fluctuations, test checking cannot be adopted on an annual basis.
2. Exceptional transactions or the transactions of a non-recurring nature are also not suitable for adoption of test checking.
3. Some transactions have legal implication, i.e. they have to be recorded on the basis of legal provisions. Such transactions cannot be test checked.
4. Areas involving computation and calculations should not be subjected to test checking.
5. There should not be test checking for opening as well as closing entries.
6. Bank reconciliation statement cannot be checked by adopting this technique.
7. Presentation and disclosure of information in the balance sheet and the profit and loss account should not be subjected to test checking.

Auditor’s duty regarding test checking

Test checking is a short-cut method of audit. It curtails costs and time of audit. But it involves risk on the part of the auditor. If some errors or frauds which escaped the notice of the auditor because of sample checking are detected subsequently, the auditor may be held liable for negligence. So, enough care and caution should be taken by the auditor while resorting to test checking. He must evaluate the internal control system existing in the organisation beforehand. He must carefully consider the circumstances for determining the sample size. Materiality of item must not escape his notice while he selects the sample. The items selected should be verified in depth from its origin to the conclusion. Test checking will then be effective. There will be minimum possibility of errors and frauds remaining undetected if the auditor exercises reasonable care according to circumstances in conducting test checking.

He must bear in mind that test checking is just like a double-edged sword. If it is used properly and with reasonable care and caution, it will not hurt the auditor, i.e. the auditor will not be held responsible for any error or fraud left undetected. However, if the tool is applied indiscriminately and negligently, he will not be spared for errors and frauds detected subsequently.

2.5.4 Auditing in Depth

Auditing in depth is a technique, which assists the auditor in conducting test checking and adoption of such a system becomes essential in large organisations, where detailed examination of all the records is not possible. It is a method of auditing under which a few selective transactions are subjected to a thorough scrutiny for arriving at the accuracy of the data.

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

Practical application of the technique

In respect of goods purchased, the auditing in depth technique will be applied through the following stages.

1. Examining the requisition note from the stores, ensuring that it has been signed by the appropriate official
2. Examining the copy of the order placed by the purchasing department, ensuring that it was properly executed on the official form, complied with all the client's regulations and was authorised by the appropriate official
3. Examining the delivery note from the supplier and comparing it with the copy of the order

4. Examining the goods inward note made out when the goods were received, noting if it has been properly signed, if it indicates that the correct goods have been received and if their quantity and condition have been checked
5. Checking the entries in the store records
6. Checking in the accounts department that the invoice received from the supplier has been matched with the copy of the order and the copy of the goods received note before being processed and that the calculations have been checked
7. Checking the appropriate entries in the accounting records
8. Comparing the cheque with the invoice and supplier's statement, if any

From the above example, it can be seen that the auditor would trace the transaction right through the system. He would not merely satisfy himself that the entries in the records were correct, but would ensure that the appropriate internal controls relating to authorisation of transactions, the checking of one document against another and physical inspection of goods has been properly operated at the appropriate times. He would also ensure that a proper system was in force to claim credits in respect of short deliveries or deliveries of defective goods.

Where the examination of successive stages in the depth test produces satisfactory results, it is an accepted practice that the auditor may progressively reduce the number of items to be examined at subsequent stages. However, if the tests reveal an unacceptable number of errors, it will be necessary for the auditor to increase the number of items examined in order to discover whether the original sample was representative.

Advantages

1. Precision in course of audit work can be achieved.
2. It guards against the fraudulent manipulation of accounts.
3. It does not offer any monotony in work to the auditor. Because the auditor will have to deal all the time with new ideas and techniques.
4. It saves the cost of audit.
5. The experience in auditing in depth can be widely used in preparing audit plan.

Disadvantages

1. As the concept is linked with selective verification, its application may be fruitless if the selection of item is wrong.
2. Instead of saving cost and time, this technique entails loss of time and extra cost because of unskilled handling of audit affairs.
3. Proper selection of transactions for conducting auditing in depth is too much risky. If the items are not properly selected, it will not at all serve the purpose of auditing.

4. This technique can not be applied to small concerns.
5. It has been observed that the auditor relies too heavily upon intuition. Here, he uses no objective method of measuring the adequacy of samples.

2.5.5 Cut-off Examination

Cut-off examinations are the procedures designed to ensure that at the year end trading transactions are entered in the period to which they relate. In other words, the term "cutoff" refers to the procedure adopted to ensure the separation of transactions as at the end of one accounting year from those at the commencement of the next following year, specially for items which may overlap, e.g. sales, purchase, stock etc.

Significance of cut-off in auditing

The cut-off procedure is very significant in auditing to ensure that the revenue and expenditure of one year is not recorded in the following year, as that will distort the true and fair view of the accounts. The auditor must either establish that there are satisfactory internal controls in respect of cut-off and carry out compliance tests to ensure that these controls are functioning properly or carry out appropriate substantive tests. An obvious way in which accounts can be manipulated is for purchase invoices in respect of goods purchased shortly before the year end to be held over and entered in the following accounting period. The goods will be included in stock, but the purchases will not be included in the accounts as either a liability or a charge. Similarly, the profits and assets can be inflated by including goods that have been sold, but not yet despatched, in both stock and sales. Tests should be carried out between the purchase invoices, goods inward records and store records on the one hand, and the sales invoices, goods outward records and store records on the other, to ensure that there is consistency in treatment.

Cut-off manipulation was an important feature in which the auditors of Thomas Gerrard & Son Ltd. (1967) were held to have been negligent. The auditors' negligence arose primarily from their failure to follow up the alterations of the purchase invoices.

2.5.6 Statistical Sampling

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

The use of this method in practice does not require a detailed mathematical or statistical knowledge of the formulae on which the actual tests are based. Sets of tables are available which, on having decided 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.

Procedures for application of statistical sampling

When statistical sampling is to be applied to a certain section of the audit, the procedure to be undertaken is as follows:

1. The nature of the unit and the field of population should be carefully defined, as any indefinite items wrongly included will vitiate the usefulness of the test.
2. The precise nature of the attributes to be tested should be defined, such as errors or authentication signatures, or if the sample is in respect of variables the data must be examined to determine the basic figures to be applied.
3. The population should be broadly examined to ascertain whether any stratification will be necessary.
4. The level of confidence and precision limits should be fixed in accordance with the auditor's judgement.
5. In accordance with the auditor's judgement as mentioned earlier, the sampling tables should be consulted giving the sample size in the case of attributes; where variables are concerned, a preliminary sample may be necessary.
6. Random digit tables should be consulted showing the items to be selected for examination.
7. The test should be evaluated comparing the result obtained with the predetermined acceptance or rejection levels.
8. Where the sample is accepted, the auditor must ensure that the results are properly recorded so that if he is called upon to prove that he has applied due care, skill and diligence to the work, he may be able to show his confidence to have been rightly placed.

2.5.7 Surprise Checking

'Surprise checking' means audit verification on a non-routine and surprise basis. Usually the routine checking plan of the auditor as well as its timing is known to the client. As a result, the client's staff try to cover up incompleteness in the books and records before the visit by the auditor. However, surprise check, as a part of normal audit procedure, significantly enhances the effectiveness of an audit. For carrying out surprise check, the auditor visits the client's office without prior intimation and verifies certain specific matters, the regularity of which is vital for audit. For example, the correctness of cash balance in hand is immensely important because of the nature of this asset. It is the general experience that irregularities and fraud are facilitated when books and records are not maintained systematically and regularly. Many important frauds and errors that are not detected from continuous check may be detected through the process of surprise checking.

Purposes of surprise checking

In any area of audit verification, the process of surprise checking is applicable. However, following are the specific areas, where the process of surprise checking can be effectively applied :

1. For the verification of books of accounts and records, which are maintained in the branch offices
2. For the verification of cash, stock and similar type of assets, which are kept at other places
3. For checking of cash balance on a non-routine basis
4. For checking of investments on a non-routine basis
5. For the verification of the regularity of the maintenance of books of accounts, statutory registers and other important documents
6. For the physical verification of stock and stores on a non-routine basis
7. For verification of the operation of any specific internal control procedures

2.5.8 Audit Flow Chart

A graphical presentation of different stages of a document, flow of goods or cash, with the aid of various symbolic marks, for the purpose of operation and control of audit organisation may be termed as 'audit flow chart'. In other words, it can be described as a map of inter-related operations.

It is arranged specially for indicating the sequence and also the types of operation as a part of total unit. Narrative description is replaced by the use of different symbols. The symbols are standardised in a greater way and the different interconnecting lines indicate the flow direction which is either horizontal or vertical. The reason for the adoption of this chart is due to its advantages of making easy to visualise the relationship between different parts of the integrated system of the organisation. The need for proper study and evaluation of internal control system has long been felt. The efficient preparation and introduction of the flow chart on a wide basis may fulfil the necessity.

Advantages

1. It acts as an effective tool to study internal control system of the organisation. Thus the weaknesses in the internal controls may be revealed by the examination of the flow chart.

2. Identification and location of various responsibility areas of the organisation can be made possible from this chart.
3. It gives a bird's eye view on the happenings of the business operations and areas where more control needs to be emphasised.
4. It can depict a situation relating to accounting and auditing system in a concise and simple way.
5. It is an important tool through which the training of audit staffs can be facilitated.
6. This chart can be introduced by the audit managers as a control device for their audit operation.

Disadvantages

1. It consumes time in preparing this chart.
2. It is not possible to have same pattern of flow chart that will be suitable to all types of organisations.
3. It is not possible to accumulate in a flow chart all the activities or operations of an organisation in all cases.
4. It is very difficult to form a judgement in selecting the level of sub-division that may give proper reflection of actual position.

2.5.9 Internal Control Questionnaires

Internal control questionnaires now form an important part of any efficiently conducted audit. By their use, any system of internal control may be investigated and its weaknesses revealed. It is usual to have sets of standardised questionnaires which may be applied, subject to modification on any type of audit.

The procedure employed is to use the standard questionnaire relevant to the various sections of a concern on the first occasion. These are completed by staff on the job and are thereafter examined by the manager in charge. Points of lesser importance may be dealt with and questions inapplicable to the job eliminated. In conjunction with the questionnaire an audit programme for the job may be prepared. This does not signify that the audit cannot be commenced until the questionnaire has been dealt with or a standard form of programme will have been already in use.

Such questionnaires have already been proved to save much time in audit planning and do much to ensure that no aspect of the work is overlooked from the point of view of the audit. On the first occasion a greater amount of work will be involved than on subsequent audits, as it is necessary to investigate the whole system of control; thereafter checks may be made to ensure that the system is being adhered to. Where changes in the system are deemed necessary, the auditor should request modification, but in any case he should be able to discover any such alterations, and no doubt the questionnaire should be updated from time to time.

2.5.10 Audit Tests

Audit tests are of two types:

- Compliance test
- Substantive test

Compliance test

A compliance test is a test which seeks to provide audit evidence that internal control procedures are being applied as prescribed.

Examples

1. Checking for authorisation on a credit note. This should confirm that all credit notes are suitably authorised before being issued.
2. Checking for the casting stamp on a purchase invoice. This should confirm that all invoices are cast before being paid.

Substantive test

A substantive test is a test of a transaction or balance which seeks to provide audit evidence as to the completeness, accuracy and validity of the information contained in the accounting records or financial statements.

Examples

1. Circularisation of letters to debtors to confirm the accuracy of the balance on the sales ledger.
2. Matching a purchase invoice with the original order and goods received note to confirm that the purchase is bonafide.

POINTS TO PONDER

- 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, the auditor will draw up an audit programme specially designed for that particular audit.

- For effective audit planning and for designing appropriate audit programme, the auditor should prepare himself before the commencement of his audit work. For this purpose, he should take a number of preparatory steps.
- Audit planning is the process of deciding in advance what is to be done, who should do it, how it should be done and when it should be done by the auditor in order to have effective and efficient completion of audit.
- Audit programme is a detailed plan of work, prepared by the auditor for carrying out an audit. It comprises a set of techniques and procedures, which the auditor plans to apply to the given audit for forming an opinion about the statement of accounts of an organisation. Audit programme can be of two types: predetermined audit programmne and progressive audit programme.
- Audit note book is a bound book in which a large variety of matters observed during the course of audit are recorded. It is of great value to the auditor at the time of preparing the audit report. In case a charge of negligence is filed against the auditor, a note book may prove to be good evidence.
- Audit working papers kept by the auditor are the written records of the evidence accumulated during the course of audit. As the working papers are prepared in respect of the client's business, they should be treated as top secret and should be preserved carefully.
- Audit file maintains different audit documents. Audit file is generally of two types: permanent audit file and temporary audit file.
- Audit manual is a written internal document, which provides different information regarding detailed auditing procedure. It is prepared for the general guidance of the auditors with the object of planning the procedure of audit.
- An audit memorandum is a statement containing all useful information regarding the business of the client. It indicates the method of operation, policies of different aspects of the business as well as the conditions in respect of audit.
- Principles of auditing refer to fundamental consideration that sustain the function of auditing and direct its activities. On the other hand, auditing techniques refer to the methods and means adopted by an auditor for collection and evaluation of audit evidence in different auditing situations. Audit techniques may vary from organisation to organisation depending upon the nature of the business, but the principles of auditing will remain the same irrespective of the nature of the organisation.
- The techniques, which are followed in order to collect proper evidence in support of the transactions recorded in the books of accounts, are termed as the techniques of auditing.

- Important techniques usually adopted by the auditors include vouching, physical verification, reconciliation, confirmation, re-computation, scanning, scrutiny and inquiry.
- The term 'evidence' includes all influences on the mind of an auditor, which affect his judgement about the truthfulness of the propositions submitted to him for review. Methods of obtaining audit evidence include inspection, observation, inquiry and confirmation, re-computation and analytical review.
- Routine checking is concerned with ascertaining the arithmetical accuracy of casting, posting and carry forwards. It is an important part of audit and deserves equal emphasis from the auditor as do other techniques of audit.
- Test checking is a method of auditing, where instead of examination of all the transactions recorded in the books only some of the transactions are selected and verified. Its basic objective is to draw a valid conclusion by undertaking examination of some transactions from the large number of transactions and thereby save both time and cost.
- Auditing in depth is a technique, which assists the auditor in conducting test checking. In this technique, a few selective transactions are subjected to a thorough scrutiny for arriving at the accuracy of the data.
- Cut-off examination refers to the procedure adopted to ensure the separation of transactions as at the end of one accounting year from those at the commencement of the following year, especially for those items which may overlap.
- Surprise checking means audit verification on a non-routine and surprise basis. Many important frauds and errors that are not detected from continuous check may be detected through the process of surprise checking.
- Audit flow chart can be described as a map of inter-related operations. It makes easier to visualise the relationship between different parts of the integrated system of an organisation.
- Internal control questionnaires form an important part of an efficiently conducted audit. Such questionnaires save much time in audit planning and do much to ensure that no aspect of the work is overlooked from the viewpoint of audit.
- Audit tests are of two types: compliance test and substantive test. A compliance test is a test which seeks to provide audit evidence that internal control procedures are being applied as prescribed. On the other hand, a substantive test is a test of a transaction or balance which seeks to provide audit evidence as to the completeness, accuracy and validity of the information contained in the accounting records or financial statements.

REVIEW QUESTIONS

Short-answer Questions

1. Test checking is based on presumption. What is that presumption?
2. What is audit memorandum?
3. What is audit manual?
4. Discuss the importance of surprise check.
5. Distinguish between principles of auditing and techniques of auditing.

Essay-type Questions

1. What are the considerations to be kept in mind by an auditor before commencement of an audit?
2. What is audit programme? Discuss the advantages and disadvantages of conducting an audit according to a predetermined audit programme. How can these disadvantages be overcome?
3. How is an audit programme prepared? State the objectives of audit programme. What are the steps to be followed in drawing an audit programme?
4. What are audit files? What are the contents of audit files? What are the advantages of audit files?
5. What is an audit note book? What purpose does it serve? What are the contents of an audit note book?
6. What are audit working papers? What are its objectives? Discuss the essential characteristics of a good working paper. Who can claim the ownership of those papers?
7. What is routine checking? What types of work are included in routine checking? What are the objectives of routine checking? Describe the advantages and disadvantages of routine checking. Discuss the duties of an auditor in this regard.
8. What is test checking? In what circumstances test checking factors are to be considered before resorting to test checking? What are the advantages and disadvantages of test checking? Discuss the duty of an auditor in this regard.
9. What is auditing in depth? Discuss the advantages and disadvantages of this audit technique.
10. Discuss briefly the methods of obtaining audit evidence. In this context, state what do you mean by ‘compliance test’ and ‘substantive test’.
11. What do you mean by techniques of auditing? Discuss the various techniques adopted by an auditor in the course of his audit work.

AUDITING PRACTICES

TYPES OF AUDIT

COMPANY AUDIT

Que. No. 1] Who can be appointed as auditor of a company?

The Board of Directors of X Ltd. desires of appointing CD & Co. as their auditors. What qualifications are necessary for the auditor to be so appointed?

Ans.: Who can be appointed as auditor of a company [Section 141(1)]: A person shall be eligible for appointment as an auditor of a company only if he is a Chartered Accountant. 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.

Where a firm including a Limited Liability Partnership (LLP) is appointed as an auditor of a company, only the partners who are Chartered Accountants shall be authorized to act and sign on behalf of the firm.

Que. NO. 2] Discuss the provisions of the Companies Act, 2013 relating to appointment of auditor of a company.

Ans.: Appointment of auditor [Section 139(1)]: Every company whether it is public or private limited shall have an auditor to audit its accounts. The appointment of auditor is mandatory in the Annual General Meeting (AGM).

Every company shall, at its first AGM, appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its 6th AGM and thereafter till the conclusion of every 6th meeting. However the company shall place the matter relating to such appointment for ratification by members at every AGM.

Before appointment of auditor, the written consent to such appointment, and a certificate in should be obtained from the auditor. Such certificate shall also indicate whether the auditor satisfies the criteria provided in Section 141.

After appointing the auditor 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. As per **Rule 4(2)** of the **Companies (Audit & Auditors) Rules, 2014,** such notice is required to be filed in **Form ADT-1**.

Recommendations of audit committee [Section 139(11)]: If a company is required to constitute an Audit Committee u/s 177, all appointments, including the filling of a casual vacancy of an auditor shall be made after taking into account the recommendations of such committee.

Que.No.3] an auditor appointed under Rule 3 of the Companies (Audit and Auditors) Rules, 2014 is required to submit a certificate and notice to the ROC. State the matters to be covered in the certificate and name of the form of the notice required to be submitted.

Ans.: Conditions for appointment and notice to Registrar [Rule 4]: The auditor appointed under Rule 3 shall submit a certificate that –

(a) The individual or the firm is eligible for appointment and is not disqualified for appointment under the Act, the Chartered Accountants Act, 1949 and the Rules and Regulations made there under.

(b) The proposed appointment is as per term provided under the Companies Act, 2013.

(c) The proposed appointment is within the limits laid down by or under the authority of the Companies Act. 2013.

(d) The list of proceedings against the auditor or audit firm or any partner of the audit firm pending with respect to professional matters of conduct, as disclosed in the certificate, is true and correct.

The notice to Registrar about appointment of auditor shall be in **Form ADT-1.**

Que. No. 4] Explain the concept of rotation of auditors as per Companies Act, 2013, Also state the class of companies to which it is applicable.

Discuss the provisions relating to rotation of auditors under the Companies Act, 2013.

Ans.: Rotation of auditors [Section 139(2)]: Listed Company or a company belonging to such class or classes of companies as may be prescribed, shall not appoint or re-appoint-

(a) An individual as auditor for more than one term of 5 consecutive years and

(b) An audit firm as auditor for more than two terms of 5 consecutive years.

However, an individual auditor who has completed his term of 5 years shall not be eligible for re-appointment as auditor in the same company for 5 years from the completion of his term.

In case of an audit firm which has completed its 2 term of 5 years shall not be eligible for re-appointment as auditor in the same company for 5 years from the completion of such term.

It is further provided that as on the date of appointment no audit firm having a common partner or financial year shall be appointed as auditor of the same company for a period of 5 years.

As per **Rule 5** of the **Companies (Audit & Auditors) Rules, 2014** for the purposes of Section 139(2), the class of companies shall mean the following class of companies excluding one person companies and small companies:-

(a) All unlisted public companies having paid up share capital of Rs. **10Crores** or

more; (b) All private limited companies having paid up share capital of Rs. **20Crores** or more; (c) All companies having public borrowings from financial institutions, bank or public deposits of Rs. **50Crores** or more.

Strict provisions relating to rotation can be imposed by members [Section 139(3)]: Members of a company may resolve to provide that:

(a) In the audit firm appointed by it, the auditing partner and his team shall be rotated at such intervals as may be resolved by members or

(b) The audit shall be conducted by more than one auditor.

Power of Central Government to prescribe rules relating to rotation [Section 139(4)]: The Central Government may, by rules, prescribe the manner in which the companies shall rotate their auditors in pursuance of Section 139(2).

Que. No. 5] On recommendation of the Board of Directors of DJA Ltd. (Listed company), Mr. R is appointed at the AGM held on 1st October, 2014 as the company's auditor for a period of 10 years. A resolution to this effect was passed unanimously with no vote against the resolution. Explaining the provisions of the Companies Act, 2013 relating to the appointment and re-appointment of auditors:

(i) Examine the validity of the above resolution.

(ii) What shall be your answer in case an audit firm Messrs R & Associate is appointed as the company's auditor?

Ans.: As per **Section 139(2),** an individual shall not be appointed or re-appointed as auditor for more than one term of 5 consecutive years. Thus, the appointment of Mr. R as auditor of the company for 10 years is not valid.

As per **Section 139(2),** an audit firm shall not appointed or re-appointed as auditor for more than two terms of 5 consecutive years. This means that a firm can be appointed for 5 years and thereafter may be re-appointed for further 5 years. The total period for which a firm can be appointed is 10 years. A firm cannot be appointed as auditor for 10 years by a single resolution. Thus, the appointment of Messrs R & Associate as the company's auditor for ten years by a single resolution is not valid.

Que. No.6] State the provisions relating to appointment of first auditor.

Ans.: Appointment of first auditor [Section 139(6)]: 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. If the Board of Directors fails to appoint such auditor, it shall inform the members of the company, who shall within 90 days at an EGM appoint auditor and such auditor shall hold office till the conclusion of the first AGM.

Appointment of first auditor by Government Company [Section 139(7)]: In the case of a Government Company or any other company owned or controlled, directly or indirectly, by the Central or any State Government(s) the first auditor shall be appointed by the Comptroller &Auditor-General (CAG) within 60 days from the date of registration of the company. If CAG of does not appoint auditor within 60 days, the Board of Directors of the company shall appoint auditor within the next 30 days, it shall inform the members of the company who shall appoint such auditor within the 60 days at an EGM, who shall hold office till the conclusion of the first AGM.

Tenure of first auditor: The first auditor shall hold office till the conclusion of first AGM.

Que.No.7] Managing Director of PQR Ltd. himself wants to appoint Shri Ganpati, a practicing Chartered Accountant, as first auditor of the company. Comment on the proposed action of the Managing Director.

Ans.: As per Section 139(6), 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. Thus, Managing Director of PQR Ltd. himself cannot appoint Shri Ganpati, a practicing Chartered Accountant, as first auditor of the company.

Que. No. 8] State the provisions relating to appointment of subsequent auditor in case of Government Companies.

Ans.: Appointment of subsequent auditor in case of Government Companies [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, within a period of 180 days from the commencement of the financial year.

Tenure: The auditor shall hold office till the conclusion of the AGM.

Que. No. 9] Write a short note on: Filling of casual vacancy of auditors

Ans.: Filling of casual vacancy of auditors [Section 139(8) (i)]: Any casual vacancy in the office of an auditor shall 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 3 months of the recommendation of the Board and he shall hold the office till the conclusion of the next AGM.

Filling of casual vacancy of auditors by government company [Section 139(8)(ii)]: In the case of a government company, any casual vacancy in the office of an auditor shall be filled by the CAG within 30 days. If the CAG does not fill the vacancy within the said period, the Board of Directors shall fill the vacancy within next 30 days.

Que. No. 10] Mr. A was appointed auditor of AAS Ltd. by Board to fill the casual vacancy that arose due to death of the auditor originally appointed in AGM. Subsequently, Mr. A also resigned on health grounds during the tenure of appointment. Comment how the vacancy arising in the place of audit will be filled up?

Ans.: As per **Section 139(8),** any casual vacancy in the office of an auditor shall be filled by the Board of Directors within 30 days. If 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 3 months of the recommendation of the Board.

In the present case the auditor Mr. A resigned and the vacancy had been filled in by Board. But, the vacancy caused by resignation cannot be filled by Board, since it does not amount to casual vacancy; it can be filled only shareholders in general meeting.

The fact that Mr. A was appointed by the Board of Director's, originally is a matter irrelevant in this situation. If the cause of vacancy is resignation, then the power of appointment shall vest with the general meeting only.

Que. No.11] If appointment of person as an auditor is void ab initio, it should be treated as a casual vacancy, Comment.

Ans.: Casual vacancy arises due to death or disqualification of auditor. Thus, if the appointment of auditor is void ab initio, it cannot be treated as casual vacancy.

Que.No.12] Due to the resignation of the existing auditor, the board of directors of Hanuman Ltd. appoints Ram as the auditor, Comment .

Ans.: As per **Section 139(8)** of the **Companies Act, 2013,** a casual vacancy, caused by the resignation of an auditor, can be filled only by the company in a general meeting convened within 3 months of the recommendation of the Board. Thus, the appointment of Ram by the Board of Directors of Hanuman Ltd. is not valid.

Que. No.13] P, the first auditor of XYZ Ltd. resigned as auditors of the Co. Board of Directors appointed Mr. Q as statutory auditors in their place.

Ans.: The first auditor appointment by the Board holds the office till the conclusion of the first annual general meeting. If P, the first auditor resigns, the board of directors still has power to appoint Mr. Q as auditor till conclusion of first AGM. The company at the AGM may remove auditor so appointed and appoint another auditor.

Que. No.14] XYZ Co. Ltd. re-appointed A and B as their joint auditors in the AGM. The AGM authorized the Board for fill up the vacancy on their own in the event of both or either of auditors declined to accept the assignment. The Board passed a resolution to appoint C if any of the auditors declined to accept the assignment. B declined to accept the assignment and Board of Directors appointed C in place of B as per its resolution.

Ans.: In the present case B is one of the joint auditors who was appointed in AGM, but declined to accept the appointment. The Board of Directors as per their resolution, appointed C as a joint auditor in his place.

In this case, the vacancy created by B is neither caused by resignation of B nor is it a casual vacancy because B's appointment had not become effective. Hence, appointment of C as joint auditor by the Board is not valid. C can only be appointed as joint shareholders in the General Meeting.

Que.No.15] Write a short note on: Re-appointment of Auditors

Ans.: Re-appointment of Auditors [Section 139(9)]: A retiring auditor may be re-appointed at an AGM 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.

It is however, to be noted that the re-appointment of the existing auditor is not automatic as there must be an act of the company re-appointing him by passing a resolution.

No auditor is appointed or re-appointed [Section 139(10)]: 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.

Que.No.16] Write a short note on: Removal of auditors

Rao & Rao, a firm of chartered accountants, have to be appointed in place of Shah &Shah as the auditor of Freebee Ltd. explain the steps to be taken with regard to appointment of auditor.

Ans.: Removal of auditors [Section 140(1)]: The auditor 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. The outgoing auditor shall be given a reasonable opportunity of being heard.

As per **Rule 7(1)** of the **Companies (Audit & Auditors) Rules, 2014**, the application to the Central Government for removal of auditor shall be made in **Form ADT-2** along with prescribed fees. The application shall be made to the Central Government within 30 days of the resolution passed by the Board. The company shall hold the general meeting within 60 days of receipt of approval of the Central Government for passing the special resolution.

Requirement of special notice [Section 140(3)]: Special notice shall be required for a resolution at an AGM appointing as auditor a person other than a retiring auditor, or providing expressly that a retiring auditor shall not be re-appointed. However, special notice is not required if the retiring auditor is not appointed due to completion of consecutive tenure of 5 years or 10 years, as provided under Section 139(2).

On receipt of notice of such a resolution, the company shall forthwith send a copy to the retiring auditor.

Where notice is given and the retiring auditor makes representation in writing to the company of 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.

If a copy of the representation is sent because it was received too late or because of the company's default, the auditor may require that the representation shall be read out at the meeting.

If copy of representation is sent a copy thereof shall be filed with the Registrar.

If the Tribunal is satisfied on an application either of the company or of any other aggrieved person that the rights conferred by section 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.

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 officer, it may, by order, direct the company to change its auditors.

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 15 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.

An auditor, whether individual or firm, against whom final order has been passed by the Tribunal shall not be eligible to be appointed as an auditor of any company for a period of 5 years from the date of passing of the order and the auditor shall also be liable for action u/s 447.

Examination I: It is clarified that the case of a firm, the liability shall be of the firm and that of every partner or partners who acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its director or officers.

Explanation II: **"**Auditor" includes a firm of auditors.

Que. No. 17] ABC Ltd. removed first auditor form his office before the expiry of his term by the company in general meeting without obtaining approval of Central Government, Comment.

Ans.: As per **Section 140**, the auditor 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. The provision also applies to first auditor. Thus, company has contravened the provisions of Section 140 of the Companies Act, 2013.

Que. No. 18] Write a short note on: Resignation by Auditor

Ans.: **Resignation by Auditor [Section 140(2)]:** 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 with the company and the Registrar, and in case of government companies referred to in Section 139(5), the auditor shall also file such statement with the CAG indicating the reasons and other facts as may be relevant with regard to his resignation.

> As per **Rule 8** of the **Companies (Audit & Auditors) Rules, 2014**, when an auditor has resigned from the company, he shall file a statement in **Form ADT-3.**

Que. No. 19] Write a short note on: Disqualification of Statutory Auditor

What are the qualification and disqualification of statutory auditor?

Ans.: **Qualification of Statutory Auditor [Section 141(1)]:** See the answer of Question No.1

Disqualification of Statutory Auditor [Section 141(3)]: The following persons shall not be eligible for appointment as an auditor of a company, namely:

I. A body corporate other than a limited liability partnership
II. An officer or employee of the company
III. A person who is a partner or employee of an officer or employee of the company
IV. A person who, or his relative or partner –
   1. 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. However the relative may hold security or interest in the company of face value not exceeding Rs. 1000 or such sum as may be prescribed.

> As per **Rule 10(1)** of the **Companies (Audit & Auditors) Rules, 2014**, for the purpose of Section 141(3)(d)(i), a relative of an auditor may hold securities in the company of face value not exceeding Rs. 100000.

2. Is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of such amount as may be prescribed.

> As per **Rule 10(2)** of the **Companies (Audit & Auditors) Rules, 2014**, for the purpose of Section 141(3)(d)(ii), person who or whose relative or partner 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. 500000 shall not be eligible for appointment.

3. 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, for such amount as may be prescribed.

> As per **Rule 10(3)** of the **Companies (Audit & Auditors) Rules, 2014**, for the purpose of Section 141(3)(d)(iii), a person who or whose relative or partner 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. 100000 shall not be eligible for appointment.

V. 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.

> As per **Rule 10(4)** of the **Companies (Audit & Auditors) Rules, 2014**, for the purpose Section 141(3)(e), the term "business relationship" shall be construed as any transaction entered into for a commercial purpose, except –
>
> 1. Commercial transactions which are in the nature of professional services permitted to be rendered by an auditor or audit firm under the Act and the Chartered Accountants Act, 1949 and the rules or the regulations made under those Acts;
> 2. Commercial transactions which are in the ordinary course of business of the company at arm's length price-like sale of products or services to the auditor, as customer, in the ordinary course of business, by companies engaged in the business of telecommunications, airlines, hospitals, hotels and such other similar businesses.

VI. A person whose relative is a director or is in the employment of the company as a director or key managerial personnel.

VII. 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 persons or partner is at the date of such appointment or reappointment holding appointment as auditor of more than 20 companies.

In case of private companies Section 141(3)(g) shall apply with the modification that the words "other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than Rs. 100Crores" shall be inserted after the words "twenty companies"- Notification[F No.1/1/2014-CL.V], dated 5.6.2015.

VIII. A person who has been convicted by a court of an offence involving fraud and a period of 10 years has not elapsed from the date of such conviction.

IX. Any person whose subsidiary or associate company or any other form of entity, is engaged as on the date of appointment in consulting and specialized services as provided in section 144.

Vacation of office if auditor is disqualified after appointment [Section 141(4)]: Where a person appointed as an auditor of a company incurs any of the disqualifications mentioned in Section 141(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.

Que. No. 20] Mr. A is a part-time Practicing Chartered Accountant and is the financial controller of X Ltd. The company wants to appoint him as its auditor in the ensuing annual general meeting. Offer your comments in the matter.

Ans.: As per **Section 141(3)**, an officer or employees of the company are not qualified for appointment as auditor of a company. In the present case Mr. A is the financial controller and thus an officer of the company. Therefore, he is disqualified for appointment as an auditor of the company.

Que. No. 21] Ram and Hanuman Associates, Chartered Accountants in practice have been appointed as Statutory Auditor of Krishna Ltd. for the accounting year 2014-2015. Mr. Hanuman holds 100 equity shares of Shiva Ltd., a subsidiary company of Krishna Ltd.

Ans.: As per **Section 141(3)(d),** a person who is holding any security of the company or its subsidiary is disqualified for appointment as auditor.

In the present case, Mr. Hanuman, a partner of M/s Ram and Hanuman Associates, holds 100 equity shares of Shiva Ltd., which is a subsidiary of Krishna Ltd. As such, the firm, M/s Ram and Hanuman Associates would be disqualified to be appointed as statutory auditor of Shiva Ltd. Thus, firm is also disqualified for appointment of auditor in Krishna Ltd. (i.e. Holding Company)

Que. No. 22] Amol & Co., a proprietary firm of Amol, a Chartered Accountant in practice, has been appointed as the statutory auditor by a private limited company. Subsequently, it came to light that Mr. Amol has been holding less than 1ñ of the shares of that company. Will this vitiate the appointment of the statutory auditor? Answer with reasons.

Ans.: As per **Section 141(3)(d),** a person who is holding any security of the company or its subsidiary is disqualified for appointment as auditor. Since Mr. Amol has been holding some shares of the company, he is disqualified for appointment as auditor and his appointment is not valid.

Que. No. 23] Mr. R, a practicing chartered accountant, is appointed as a Tax Consultant of MN Ltd. in which his father Mr. C is the managing director. Comment.

Ans.: There is no bar under the Companies Act, 2013 to prohibit an auditor of the company from rendering other services in the capacity of a consultant. Hence, Mr. R can be appointed as a Tax Consultant of MN Ltd. in which his father Mr. C is the managing director.

Que. No. 24] Write a short note on: Remuneration of auditors

Ans.: Remuneration of auditors [Section 142]: The remuneration of the auditor shall be fixed in its general meeting or in such manner as may be determined therein. However the Board may fix remuneration of the first auditor appointed by it.

The remuneration 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.

Que. No. 25] Discuss in brief the various rights of statutory auditors.

Ans.: Statutory Auditor of a company has been given enough vested power by the act so as to enable him to carry out the auditing of the books of account independently. The rights of a auditors are discussed herein given below:

1. **Right to receive information and explanations:** The company auditor has to state in his report, whether he has received necessary information and explanations for the purpose of audit. When the auditor is not provided the information required by him his only remedy would be to report the same to the shareholder's through qualification in the auditor's report. [Section 143(1)]
2. **Right of accessibility to the books and records:** The auditor enjoys the right of accessibility to books and records because he has to mention in his report whether proper books and records are maintained. It is for the auditor to determine what record or document is necessary for the purpose of the audit. [Section 143(1)]

The auditor of a company which is a holding company shall also have the right of access to the records of all its subsidiaries in so far as it relates to the consolidation of its financial statements with that of its subsidiaries. [Proviso to Section 143(1)]

3. **Right to visit branches:** Since the auditor has to report on the consolidated financial statements which also include the results of the branch operations, he has the right to visit the branches to obtain information. Even if the branch accounts are audited by another auditor, this right is still available because it is possible that the auditor may not be getting full information from the branch auditor regarding the branch accounts.
4. **Right of lien:** The term lien refers to the right of possession. The auditor enjoys this right over the books of the clients if there is a fee due. The guidelines to be followed while exercising this right is:
    (a) Documents retained must belong to the client who owes the money.
    (b) Documents must have come into possession of the auditor on the authority of the client. They must not have been received through irregular or illegal means. In case of a company client, they must be received on the authority of the board of directors.
    (c) Such of the documents can be retained which are connected with the work on which fees have not been paid.

Que. NO. 26] The auditor of a Company wanted to see the minute's book of Directors meetings. The Chairman of the company refused for the same on the ground that matters of confidential nature were contained therein.

Ans.: As per **Section 143,** the auditor enjoys the right of accessibility to books and records because he has to mention in his report whether proper books and records are maintained. It is for the auditor to determine what record or document is necessary for the purpose of the audit.

Thus, auditor has right to inspect the minute's books of Directors meetings. Hence, contention of Chairman is not acceptable.

Que. No. 27] Director (Finance) of KK Ltd. informed their newly appointed statutory auditor that they have sound Internal control system implemented by a renowned professional firm and he is satisfied with its effectiveness and functioning and therefore, the statutory auditor should concentrate on verifying only the routine books and financial statements.

Ans.: The objective of an audit of financial statement is to enable an auditor to determine true and fair view of the financial position and operating results and to express an opinion thereon.

The report of the auditor is based on his examination of financial statements and the underlying documents and evidences. It is for the auditor to decide based on his evaluation of the internal control as to its existence and effectiveness. The nature, timing and extent of audit procedure are based on such evaluation.

In the instant case, management has no right to guide and place any restriction on the work of the auditor as it would amount to restriction on the scope of the audit. The auditor should ask the management not to impose such restriction on his scope of the audit that impairs his ability to examine and express an opinion and if the management does not agrees, he should issue a qualified opinion or disclaimer, as appropriate.

Que. No. 28] Auditor's lien on his client's books and record is not unconditional. Comment.

Ans.: The term lien refers to the right of possession. The auditor enjoys this right over the books of the clients if there is a fee due. The auditor can exercise his lien on client's books and records subject to the following conditions:

(a) Document retained must belong to the client who owes the money.
(b) Such documents must have come into auditor's possession with the client's authority.
(c) Some work must have been done and fees for work performed must be outstanding.

Que. No. 29] Discuss in brief the various duties of statutory auditors.

Ans.: The duties of an auditor are many and varied. He must examine the original books of account, kept by the company to discover any inaccuracies or omissions therein, to examine the company's balance sheet and profit and loss account, and report on the original books of account and the annual accounts to the members.

Duties of Auditor [Section 143(1)]: An auditor has to inquire:

(a) Whether loans and advances are properly secured and the terms on which they have been made are not prejudicial to the interests of the company or its members;
(b) Whether transactions which are represented merely by book entries are not prejudicial to the interests of the company;
(c) Where the assets of the company as consists of shares, debentures and other securities have not been sold at a price less than that at which they were purchased by the company (except for investment or a banking company);
(d) Whether loans and advances made by the company have not been shown as deposits;
(e) Whether personal expenses have not been charged to revenue accounts;
(f) Whether cash has actually been received in respect of any shares shown in the books to have been allotted for cash; and if no cash has actually been so received, the position as stated in the books is correct, regular and is not misleading.

Duty of the auditor to make a report to the members [Section 143(2): It is the duty of the auditor to make a report to the members of the company on the accounts examined by him, and on every balance sheet, every profit and loss account and on every other document to be part of or annexed to the balance sheet or profit and loss account and laid before the company in general meeting.

Auditors Report [Section 143(3)]: The report, besides other things necessary in any particular case, must expressly state:

(a) Whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;

(b) Whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;

(c) Whether the report on the accounts of any branch office of the company by a person other than the company's auditor has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;

(d) Whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;

(e) Whether in his opinion, the financial statements comply with the accounting standards;

(f) The observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;

(g) Whether any director is disqualified from being appointed as a director u/s 164(2);

(h) Any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;

(i) Whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls;

(j) Such other matters as may be prescribed.

Duty to give reason for qualification in audit report [Section 143(4)]: Where any of the above matters is answered in the negative or with a qualification, the auditor's report must state the reason for the same.

Duty to comply with Auditing Standards [Section 143(9)]: Every auditor shall comply with the Auditing Standards.

As per **Section 143(10)**, the Central Government may prescribe the standards of auditing or any addendum thereto, as recommended by the ICAI in consultation with the **National Financial Reporting Authority (NFRA).** However until any auditing standards are notified, any standard or standards of auditing specified by the ICAI shall be deemed to be the auditing standards.

Duty to sign audit reports [Section 145]: The person appointed as an auditor of the company shall sign the auditor's report or sign or certify any other document and the qualifications, observations or comments on financial transactions or matters, which have any adverse effect on the functioning of the company mentioned in the auditor's report which shall be read before the company in general meeting and shall be open to inspection by any member of the company.

Duty to attend general meeting [Section 146]: All notices of, and other communications relating to, any general meeting shall be forwarded to the auditor of the company, and the auditor shall, unless otherwise exempted by the company, attend either by himself or through his authorized representative, who shall also be qualified to be an auditor, any general meeting and shall have right to be heard at such meeting on any part of the business which concerns him as the auditor.

Under **Section 143(11)** the Central Government may, in consultation with the NFRA, by general or special order, direct, in respect of certain class or description of companies, that the auditor's report shall also include a statement on such matters as may be specified therein the Central Government is empowered to issue order requiring the auditor to include in his report a statement on such matters as may be specified.

Que. No. 30] Mr. X, a Director of KP Private Ltd., is also a Director of another company viz., GP Private Ltd., which has not filed the annual accounts and annual return for last three years 2013-2014 to 2015-2016. Mr. X is of the opinion that he is not disqualified u/s 164(2) of the Companies Act, 2013 and auditor should not mention disqualification remark in his audit report.

Ans.: Section 164(2) of the Companies Act, 2013 imposes a specific duty on the auditor to report whether any director is disqualified from being appointed as director u/s 164(2) of the Companies Act, 2013. As per provisions of section 164 (2), if a director is already holding a directorship of a company (public or private) which has not filed financial statements or annual returns for any continuous three financial years shall not be eligible to be appointed as a director of that company or director of any other company.

In this case since Mr. X is a director of Private Ltd. Company, hence the provisions of section 164(2) are applicable to him and as such he is disqualified from reappointment of directorship of KP Private Ltd. and also disqualified to be appointed as director in GP Private Ltd. Therefore, the auditor shall 164(2) report about the disqualification u/s 164(2) of the Companies Act, 2013.

Que. No. 31] Mr. X is a Chartered Accountant, is an employee of the M/s M & N Co. a firm of Chartered Accountants. The firm is the auditor of ABC Ltd. After auditing the accounts of the company the auditor of the firm allowed Mr. X, their employee, to sign audit report; which he did. Comment.

Ans.: As per **section 145**, the person appointed as an auditor of the company shall sign the auditor's report or sign or certify any other document and the qualification, observations or comments on financial transactions or matters, which have any adverse effect on the functioning of the company mentioned in the auditor's report.

Mr. X though a Chartered Accountant cannot sign the audit report as he is employee. Only partners of the firm can sign the audit report.

Que. NO. 32] The Board of Directors of a Company have filed a complaint with the Institute of Chartered Accountants of India against their statutory auditors for their failing to attend the Annual General Meeting of the Shareholders in which audited accounts were considered.

Ans.: As per **section 146**, all notices of, and other communications relating to, any general meeting shall be forwarded to the auditor of the company, and the auditor shall, unless otherwise exempted by the company, attend either by himself or through his authorized representative, who shall also be qualified to be an auditor, any general meeting and shall have right to be heard at such meeting on any part of the business which concerns him as the auditor. Thus, by not attending AGM, the auditor has contravened the provisions of section 146 of the Companies Act, 2013.

Que. No. 33] The auditors of PQR Ltd. accepted the Certificate of the Manager, a person of knowledge, competence and high reputation, as to the value of the stock in trade. The stock was grossly overstated for several years in the balance sheets of the company. As a result of this over valuation dividends were paid out of capital.

The Auditors did not examine the books of account very minutely. If they had done so and compared the amount of stock at the beginning of the year, with the purchases and sales during the year, they would have noticed the over valuation. The company subsequently went into liquidation and the auditors were sued to make good the loss caused by the wrongful payment of dividends relying on the balance sheets figures. Based on the above facts, you are required to decide, with reference to the provisions of the Companies Act, 2013 and the decided case laws, the following issues:

1. **Whether auditors of the company will be liable for the loss caused to the company by the wrongful payment of dividends based on the Balance Sheets duly audited by the Auditors.**
2. **What are statutory duties of the Auditors in this regard?**

Ans.: **Section 143** provides that the main duty of the auditor is to make a report to the members of the company on the accounts examined by him and the balance sheet and the profit and loss account and on every document which is annexed to the balance sheet or profit and loss account laid before the company in general meeting. The auditor owes a duty to the members to state whether the accounts give a true and fair view of the affairs of the company at the end of the financial year and of the profit and loss account of the year.

The duty of an auditor is to give information in direct and express terms and not merely to arouse inquiry.

If he discovers that any illegal or improper payments or any other papers have been made, his duty will be to make it public by reporting.

The auditor occupies a fiduciary position in relation to the shareholders and in auditing the accounts maintained by the directors, he must act in the best interest of the shareholders who are in the position of beneficiaries. But, there is a limitation relating the duties to be performed by the auditors. An auditor is not bound to be a detective, as loss laid to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watchdog but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion, he should probe it to the bottom, but in the absence of anything of that kind he is only bound to be reasonably cautious and careful.

The above problem is related to case of Kingston Mill Co. Re (No.2) (1896) 2 Ch 279. In this case it was held that, the auditors where not liable. It is not auditor's duty to take stock. There are many matters in which he may rely on the honesty and accuracy of others. Further they (auditors) do not guarantee the discovery of all frauds.

Que. No. 34] What are the special provisions are made under the Companies Act, 2013 in relation to audit of Government Companies?

Ans.: Direction by CAG in relation to government audit [Section 143(5)]: In the case of a Government company, the Comptroller & Auditor-General (CAG) of India shall appoint the auditor Section 139(5) or 139(7).

The Comptroller & Auditor-General direct appointed auditor the manner in which the accounts of the Government companies are required to be audited.

The auditor so appointed shall submit a copy of the audit report to the Comptroller & Auditor –General of India.

Such audit report includes the directions issued by the Comptroller & Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

Right of CAG to conduct supplementary audit [Section 143(6)]: The Comptroller & Auditor-General of India shall within 60 days from the date of receipt of the audit report have a right to conduct a supplementary audit of the financial statement of the government company by person authorized him. For the purposes of such audit, he may require information or additional information to be furnished to person authorized by him, on such matters and in such form, as the Comptroller and Auditor-General of India may direct.

The Comptroller & Auditor-General of India may comment upon or supplement such audit report.

Any comments given by the Comptroller & Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements and also be placed before the AGM of the company at the same time and in the same manner as the audit report.

Test Audit [Section 143(7)]: The Comptroller & Auditor-General of India may by an order, cause test audit of the accounts and the provisions of section 19A of the **Comptroller and Auditor-General's (Duties, Powers & Conditions of Service) Act, 1971**, shall apply to the report of such test audit.

<u>Que. No. 35] Write a brief note on branch audit.</u>

Ans.: Branch Audit [Section 143(8)]: Where a company has a branch office, the accounts of that office shall be audited either by the company's auditor appointed for the company or by any other person qualified for appointment as an auditor of the company.

Where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country.

The duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed.

As per **Rule 12** of the **Companies (Audit & Auditors) Rules, 2014**, duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor are as follows.

(1) For the purposes of sub-section (8) of section 143, the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be as contained in section 143(1) to 143(4).
(2) The branch auditor shall submit his report to the company's auditor.
(3) The provisions of section 143(12) with Rule 12 hereunder regarding reporting of fraud by the auditor shall also extend to such branch auditor to the extent it relates to the concerned branch.

The branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.

<u>Que. No. 36] State the provisions relating to reporting of fraud by an auditor as contained in the Companies Act, 2013.</u>

<u>Explain the procedure of fraud reporting by an auditor as per the Companies Act,2013.</u>

Ans.: Duty to report fraud [Section 143(13) to (15)]: If an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving prescribed amount, is being or has been committed in the company by its officer or employees, the auditor shall report the matter to the Central Government within prescribed time and in prescribed manner.

In case of a fraud involving lesser than the specified amount, the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within prescribed time and in prescribed manner.

The companies, whose auditors have reported frauds to the audit committee or the Board but not reported to the Central Government, shall disclose the details about such frauds in the Board's report in prescribed manner.

Reporting of frauds by auditor [Rule 12 of the Companies (Audit & Auditors) Rules, 2014]:

(1) For the purpose of section 143(12), in case the auditor has sufficient reason to believe that an offence involving fraud, is being or has been committed against the company by officers or employees of the company, he shall report the matter to the Central Government immediately but not later than 60 days of his knowledge and after following the procedure indicated below:

(i) Auditor shall forward his report to the Board or the Audit Committee, as the case may be, immediately after he comes to knowledge of the fraud, seeking their reply or observations with 45 days.

(ii) On receipt of reply or observations the auditor shall forward his report and the reply or observation of the Board or the Audit Committee along with his comments (on reply or observations of the Board or the Audit Committee) to the Central Government within 15 days of receipt of such reply or observations.

(i) In case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of 45 days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he failed to receive any reply or observations within the stipulated time.

(2) The report shall be sent to the Secretary, Ministry of Corporate Affairs in a sealed cover by Registered Post with Acknowledgement Due or by Speed post followed by an e-mail in confirmation of the same.

(3) The report shall be on the letter –head of the auditor containing postal address, e-mail address and contact number and be signed by the auditor with his seal and shall indicate his Membership Number.

(4) The report shall be in the form of a statement as specified in **Form ADT-4.**

(5) The provision of this rule shall also apply, mutatis mutandis, to a Cost Auditor and a Secretarial Auditor during the performance of his duties under sections 148 & 204 respectively.

Que. No. 37] Which type of services cannot be provided by the auditor as provided in Section 144 of the Companies Act, 2013?

An auditor appointed under the Companies Act, 2013 shall provide only such other services as are approved by the Board of directors or audit committee but shall not include some services. Specify the services which cannot be rendered by an auditor of a company.

Ans.: Auditor not to render certain services [Section 144]: An auditor shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, 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 prescribed services

Explanation: The term "directly or indirectly" shall include rendering of services by the auditor:

(i) 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.

(ii) 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.

Que. No. 38] State the provisions of the Companies Act, 2013 relating to signing of audit report.

Ans. : Auditor to sign audit reports [Section 145]: The person appointed as an auditor of the company shall sign the auditor's report or sign or certify any other document of the company in accordance with the provisions of section 141(2).

Qualification to be read in general meeting and inspection thereof: The qualifications, observations or comments on financial transactions or matters, which have any adverse effect on the functioning of the company mentioned in the auditor's report shall be read before the company in general meeting and shall be open to inspection by any member of the company.

Que. No. 39] Whether it obligatory for the auditor to attend the annual general meeting under the Companies Act, 2013? What are the right available to him, when he attends such meeting?

Ans.: Auditors to attend general meeting [Section 146]: All notices of, and other communications relating to, any general meeting shall be forwarded to the auditor of the company.

The auditor shall, unless otherwise exempted by the company, attend either by himself or through his authorized representative, who shall also be qualified to be an auditor, any general meeting and shall have right to be heard at such meeting on any part of the business which concerns him as the auditor.

Que. No. 40] What are the punishments provided under the Companies Act, 2013 relating to contravention of provisions relating to "audit & auditors (i.e. Section 139 to 146)"?

Ans.: Punishment for contravention to company and its officers [Section 147(1)]: If any of the provisions of sections 139 to 146 (both inclusive) is contravened:

- The company shall be punishable with fine which shall not be less than Rs. 25000 but which may extend to **Rs. 500000** and
- Every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to 1 year or with fine which shall not be less than **Rs. 10000** but which may extend to **Rs. 100000** or **with both.**

Punishment for Auditors [Section 147(2)]: If an auditor of a company contravenes any of the provisions of section 139, 143, 144 or 145, the auditor shall be punishable with fine which shall not be less than **Rs. 25000** but which may extend to **Rs. 500000.**

If an auditor has contravened such provisions knowingly or willfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be punishable with imprisonment for a term which may extend to **1 year** and with fine which shall not be less than **Rs. 100000** but which may extend to **Rs. 2500000.**

Conviction of auditor [Section 147(3)]: Where an auditor has been convicted section 147(2), he shall be liable to –

1. refund the remuneration received by him to the company; and
2. pay for damages to the company, statutory bodies or authorities or to any other persons for loss arising out of incorrect or misleading statements of particulars made in his audit report.

Measures for prompt payment of damages [Section 147] (4)]: The Central Government shall, by notification, specify any statutory body or authority or an officer for ensuring prompt payment of damages to the company or the persons under section 147(3) (ii).

Such body, authority or officer shall after payment of damages to such company or persons file a report with the Central Government in respect of making such damages in such manner as may be specified in the said notification.

Joint and several liability of partners [Section 147(5)]: Where, in case of audit of a company being conducted by an audit firm, it is proved that the partner or partners of the audit firm has or have acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to or by, the company or its directors or officers, the liability, whether civil or criminal as provided in Companies Act, 2013 or in any other law for the time being in force, for such act shall be of the partner or partners concerned of the audit firm and of the firm jointly and severally.

Que. No. 41] Explain the penal provisions applicable to auditors under the Companies Act, 2013.

Ans.: Punishment for Contravention by Auditors [Section 147(2) to (5)]: If an auditor of a company contravenes any of the provisions of section 139, 143, 144 or 145, the auditor shall be punishable with fine of Rs. 25000 but which may extend to **Rs. 5 lakhs.**

If an auditor has contravened such provisions knowingly or willfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be punishable with imprisonment for a term which may extend to **1 year** and with fine of Rs. **1 lakh** but which may extend to **Rs. 25 lakhs.**

Where an auditor has been convicted he shall be liable to –

(i) Refund the remuneration received by him to the company and
(ii) Pay for damages to the company, statutory bodies or authorities or to any other persons for loss arising out of incorrect or misleading statements of particulars made in his audit report.

In case of audit conducted by an audit firm and it is proved that the partners of the audit firm has or have acted in a fraudulent manner or abetted or colluded in any fraud then they are liable jointly and severally.

Que. No. 41] Write a short note on: Liabilities of an auditor

Ans.: Apart from liability under the common law, the statutory liabilities of auditor could be either Civil or Criminal.

Civil Liability: An auditor may be held liable to the company for negligence where loss is caused to the company due to the failure of the auditors to perform his duties with reasonable care and skill.

He is also liable for:

(i) breach of trust regarding any money or property of the company or
(ii) breach of duty.

Criminal Liability: An auditor is responsible for the destruction, mutilation, alternation, falsification or fraudulent concealment of any books, papers or documents belonging to the company with an intent to defraud or deceive; and also where he makes intentionally any false statement in any report or document prepared by him.

Criminal liability of an auditor may extend to imprisonment and and/or fine at the discretion of the court.

Que. No. 43] Write a short note on: Special Audit

Ans.: The Companies Act, 2013 do not contain any provision relating to special audit.

Que. No. 44] Write a short note on: Joint Auditors

Ans.: Meaning of Joint Audit: when two or more auditors are appointed for the execution of same audit assignment, it is termed as joint audit. Joint Auditors are mainly appointed for audit assignment of public enterprises and big companies. ICAI has issued SA 299 on “Responsibility of Joint Auditors”.

Reporting Responsibilities: Normally, the joint auditors are able to arrive at an agreed report. However, where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express his owns opinion through a separate report.

A joint auditor is not bound by the view of the majority of the joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

Que. No. 45] Mention the areas in which all the joint auditors are jointly and severally responsible.

Ans.: Relationship among joint auditors: In respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared as separate report on the work performed by him. On the other hand, all the joint auditors are jointly and severally responsible:

(i) In respect of the audit work which is not divided among the joint auditors and is carried out by all of them;
(ii) In respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors. It may, however, be clarifies that all the joint auditors are responsible only in respect of the appropriateness of the decisions concerning the nature, timing or extent of the audit procedures agreed upon among them; proper execution of these audit procedures is the separate and specific responsibility of the joint auditor concerned;
(iii) In respect of matters which are brought to notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;
(iv) For examining that the financial statements of the entity comply with the disclosure requirement of the relevant statute; and
(v) For ensuring that the audit report complies with the requirements of the relevant statute.

If any matters of the nature referred above are brought to the attention of the entity or other joint auditors by an auditor after the audit report has been submitted, the other joint auditors would not be responsible for those matters. It is the responsibility of each joint auditor to determine the nature, timing and extent of audit procedures to be applied in relation to the area of work allocated to him. The issues such as appropriateness of using test checks or sampling should be decided by each joint auditor in relation to his own area of work. This responsibility is not shared by the other joint auditors.

Thus, it is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him. Similarly, the nature, timing and extent of the enquiries to be made in the course of audit as well as the other audit procedures to be applied are solely the responsibility of each joint auditor. In the case of audit of a large entity with several branches, including those required to be audited by branch auditors, the branch audit reports/ returns may be required to be scrutinized by different joint auditors in accordance with the allocation of work. In such cases, it is the specific and separate responsibility of each joint auditor to review the audit reports of the division/branches allocated to him and to ensure that they are properly incorporated into the accounts of the entity. In respect of the branches which do not fall within any divisions or zones which are separately assigned to the various joint auditors, they may agree among themselves as regards the division of work relating to the review of such branch returns. It is also the separate and specific responsibility of each joint auditor to exercise his judgment with regard to the necessity of visiting such divisions/ branches in respect of which the work is allocated to him. A significant part of the audit work involves obtaining and evaluating information and explanations from the management. This responsibility is shared by all the joint auditors unless they agree upon a specific pattern of distribution of this responsibility. In cases where specific responsibility of each joint auditor to obtain appropriate information and explanations from the management in respect of such divisions/zones/units and to evaluate the information and explanations so obtained by him.

Each joint auditor is entitled to assume that the other joint auditors have carried out their part of the audit work in accordance with the generally accepted audit procedures. It is not necessary for a joint auditor to review the work performed by other joint auditors or perform any tests in order to ascertain whether the work has actually been performed in such a manner. Each joint auditor is entitled to rely upon the other joint auditors for bringing to his notice accounting principles or any material error noticed in the course of the audit. Where separate financial statements of a division/branch are audited by one of the joint auditors, the other joint auditors are entitled to proceed on the basis that such financial statements comply with all the legal and professional requirements regarding the disclosures to be made and present a true and fair view of the state of affairs and of the working results of the division/branch concerned, subject to such observations as may be communicated by the joint auditor concerned.

<u>Que. No. 46] If there is difference of opinion among the joint auditors with regard to any matter, majority joint auditor's opinion will prevail while reporting. Comment.</u>

Ans.: False: As per SA-299 "Responsibility of Joint Auditors", where the joint auditors are in disagreement with regard to any matter to be covered by the audit report each one of them should express his own opinion through a separate report.

<u>Que. No. 47] What do you understand by Cost Audit? Explain the provisions of Companies Act, 1956 relating to cost audit?</u>

<u>Write a short note on: Appointment of cost auditor</u>

<u>Explain the requirements of cost audit in brief.</u>

Ans.: Cost Audit is a *<u>critical review</u>* undertaken for the purpose of:

(a) Verification of the ***<u>correctness of cost accounts</u>*** and
(b) ***<u>Checking that cost accounting plan</u>*** is adhered to.

The Institute of Cost Accountants of India defines statutory cost audit as, "A system of audit introduced by the Government of India for the review, examination and appraisal of the cost accounting records and added information required to be maintained by the specified industries".

Maintenance of costing records [Section 148 (1)]: The ***Central Government*** may, by order, in respect of such class of companies engaged in the production of such goods or providing such services ***as may be prescribed***, direct that particulars relating to the utilization of material or labour or to other items of cost as may be prescribed shall also be included in the books of account kept by that class companies.

The Central Government shall, before issuing such order in respect of any class of companies regulated under a special Act, consult the regulatory body constituted or established under such special Act.

Commented [u1]: Central Government may order for maintenance of prescribed records.

Commented [u2]: Before prescribing records CS will consult with regulatory body.

Rule 5 of the **Companies (Cost Records & Audit) Rules, 2014** makes following provisions relating to maintenance of costing records: **(1)** Every company under Rule 3 including all units and branches, shall, maintain cost records in F**orm CRA-1.**
(2) The cost records shall be maintained on regular basis in such manner as to facilitate calculation of per unit cost of production or cost of operation, cost of sales and margin for each of its products and activities for every financial year on monthly or quarterly or half-yearly or annual basis. **(3)** The cost records shall be maintained in such manner so as to enable the company to exercise, as far as possible, control over the various operations and costs to achieve optimum economies in utilization of resources and these records shall also provide necessary data which is required to be furnished under these rules.

Cost Audit [Section 148(2)]: If the Central Government is of the opinion, that it is necessary to do so, it may, by order, direct that the audit of cost records of class of companies, which are covered under Section 148(1) and which have a net worth of prescribed amount or a turnover of prescribed amount, shall be conducted in the manner specified in the order.

Commented [u3]: CG may order for cost audit on the basis of Net Worth / Turnover.

Rule 4 of the **Companies (Cost Records & Audit) Rules, 2014** specifies the following class of companies:

(1) Every company specified in item (A) of Rule 3 shall get its cost records audited in accordance with these rules if the **overall annual turnover** of the company from all its products and services during the immediately preceding financial year is **Rs. 50 Crores or more** and the **aggregate turnover of the individual product** or products or service or services for which cost records are required to be maintained under rule 3 is **Rs. 25 Crores or more**.

(2) Every company specified in item (B) of Rule 3 shall get its cost records audited in accordance with these rules if the **overall annual turnover** of the company from all its products and services during the immediately preceding financial year is rupees **Rs. 100 Crores or more** and the **aggregate turnover** of the individual product or products or service or services for which cost records are required to be maintained under Rule 3 is **Rs. 35 Crores or more.**

(3) The requirement for cost audit under these rules **shall not apply** to a company which is covered in Rule 3 and

Commented [u4]: Industry Specific

(i)	whose revenue from exports, in foreign exchange, exceeds 75% of its total revenue or
(ii)	which is operating from a special economic zone.

Appointment of cost auditor [Section 148(3)]: The cost audit shall be conducted by Practicing Cost Accountant who shall be appointed by the Board on such remuneration as may be determined by the members.

No person appointed under section 139 (i.e. statutory auditor) as an auditor of the company shall be appointed for conducting the audit of cost records.

The cost auditor shall comply with the cost auditing standards.

Cost audit shall be in addition to the audit conducted under section 143.

Qualifications, disqualifications, rights, duties and obligations applicable to cost auditor [Section 148(5)]:

The qualifications, disqualifications, rights, duties and obligations applicable to statutory auditors, so far as may be applicable, also apply to a cost auditor.

It shall be the duty of the company to give all assistance and facilities to the cost auditor for auditing the cost records of the company.

The cost audit report shall be submitted by the cost accountant to the Board of Directors of the company.

Submission of cost audit report to the Central Government [Section 148(6)]: Within 30 days from receipt of cost audit report from cost auditor, the company shall furnish the cost audit report to the Central Government, along with full information and explanation on every reservation or qualification contained therein.

Further information and explanation [Section 148(7)]: If, after considering the cost audit report and the information and explanation furnished by the company, the Central Government is of the opinion that any further information or explanation is necessary, it may call for such further information and explanation.

The company shall furnish the same within time specified by the Central Government.

Rule 6 of the **Companies (Cost Records & Audit) Rules, 2014** makes following provisions relating to appointment of cost audit and procedure for cost audit:

(1) The category of companies specified in Rule 3 and the thresholds limits laid down in Rule 4, shall with 180 days of the commencement of every financial year, appoint a cost auditor.

(2) The company shall inform the cost auditor of his or its appointment and file a notice of such appointment with the Central Government within a period of 30 days of the Board meeting in which such appointment is made or within a period of 180 of the commencement of the financial year, whichever is earlier, through electronic mode, in **Form CRA-2,** along with prescribed fees.

(3) Every cost auditor appointed as such shall continue in such capacity till the expiry of 180 from the closure of the financial year or till he submits the cost audit report, for the financial year for which he has been appointed.

(4) Every cost auditor, who conducts an audit of the cost records of a company, shall submit the cost audit report along with his or its reservations or qualifications or observations or suggestions, if any, in **Form CRA-3.**

(5) Every cost auditor shall forward his report to the Board of Directors of the company within a period of 180 from the closure of the financial year to which the report relates and the Board of Directors shall consider and examine such report particularly any reservation or qualification contained therein.

(6) The company within a period of 30 days from the date of receipt of a copy of the cost audit report, furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein, in **Form CRA-4** along with prescribed fee.

Que. No. 48] Distinguish between: Cost Audit & Statutory Audit

Ans.: The following are the main points of distinction between cost audit and statutory audit:

Points	Cost Audit	Statutory Audit
To whom it applies	Covers only select **specified industries.** Product wise coverage and not the whole company.	Compulsory for **all companies** incorporated under the Companies Act, 2013.
How applies	The Central Government may, by order, in respect of certain class of companies engaged in the production of prescribed goods or services direct that particulars relating to the utilization of material or labour or to other items of cost as may be prescribed shall also be included in the books of account kept by that class of companies.	Automatic application of provisions for all registered companies as per **Section 139** of Companies Act, 2013.
By whom	Cost Audit is done by Cost Accountant.	Statutory Audit is done by Chartered Accountant.
Appointment of auditor	The Cost Auditor is appointed by the Board of directors.	Statutory Auditor is appointed by the members in AGM.

To Whom Audit report is submitted	The cost audit report shall be submitted by the Cost Accountant to the Board of Directors of the company. A company shall within 30 days from the date of receipt of a copy of the cost audit report furnish the Central Government such report along with full information and explanation on every reservation or qualification contained therein.	Audit report is submitted to the **members** in the AGM.
Base of report	The report is on efficiency and propriety.	The report is on true & fair view of the state of affairs and the profit and loss.
Emphasis is on	The emphasis is on adequacy or otherwise of the cost accounting system.	The emphasis is on verification & authenticity of transactions.
Form of audit report	Every cost auditor, who conducts and audit of the cost records of a company, shall submit the cost audit report along with his or its reservations or qualifications or observations or suggestions, if any, in **Form CRA-3**	There is no specific format provided for statutory audit under the Companies Act, 2013.

Que. No. 49] List out eight industry covered by the Companies (Cost Records & Audit) Rules, 2014.

Ans.: Some of the industries covered by **Rule 3** of the **Companies (Cost Records & Audit) Rules, 2014** are:

- Cement
- Tyres & tubes
- Electricals or electronic machinery
- Coffee and tea
- Drugs and pharmaceuticals
- Sugar and industrial alcohol
- Paper
- Plastics and polymers
- Milk Powder
- Jute and jute products

Que. No. 50]: Write a short note on: Internal Audit

Whether a private company is mandatorily required to appoint an internal auditor? Who may be appointed as internal auditor?

Ans.: Internal Audit [Section 138]: Such class or classes of companies as may be prescribed shall be required to appoint an internal auditor, who shall either be a Chartered Accountant or a Cost Accountant, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the company.

The Central Government may, by rules prescribe the manner and the intervals in which the internal audit shall be conducted and reported to the Board.

Rule 13 of the **Companies (Accounts) Rules, 2014** makes following provisions relating to internal audit: The following class of companies shall be required to appoint an internal auditor or a firm of internal auditors, namely: (f) Every listed company (g) Every unlisted public company having – (i) paid up share capital of **Rs. 50 Crores** or more during the preceding financial year or (ii) turnover of **Rs. 200 Crores** or more during the preceding financial year or (iii) outstanding loans or borrowings from banks or public financial institutions exceeding **Rs. 100 Crores** or more at any point of time during the preceding financial year or (iv) outstanding deposits of Rs. **25 Crores** or more at any point of time during the preceding financial year (c) Every private company having – (i) turnover of **Rs. 200 Crores** or more during the preceding financial year or (ii) outstanding loans or borrowings from banks or public financial institutions exceeding **Rs. 100 Crores** rupees or more at any point of time during the preceding financial year:
Explanation: For the purposes of this rule – (i) The internal auditor may or may not be an employee of the company. (ii) The term "Chartered Accountant" shall mean a Chartered Accountant whether engaged in practice or not. The Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit.

Que. No. 51] PQR Ltd. is unlisted public company having paid-up share capital of Rs. 80 Crores during the preceding financial year 2014-2015. The turnover of the company was Rs. 110 Crores for the same period. Referring to the provisions of the Companies Act, 2013, Answer the following:

(i) Is it mandatory for the above company to appoint internal auditor for the financial year 2015-2016?

(ii) What are the qualifications of the Internal Auditor?

Ans.: As per **Section 138** read with **Rule 13** of the **Companies (Accounts) Rules, 2014,** in case of unlisted public company, appointment of internal auditor is mandatory in following cases:

- If paid –up share capital is Rs. 50 Crores or more during the preceding financial year or
- If turnover is Rs. 200 Crores or more during the preceding financial year or
- If outstanding loans or borrowings from banks or public financial institutions exceeds Rs. 100 Crores or more at any point of time during the preceding financial year or

- If outstanding deposits is Rs. 25 Crores or more at any point of time during the preceding financial year.

As per the facts given in the question, PQR Ltd. is an unlisted public company with the paid-up share capital of Rs. 80 Crores during the preceding financial year with the turnover of Rs. 110 Crores. Since PQR Ltd. fulfils one of the criteria with paid up share capital of more than Rs. 50 Crores during the preceding financial year, it is mandatory for the PQR Ltd. to appoint an internal auditor for the financial year 2015-2016.

Qualifications of Internal Auditor: Internal Auditor shall either be a Chartered Accountant or a Cost Accountant or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the company. The internal auditor may or may not be an employee of the company.

Que. No. 52] Which types of Companies are required to constitute audit committee? Also state the scope and powers of audit committee.

Ans.: Constitution of Audit Committee [Section 177(1)]: The Board of Directors of every listed company and such other class or classes of companies, as may be prescribed, shall constitute an Audit Committee.

As per **Rule 6** of the **Companies (Meetings of Board & its Powers) Rules, 2014**, the Board of directors of every listed companies and the following classes of companies shall constitute an Audit Committee and a Nomination and Remuneration Committee of the Board-

(i) All public companies with a paid up capital of **Rs. 10 Crores** or more
(ii) All public companies having turnover of **Rs. 100 Crores** or more;
(iii) All public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding **Rs. 50 Crores** or more.

The paid up share capital or turnover or outstanding loans, or borrowings or debentures or deposits, as the case may be, as existing on the date of last audited Financial Statements shall be taken into account.

Composition of Audit Committee [Section 177(2)]: The Audit Committee shall consist of a minimum of 3 directors with independent directors forming a majority.

The majority of members of Audit Committee including its Chairperson shall be persons with ability to read and understand the financial statement.

Scope of Audit Committee [Section 177(4)]: Every Audit Committee shall act in accordance with the terms of reference specified in writing by the Board which shall, inter alia, include –

(i) The recommendation for appointment, remuneration and terms of appointment of auditors of the company.
(ii) Review and monitor the auditor's independence and performance, and effectiveness of audit process.
(iii) Examination of the financial statement and the auditors' report.
(iv) Approval or any subsequent modification of transactions of the company with related parties. However, the audit committee may make omnibus approval for related party transactions proposed to be entered by the company subject to such conditions as may be prescribed.

(v) Scrutiny of inter-corporate loans and investments
(vi) Valuation of undertakings or assets of the company, wherever it is necessary.
(vii) Evaluation of internal financial controls and risk management systems
(viii) Monitoring the end use of funds raised through public offers and related matters.

"Omnibus Approval" shall mean a blanket pre-activity approval by the Audit Committee subject to compliance of the conditions as laid in this Policy. [Revised Clause 49 mandated by the SEBI effective from October 1, 2014]

Interaction with internal and statutory auditors [Section 177(5)]: The Audit Committee may call for the comments of the auditors about internal control systems, the scope of audit, including the observations of the auditors and review of financial statement before their submission to the Board and may also discuss any related issues with the internal and statutory auditors and the management of the company.

Power to investigate and obtains professional advice [Section 177(6)]: The Audit Committee shall have authority to investigate into any matter in relation to the items specified section 177(4) or referred to it by the Board and shall have power to obtain professional advice from external sources and have full access to information contained in the records of the company.

Auditor and KMP right to be heard in the meetings of the Audit Committee [Section 177(7)]: The auditors of a company and the key managerial personnel shall have a right to be heard in the meetings of the Audit Committee when it considers the auditor's report but shall not have the right to vote.

Disclosure in Board's report [Section 177(8)]: The Board's report section 134(3) shall disclose the composition of an Audit Committee and where the Board had not accepted any recommendation of the Audit Committee, the same shall be disclosed in such report along with the reasons.

Que. No. 53] What are the provisions of the Companies Act, 2013 regarding establishment of Vigil Mechanism?

Ans.: Establishment of Vigil Mechanism [Section 177(9)]: Every listed company or prescribed classes of companies shall establish a vigil mechanism for directors and employees to report genuine concerns in prescribed manner.

Requirements of Vigil Mechanism [Section 177(10)]: The vigil mechanism shall provide for adequate safeguards against victimization of persons who use such mechanism and make provision for direct access to the chairperson of the Audit Committee in appropriate or exceptional cases.

Disclosure: The details of establishment of vigil mechanism shall be disclosed by the company on its website and in the Board's report.

As per **Rule 7** of the **Companies (Meetings of Board & its Powers) Rules, 2014**, every listed company and the companies belonging to the following class or classes shall establish a vigil mechanism for their directors and employees to report their genuine concerns or grievances-
(a) The Companies which accept deposits from the public
(b) The Companies which have borrowed money from banks and public financial institutions in excess of **Rs. 50 Crores.**

Audit committee to see the vigil mechanism: The companies which are required to constitute an audit committee shall oversee the vigil mechanism through the committee and if any of the members of the committee have a conflict of interest in a given case, they should rescue themselves and the others on the committee would deal with the matter on hand.

In case of other companies, the Board of directors shall nominate a director to play the role of audit committee for the purpose of vigil mechanism to whom other directors and employees may report their concerns.

Safeguards against victimization and access to audit committee: The vigil mechanism shall provide for adequate safeguards against victimization of employees and directors who avail of the vigil mechanism and also provide for direct access to the Chairperson of the Audit Committee or the director nominated to play the role of Audit Committee in exceptional cases.

Safeguards against frivolous complaints: In case of repeated frivolous complaints being filed by a director or an employee, the audit committee or the director nominated to play the role of audit committee may take suitable action against the concerned director or employee including reprimand.

Que. No. 54] Which types of companies are required to conduct secretarial audit? By whom such audit will be conducted? What is the penalty for or not conducting secretarial audit?

Ans.: Secretarial audit for bigger companies [Section 204]: Every listed company and a company belonging to prescribed class shall annex with its Board's report, a secretarial audit report, given by **Practicing Company Secretary (PCS)** in prescribed form.

It shall be the duty of the company to give all assistance and facilities to the PCS, for auditing the secretarial and related records of the company.

The Board of Directors, in their report shall explain in full any qualification or observation or other remarks made by the PCS.

If a company or any officer or PCS, contravenes the provisions of this section, they shall be punishable with fine which shall not be less than **Rs. 100000** but which may extend to **Rs. 500000.**

Secretarial Audit Report [Rule 9 of the Companies (Appointment & Remuneration of Managerial Personnel) Rules, 2014]: For the purposes section 204(1), the other class of companies shall be as under-

(a) Every public company having a paid-up share capital of **Rs. 50 Crores** or more or
(b) Every public company having a turnover of **Rs. 200 Crores** or more.

The format of the Secretarial Audit Report shall be in **Form No. MR.3.**

Que. No. 55] Write a short note on: CAG Audit

Ans.: In India, government audit is performed by an independent constitutional authority, i.e. Comptroller and Audit General of India (CAG), through the Indian Audit and Accounts Department. The Constitution of India gives a special status to the CAG and contains provisions to safeguard his independence.

Article 148 of the constitution provides that the CAG shall be appointed by the President and can be removed from the office only in a like manner and on the like grounds as a judge of the Supreme Court.

Article 151 requires that the audit reports of the CAG relating to the accounts of the Central/State Government should be submitted to the President/Governor of the State who shall cause them to be laid before Parliament/State Legislative.

The Comptroller & Audit General's (Duties, Power & Conditions of Services) Act, 1971, prescribes that the CAG shall hold office for a term of 6 years or up to the age of 65 years, which is earlier. He can resign at any time through a resignation letter addressed to the President. The Act also assigns the duties regarding the audit to be followed by CAG.

The organizations subject to the audit of the Comptroller and Auditor General of India are:-

- All the Union and State Government departments and offices including the Indian Railways and Posts and Telecommunications.
- About 1500 public commercial enterprises controlled by the Union and State government, i.e. government companies and corporations.
- Around 400 non-commercial autonomous bodies and authorities owned or controlled by the Union or the States.
- Over 4400 authorities and bodies substantially financed from Union or State revenues.

Que. No. 56] Write a short note on: Appointment of auditor of Government Companies

Ans.: Section 139(5) of **the Companies Act, 2013** 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 Comptroller and Auditor-General (CAG) of India shall, in respect of a financial Year, appoint an auditor duly qualified to be appointed as an auditor of companies within a period of 180 days from the commencement of the financial year, who shall hold office till the conclusion of the AGM.

Appointment of first auditor of a Government company: The first auditor of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any

State Government, the first auditor shall be appointed by the CAG within 60 days from the date of registration of the company and in case the CAG does not appoint such auditor within the said period, the Board of Directors of the company shall appoint such auditor within the next 30 days and in the case of failure of the Board to appoint such auditor within the next 30 days, it shall inform the members of the company who shall appoint such auditor within the 60 days at an EGM, who shall hold office till the conclusion of the first AGM.

Filling of casual vacancy of a Government company: In the case of a company whose accounts are subject to audit by an auditor appointed by the CAG, be filled by the CAG within 30 days. However in case the CAG does not fill the vacancy within the 30 days, the Board of Directors shall fill the vacancy within next 30 days.

Que. No. 57] In case of government companies, Comptroller and Auditor General of India have a right to issue direction to auditors and do supplementary audit. Explain.

Ans.: The Comptroller & Auditor General (CAG) plays a key role in the functioning of the financial committees of Parliament and the State Legislatures. He has come to be recognized as a 'friend, philosopher and guide' of the Committee.

As per **section 143** of the Companies Act, 2013, in the case of a government company, the CAG shall appoint the auditor and direct such auditor the manner in which the accounts of the government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the CAG which, among other things, include the directions, if any, issued by the CAG, the action taken thereon and its impact on the accounts and financial statement of the company.

The CAG shall within 60 days from the date of receipt of the audit report have a right to –

(a) Conduct a supplementary audit of the financial statement of the company by such person or persons as he may authorize in this behalf; and for the purposes of such audit, require information or additional information to be furnished to any person or persons, so authorized, on such matter, by such person or persons, and in such form, as the Comptroller and Auditor-General of India may direct and
(b) Comment upon or supplement such audit report:

Provided that any comments given by the CAG of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

Que. No. 58] Write a short note on: Audit of Government Companies (Commercial Audit)

Ans.: There is a special arrangement for the audit of companies where the equity participation by Government is 51% or more. The primary auditors of these companies are Chartered Accountants, appointed by the CAG, who gives the directions to the auditors on the manner in which the audit should be conducted by them. The CAG is also empowered to comment upon the audit reports of the primary auditors. In addition, the CAG conducts a test audit of the accounts of such companies and reports the results of his audit to Parliament and State Legislatures.

Que. No. 59] Write a short note on: Regularity & Performance Audit by CAG

Ans.: Nature of Audit: While fulfilling his Constitutional obligations, the CAG examines various aspects of Government expenditure. The audit done by CAG is broadly classified into Regularity Audit and Performance Audit.

Regularity Audit (Compliance):

- Audit against provision of funds to ascertain whether the moneys shown as expenditure in the Accounts were authorized for the purpose for which they were spent.
- Audit against rules and regulation to see that the expenditure incurred was in conformity with the laws, rules and regulations framed to regulate the procedure for expending public money.
- Audit of sanctions to expenditure to see that every item of expenditure was done with the approval of the competent authority in the Government for expending the public money.
- Propriety Audit which extends beyond scrutinizing the mere formality of expenditure to it wisdom and economy and to bring to light cases of improper expenditure or waste of public money.

While conducting the audit of receipts of the Central and State Governments, the Comptroller & Auditor General satisfies himself that the rules and procedures ensure that assessment, collection and allocation of revenue are done in accordance with the law and there is no leakage of revenue which legally should come to Government.

Regularity Audit (Financial): In regularity (financial) audit and in other types of audit when applicable, auditors analyze the financial statements to establish whether acceptable accounting standards for financial reporting and disclosure are complied with. Analysis of financial statements is performed to such a degree that a rational basis is obtained to express an opinion on financial statements.

Performance Audit: Performance audit is done to see that Government programs have achieved the desired objectives at lowest cost and given the intended benefits.

Que. No. 60] What actions are taken on audit report submitted by CAG? Who examines such audit report?

Ans.: Action on CAG Audit Reports: The Annual Accounts and the Audit Reports of public enterprises and government companies are scrutinized by the Parliament. Since parliament has limited time for discussion on the issue of national importance, therefore the Parliament and the State Legislatures have, constituted specialized Committees like the Public Accounts Committee (PAC) and the Committee on Public Undertakings (COPU) for review and scrutiny of audit Reports and Annual Accounts of public enterprises and government companies.

Que. No. 61] Write a short note on: Public Accounts Committee

Ans.: The Committee on Public Accounts is constituted by Parliament each year for examination of accounts showing the appropriation of sums granted by Parliament for expenditure of Government of India, the annual Finance Accounts of Government of India, and such other Accounts laid before Parliament as the Committee may deem fit, such as accounts of autonomous and semi-autonomous bodies.

Constitution of the Committee: The Committee consists of not more than **22 members** comprising 15 members elected by Lok Sabha every year from amongst its members according to the principle of proportional representation by means of single transferable vote and not more than 7 members of Rajya Sabha elected by that House in like manner are associated with the Committee. The Chairman is appointed by the Speaker from amongst its members of Lok Sabha. The Speaker, for the first time, appointed a member of the Opposition as the Chairman of the Committee for 1967-68. This practice has been continued since then. A Minister is not eligible to be elected as a member of the Committee. If a member, after his election to the Committee is appointed a Minister, he ceases to be a member of the Committee from the date of such appointment.

The Public Accounts Committee satisfies itself:

(a) That the money shown in the accounts as having been disbursed were legally available for, and applicable to the service or purpose to which they have been applied or charged;
(b) That the expenditure conforms to the authority which governs it; and
(c) That every re-appropriation has been made in accordance with the provisions made in this behalf under rules framed by the competent authority.

It is also the duty of the PAC to examine the statement of accounts of autonomous and semi-autonomous bodies, the audit of which is conducted by the CAG either under the directions of the President or by a Statute or Parliament.

Que. No. 62] Write a short note on: Committee on Public Undertakings

Ans.: The Committee on Public Undertakings exercises the same financial control on the public sector undertakings as the Public Accounts Committee exercises over the functioning of the Government Departments. The functions of the Committee are:

(a) To examine the reports and accounts of public undertakings.
(b) To examine the reports of the Comptroller & Auditor General on public undertakings.

(c) To examine the efficiency of public undertakings and to see whether they are being managed in accordance with sound business principles and prudent commercial practices.

The examination of public enterprises by the Committee takes the form of comprehensive appraisal or evaluation of performance of the undertaking. It involves a thorough examination, including evaluation of the policies, programs and financial working of the undertaking.

The objective of the Financial Committees, in doing so, is not to focus only on the individual irregularity, but on the defects in the system which led to such irregularity, and the need for correction of such systems and procedures.

<u>Que. No. 63] Explain the role of CAG in the functioning of financial committees of the Parliament.</u>

Ans.: The Comptroller & Auditor General (CAG) of India plays a key role in the functioning of the financial committees of Parliament and the State Legislatures. He has come to be recognized as a 'friend, philosopher and guide' of the Committee. His Reports generally form the basis of the Committees' working, although they are not precluded from examining issues not brought out in his Reports. He scrutinizes the notes which the Ministries submit to the Committees and helps the Committees to check the correctness submit to the Committees and helps the Committees to check the correctness of facts and figures in their draft reports.

The Financial Committees present their Report to the Parliament/State Legislature with their observations and recommendations. The various Ministries/Department of the Government are required to inform the Committees of the action taken by them on the recommendations of the Committees (which are generally accepted) and the Committees present Action Taken Reports to Parliament/Legislature.

In respect of those cases in Audit Reports, which could not be discussed in details by the Committees, written answers are obtained from the Department/Ministry concerned and are sometimes incorporated in the Reports presented to the Parliament/State Legislature. This ensures that the audit Reports are not taken lightly by the Government, even if the entire report is not deliberated upon by the Committee.

Que. No. 64] Following data is extracted from the books of Right Ltd, an unlisted company for the accounting year 2014-2015:

- Equity share capital	**: 40 Crores (80% of equity shares are held by the Central Government)**
- Outstanding term loans From various banks on Balance sheet date	**: 85 Crores (maximum outstanding balance during preceding accounting year was Rs. 118 Crores)**
- Turnover for the year	**: Rs. 1750 Crores.**

Considering the above, answer the following questions with brief reasoning –

(a) Should the company be subject to CAG audit?

(b) Is the company required to appoint internal auditor?

(c) **Is the company required to appoint secretarial auditor?**
(d) **Can the company appoint statutory auditor?**
(e) **Is it compulsory for the company to appoint cost auditor?**

Ans.: Answer to given problem is as follows:

(a) **CAG Audit:** More than 50% shares i.e. 80% shares in Right Ltd, is held by the Central Government and thus auditor in Right Ltd. will be appointed by the Comptroller & Auditor General of India (CAG). **[Section 139(5)]**

(b) **Appointment internal Auditor:** As per **Rule 13** of the **Companies (Accounts) Rules, 2014** the following class of companies shall be required to appoint an internal auditor or a firm of internal auditors, namely:

- **(a)** Every listed company
- **(b)** Every unlisted public company having –
  - (i) Paid up share capital of **Rs. 50 Crores of more** during the preceding financial year or
  - (ii) Turnover of **Rs. 200 Crores or more** during the preceding financial year or
  - (iii) Outstanding loans or borrowings from banks or public financial institutions exceeding **Rs. 100 Crores** or more at any point of time during the preceding financial year or
  - (iv) Outstanding deposits of **Rs. 25 Crores or more** at any point of time during the preceding financial year.

As per facts given in case, turnover of Right is more than Rs. 200 Crores i.e. Rs. 1750 Crores and hence appointment of internal auditor is compulsory.

(c) **Appointment secretarial auditor:** As per **Rule 9** of the **Companies (Appointment & Remuneration of Managerial Personnel) Rules, 2014** every public company having a paid-up share capital of **Rs. 50 Crores** or more or every public company having a turnover of **Rs. 200 Crores** or more has to appoint secretarial auditor. As per facts given in case, turnover of Right is more than Rs. 200 Crores i.e. Rs. 1750 Crores and hence appointment of internal auditor is compulsory.

(d) **Appointment statutory auditor:** Since Right Ltd. is Government Company and auditor is appointed by the CAG, it is not required to appoint statutory auditor.

(e) **Appointment cost auditor:** As per **Rule 4** of the **Companies (Cost Records & Audit) Rules, 2014**, the Right Ltd. is also required to appoint cost auditor if the company is covered by the Rule 3 of the said Rule.

Que. No. 65] Write a short note on: Internal Audit

Ans.: Internal audit is an evaluation and analysis of the business operation conducted by the internal audit staff. It is the part of overall system of internal control established in an organization. Internal audit is the independent appraisal activity within an organization for the review of accounting, financial and other business practices as protective and constructive arms of management. It is a type of control which functions by measuring and evaluating the effectiveness of other type of controls.

In big organization, an internal audit is carried out by the team of professionals in the organization. The internal audit is not mandatory but organization gets the internal audit done with a view to evaluate the effectiveness of internal control, the soundness of financial system, effectiveness of business processes etc. This provides management an assurance about the control process in the organization and it aids in early detection of inefficiencies/fraud etc. it helps the statutory auditors too in getting the statutory audit done effectively.

Que. No. 66] Write a short note on: Tax Audit

Ans.: In India, the Income-tax Act, 1961, provides for the compulsory audit of the accounts of certain income tax assessee whose turnover or receipts exceed the specified limits. The objective of such audit is to assist the tax authorities in making the correct income tax assessment of the assessee concerned. The tax auditor has to specifically report on certain transactions which have an effect on the income tax liability of the assessee concerned and are, thus important to the tax authorities. The Income-tax Act, 1961 also contains various other provisions whereby audit report is required to be submitted to get certain deductions, exemptions etc.

As per the Income-tax Act, every person carrying on business whose turnover exceeds Rs. 10000000 or gross receipts exceeds Rs. 2500000 if carrying on profession in the previous year shall get his accounts audited.

Que. No. 67] Write a short note on: Management Audit

Ans.: Management Audit is a structured review of the systems and procedures of an organization in order to evaluate whether they are being conducted efficiently and effectively. A management audit involves establishing performance objectives, agreeing the standards and criteria for assessment, and evaluating actual performance against targeted performance. Management audit is not mandatory but it recommendatory.

Que. No. 68] Write a short note on: Functional Audit

Ans.: In this form of audit, a function is analyzed thoroughly with respect to system process, input and output. This audit is being carried so as to evaluate the effectiveness of the department processes and for finding out the gaps in desired output and actual output with reasons. After the function audit, proper systems are put in place and gaps as indentified are filled by way of corrective actions.

Que. No. 69] Write a short note on: Propriety Audit

Ans.: Under this type of audit, the expenditure is analyzed with a view to ascertain the cases of improper, avoidable or in fructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. This audit is very important form of management audit and helps the management in finding out the inefficiencies in the system.

Propriety Audit carry out to check, mean whether the transactions have been done in conformity with established rules, principles and established standard. The Propriety Audit means the verification of following main aspects to find out whether:

- Proper recording has been done in appropriate books of account.
- The assets have not been misused and have been properly safeguarded.
- The business funds have been utilized properly.
- The concern is yielding the expected results.

The system of Propriety Audit is applied in respect to Government companies, Government Department because public money and public interest are involved therein. It is an essential function of audit to bring to light not only cases of clear irregularity but also every matter which in its judgment appears to involve improper expenditure or waste of public money or store, even though the accounts themselves may be insufficient to see that sundry rules or orders of competent authority have been observed. It is of equal importance to ensure that the broad principles of orthodox finance are borne in mind not only by disbursing officers but also by sanctioning authorities.

Que. No. 70] Write a short note on: Efficiency Audit

Ans.: Efficiency audit or performance audit is a form of audit which is being carried out for ascertaining the efficiency/performance of a system/process/input. This is being carried out to judge whether the result as achieved are in conformity with set standards or not. Such review may cover any activity within a department, division, or local area. A performance audit can be a review of a program to assure that it is satisfying its objectives. The performance audit may be initiated by the organization or by external interested parties.

Advantages of Efficiency Audit: Auditing efficiency enables the management/ owner to know whether the departments and agencies manage resources with due regards to efficiency. It can also directly or indirectly help departments and agencies to identify opportunities to provide more or better services at the same or lower cost. More specifically, such audits can:

- Help managers and staff to be more sensitive to their obligation of due regards to efficiency
- Underline the importance of measuring efficiency and of using that information for managing operations and providing accountability;
- Identify means for improving efficiency, even in operations where efficiency is difficult to measure;
- Demonstrate the scope for lowering the cost of delivering programs without reducing the quantity or quality of outputs or the level of service;
- Increase the quantity or improve the quality of outputs and level of service without increasing spending; and
- Identity needed improvements in existing controls, operational systems, and work processes for better use of resources.

Que. No. 71] What do you understand by "Compliance Audit"? What are the objectives of compliance audit? Also state the benefit of it.

Ans.: A compliance audit is a comprehensive review of an organization's adherence to regulatory guidelines. What, precisely, is examined in a compliance audit will vary depending upon whether an organization is a public or private company, what kind of data it handles and if it transmits or stores sensitive financial data.

It is common to us that the business undertakings require some certified statement on various matters and the auditors certify such statements after carrying out audit which might be necessary under the particular cases. All such audits are called compliance audit.

Example of compliance audit: If a company applies to a bank for some loan, a certified statement showing the turnover for the past 2 or 3 years might be necessary otherwise the application will be rejected. So these certified statements showing the turnover fall under the category of compliance audit. Internal audit for compliance could be broader base to include compliance with documented procedures/policies, compliance with statutory requirements in the relevant areas etc.

Objectives of compliance audit: The objective of a compliance audit is to determine whether the auditee is following prescribed laws, regulations, policies, or procedures. These audits can be performed within a business organization for internal purposes or in response to requirements by outside groups, particularly government.

Benefits of compliance audit:

- Adherence to the established standards.
- Improvement of internal processes and technologies.
- Maintenance of Certifications.
- Adherence to governmental regulations.
- Cost recovery.
- Elevate fraud awareness and deter fraudulent activity.
- Manage contract areas of risk.

INTERNAL CONTROL, INTERNAL CHECK AND INTERNAL AUDIT

Chapter 3

AHMED ALI
ca.ahmedali@gmail.com

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3.1 INTRODUCTION

An auditor must ensure that he fully understands the enterprise with which he is dealing before he determines his basic approach to an audit. He must familiarise himself with its organisation and comprehend the nature of the business. He must also ensure that he has thoroughly grasped any technicalities peculiar to the business. Only then will he 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.

Formerly, business systems were usually installed with the object of getting work done by the cheapest and quickest methods available, but whilst these objects have not been lost sight of, it has been realised that establishment of the piecemeal methods of uncoordinated work process is ultimately neither cheap nor efficient. Overall planning is necessary to establish a flow of work through the whole business, enabling it to run smoothly and efficiently and with the added requirement that its assets shall be safeguarded at the same time.

This overall planning and its practical operation is included under the title of internal control which is established by the management. Although the auditor in his role as an auditor has no right to practice any particular method of control to be operated, he is virtually concerned with it, as the efficiency or otherwise of the internal control will greatly influence the auditor’s method of working.

3.2 INTERNAL CONTROL

3.2.1 Definition

INTERNAL CONTROL is a process for assuring achievement of an organization's objectives in operational effectiveness and efficiency, reliable financial reporting, and compliance with laws, regulations and policies.

In other words, internal control system—the whole system of controls, financial or otherwise, established by the management in order to carry on the business of the enterprise in an orderly and efficient manner—ensures adherence to management policies, safeguards the assets and secures as far as possible the completeness and accuracy of the records.

Based on Various definitions provided by various author, it may be stated that a system of internal control provides a measure for the management to obtain information, protection and control which are quite important for the successful working of a business organisation.

3.2.2 Objectives of Internal Control

Internal control is of fundamental importance to the auditor, because before he can plan the tests he intends to carry out in his audit programme, he must decide the extent to which he intends to rely on the system of internal control. But before depending upon the internal control system of the organisation, the auditor should ensure himself that the following objectives of internal control as per AAS-6 is achieved by the organisation:

Proper authorisation Transactions are executed with management's general and specific authorisation.

Prompt recording of transactions All the transactions are promptly recorded in the correct amount in the appropriate accounts and in the accounting period in which they are executed so as to permit preparation of financial information within a framework of recognised accounting policies and to maintain accountability of assets.

Restricted access to assets Access to assets is permitted only in accordance with management's authorisation.

Actions against deviations The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

3.2.3 Basic Elements of Internal Control

An effective system of internal control should have the following basic elements:

1. *Financial and other organisational plans* This may take the form of a manual suitably classified by flow charts. It should specify the various duties and responsibilities of both management and staff, stating the powers of authorisation that reside with various members. This is important as in the event of staff absence or otherwise the correct flow of work and the internal control system could be vitiated by the wrong implementation of procedures by staff either innocently or willfully.

2. *Competent personnel* Personnel are the most important element of any internal control system. If the employees are competent and efficient in their assigned work, internal control system can be operated effectively even if some of the other elements of internal control system are absent.

3. *Division of work* This refers to the procedure of division of work properly among the employees of the organisation. Each and every work of the organisation should be divided in different stages and should be allocated to the employees in accordance with quality and skill.

4. *Separation of operational responsibility from record keeping* If each department of an organisation is being assigned to prepare its own records and reports, there may be a tendency to manipulate results for showing better performance. So, in order to ensure reliable records and information, record-keeping function is separated from the operational responsibility of the concerned department.

5. *Separation of the custody of assets from accounting* To protect against misuse of assets and their misappropriation, it is required that the custody of assets and their accounting should be done by separate persons. When a particular person performs both the functions, there is a chance of utilising the organisation's assets for his personal interest and adjusting the records to relieve himself from the responsibility of the asset.

6. *Authorisation* Under the internal control system, all the activities must be authorised by a proper authority. The individual or group which can grant either specific or general authority for transactions should hold a position commensurate with the nature and significance of the transactions and the policy for such authority should be established by top management.

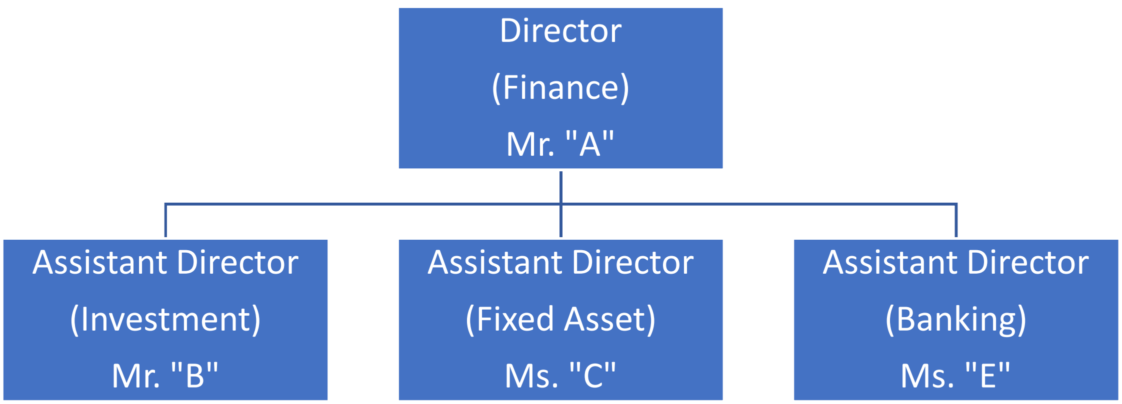
7. *Managerial supervision and review* The internal control system should be implemented and maintained in conformity with the environmental changes of the concern. By adapting any specific control system permanently, the extent to which the procedures of flexible controls have been followed in real practice should be observed and re-examined.

3.2.4 Types of Internal Control

Internal control can be categorised as follows:

1. Organisational

An enterprise should have a plan of organisation which should (a) define and allocate responsibilities and (b) identify lines of reporting, i.e. The delegation of authority and responsibility should be clearly specified. An employee should always know the precise powers delegated to him, the extent of his authority and to whom he should report.



2. By Segregation of Duties

1. No one person should be responsible for the recording and processing of a complete transaction.
2. The involvement of several people reduces the risk of intentional manipulation or accidental error and increases the element of checking of work.

3. Physical

1. This concerns physical custody of assets and involves procedures designed to limit access to authorised personnel only.
2. Access can be direct or indirect & are especially important in case of valuable, portable, exchangeable or desirable assets.

4. By Authorisation and Approval

All transactions should require authorisation or approval by an appropriate person. The limits to these authorisations should be specified. For example, all credit sales must be approved by the credit control department or all overtime must be authorised by the works manager.

5. Arithmetical and Accounting

1. These are the controls in the recording function which check that the transactions have been authorised, that they are all included and that they are correctly recorded and accurately processed. It include checking the arithmetical accuracy of the records, maintenance and checking of totals, reconciliation, control accounts, trial balances, accounting for documents and preview.

6. By Personnel

1. Procedures should be designed to ensure that the personnel operating a system are competent and motivated to carry out the tasks assigned to them, as the proper functioning of a system depends upon the competence and integrity of the operating personnel.
2. Measures include appropriate remuneration, promotion and career development prospects, selection of people with appropriate personal characteristics and training and assignment of tasks to the right level.

7. By supervision

All actions by all levels of staff should be supervised. The responsibility for supervision should be clearly laid down and communicated to the person being supervised.

8. By management

1. These are controls, exercised by management, which are outside and over and above the day-to-day routine of the system.
2. They include overall supervisory controls, review of management accounts, comparison with budgets, internal audit and any other special review procedures.

3.2.5 Advantages & Disadvantage of Internal Control

Advantages

The various advantages that may be derived from internal control system are summarised as follows:

1. *Identification of defects* Under internal control system, the total activities are segregated in such a way that the work preformed by one employee is automatically checked by another employee. So, if there is any defect in the system, it is easily detected.

2. *Flexibility* In this system, year-wise comparative analysis is done. So, if there is any change in the mode of operation, the changes in the system can easily be accommodated. Therefore, the opportunity for flexibility is available.

3. *Time savings* If the internal control system is in operation in an organisation, there is no need for the preparation of separate audit programmes for each and every audit engagement. Thus it saves time to a great extent.

4. *Lesser risk of omission* Under this system, the total work is sub-divided into a number of activities and each employee is assigned with a particular type of activity. So, there is least chance of oversight or omission of any matter.

5. *Provision for training facility* Due to lack of adequate experience, the auditor may face difficulty in establishing a close relationship between audit programme and the internal control system. This system itself provides training facilities to auditors to overcome this difficulty.

Disadvantages

It is also important to appreciate the following inherent limitations of internal control system:

1. *Chances of human error* The possibility of human error due to carelessness, mistakes of judgment or the misunderstanding of instructions may make the system ineffective.

2. *Cost* Management's usual requirement is that a control procedure should be cost-effective. But in many cases, the cost of internal control procedure will not be proportionate to the potential loss due to fraud and error.

3. *Ignorance of unusual activity* It is a fact that most of the internal control techniques are directed towards anticipated types of transactions and not on unusual transactions.

4. *Collusion* There may be the possibility of circumvention of controls through collusion with parties outside the entity or with employees of the entity.

5. *Abuse of responsibility* It may happen that a person responsible for exercising control abuses his responsibility.

6. *Rigidity* There is the possibility that the system may become inadequate due to changes in the conditions, and compliance with procedures may deteriorate.

3.2.6 Evaluation of Internal Control

Evaluation of internal controls is fundamental to an audit. It is on the basis of this evaluation that the auditor will do the following:

- Determine the nature and extent of his audit procedure, i.e. draw up his audit programme.
- Draft letters of weaknesses, to draw the attention of the management to inform them about the weaknesses of the system.

Because of its importance, evaluation must be clearly distinguished from the process of ascertaining and recording the system.

Before taking up the work of audit in an organisation, the auditor should ascertain the authenticity of the internal control system existing in the organisation. He should evaluate the control system in order to determine whether he would depend on the internal control system or not and if so, to what extent he would depend on it.

The auditor himself should determine the process or procedure applying his own knowledge and judgment in the context of nature and size of the organisation under audit.

The auditor, while evaluating the system of internal control, should consider the following matters.

- Whether the basic principles of internal control, which is prevailing in the organisation have been properly followed.
- Whether the procedures which are stated from theoretical point of view have been properly implemented.
- After definite interval of time, whether any changes are made in the system of internal control in the context of changed circumstances of the organisation.

On the basis of evaluation on the effectiveness of the internal audit system, the external auditor will decide the extent or degree of his reliance on the functioning of the internal audit system.

3.2.7 Internal Control and the Auditor

The Institute of Chartered Accountants of India in its Statement of Standard Auditing Practices (AAS-6) has stated the following.

"The duty of safeguarding the assets of a company is primarily that of the management and the auditor is entitled to rely upon the safeguards and internal controls instituted by the management, although he will of course take into account any deficiencies he may find therein, while drafting his programme."

So far as the auditor is concerned, the examination and evaluation of internal control system is an indispensable part of the overall audit programme. The auditor needs reasonable assurance that the accounting system is adequate and that all the accounting information, which should be recorded, has in fact been recorded. Internal control normally contributes to such assurance. The auditor should gain an understanding of the accounting system and related internal controls and should study and evaluate the operations of these internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures.

He can formulate his entire audit programme only after he has had a satisfactory understanding of the internal control systems and their actual operations. According to the American Institute of Certified Public Accountants, the auditor is required to make a proper review of the existing internal control and on the basis of such a review, the auditor should determine the resultant extent of the tests to which auditing procedures are to be restricted.

A proper understanding of the internal control system in its control and working also enable an auditor to decide upon the appropriate audit procedure to be applied in different areas that are covered in the audit programme. In a situation, where the internal controls are considered weak in some areas, the auditor might choose an audit procedure on test that otherwise might not be required; he might extend certain tests to cover a large number of transactions or other items than he otherwise would examine and at times he may perform additional tests for his satisfaction.

From the above, it can be concluded that the extent and nature of the audit programme is substantially influenced by the internal control system in operation. In deciding upon a plan of selective checking, the existence and operation of internal control system is of great significance.

3.2.8 Internal Control Checklist

This Checklist is basically a list of questions, to facilitate auditor in assessment of Internal Control, the questions answered 'yes' indicates Good Internal Control, whereas if answered 'no' it indicate a weak Internal Control. It helps auditor to assess strength of Internal Control & to design its Audit Sample & Techniques based on this assessments.

Example of Typical enquiries to be made to ensure effectiveness of an internal control:

1. *Inventory and Work-In-Progress*
    1. Are stocks kept in proper storage accommodation which protects them against various risks of Damages, Deterioration etc?
    2. Are all stock issues from stores made only against properly authorised requisitions?
    3. By whom can requisitions be authorised?
    4. Are proper Issue records maintained at the stores?
    5. Are inventory records maintained in respect of both quantity and value for each item?
    6. Are store records maintained by persons independent?
    7. Are the physical stock quantities regularly counted and reconciled with the stores records by persons independent of the storekeepers? Do they state approximate frequency of reconciliation?
    8. Are all material discrepancies independently investigated revealed?
    9. Are stores records amended to agree with actual quantities?
    10. Has adequate insurance been taken out in respect of the following catastrophe?
        i. Theft,
        ii. Fire or
        iii. Other risks (eg. Flood etc)
2. *In respect of Fixed Assets*

1. Are registers of fixed assets maintained, showing adequate details of all material assets?
2. Are regular physical inspections done to ensure the continued existence and to confirm the condition of assets by responsible officials?
3. Is there a proper system for distinguishing between capital and revenue expenditure?
4. Is the authorisation of capital expenditure properly evidenced?
5. By whom is the sale or scrapping of fixed assets authorised? Give details of who may authorise the sale or scrapping of fixed assets and the precise limits of their authority.
6. Do the rates of depreciation take due account of obsolescence?
7. Is the system adequate to ensure the correct calculation of depreciation in respect of individual assets?
8. Are the balances on the asset register regularly reconciled with the accounting records?

Note: The above have been given to give an idea about the internal control effectiveness, because of various method to control the business it would be difficult to draft a standardized Question.

3.2.9 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 which will achieve the objectives then follow.

1. 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

- An appropriate and integrated system of accounts and records
- Internal controls over those accounts and record
- Financial supervision and control by management, including budgetary control, management accounting reports, and interim accounts

- Safeguarding and, if necessary, duplicating records
- Engaging, training, allocating duties to specific staff who are capable of fulfilling their responsibilities, rotation of duties and cover for absences

2. Cash sales and collections

Objectives

- To ensure that all cash, to which the enterprise is entitled, is received
- To ensure that all such cash is properly accounted for and entered in the records
- To ensure that all such cash is deposited promptly and is intact

Measures

- Prescribing and limiting the number of persons who are authorised to receive cash, e.g., sales assistants, cashiers, etc.
- Establishing a means of evidencing cash receipts, e.g., pre-numbered duplicate receipt forms, cash registers with sealed till rolls; the duplicate receipt books should be securely held and issue controlled
- Ensuring that customers are aware that they must receive a receipt form or ensuring that the amount rung up on the cash register is clearly visible to the customer
- Appointment of officers with responsibility for emptying cash registers at prescribed intervals, and agreeing the amount present with till roll totals or internal registers. Such collections should be evidenced in writing and be initialed by the assistant and the supervisor
- Immediate and intact banking; payments should be made from funds drawn from the bank on an imprest system
- Investigation of shortage and excesses
- Independent comparison of agreed till roll totals with subsequent banking records
- Rotation of duties and cover for holidays (which should be compulsory) and sickness
- Collections by salesmen should be deposited in the bank promptly every day. There should be independent comparison of the amounts deposited with records of the salesmen
- Persons handling cash should not have access to other cash funds or to sales ledger records

3. Payment into bank

Objectives

- To ensure that all cash and cheques received is deposited in the bank promptly
- To ensure that all cash and cheques received are deposited without delay at prescribed intervals, preferably daily
- To ensure that all cash and cheques received are accounted for and recorded accordingly

Measures

- Cash and cheques should be intact
- Cash and cheques should be banked without delay
- The bank paying-in-slip should be prepared by an official with no access to cash collection points or bought or sales ledger
- Banking should be made with security in mind, e.g. for large cash deposits, security guards should be used
- There should be independent comparison of paying-in-slips with collection records, post lists and sales ledger records

4. Cash balances

Objectives

- To prevent misappropriation of cash
- To prevent unauthorised cash payments

Measures

- Establishment of cash floats of specified amounts and locations
- Appointment of officials responsible for each cash transaction
- Arrangement of security measures including use of safes and restriction of access
- Use of imprest system with rules on reimbursement only against authorised vouchers
- Strict rules on the authorising of cash payments
- Independent cash counts on a regular and a surprise basis
- Insurance arrangements, e.g. for cash balances and fidelity guarantee
- Special rules for IOUs. Preferably these should not be permitted

5. Cheque payments

Objective

To prevent unauthorised payments being made from bank accounts

Measures

- Control over custody and issue of unused cheque books. A register should be maintained if necessary
- Appointment of an official to be responsible for the preparation of cheques or traders credits
- Rules should be established for the presentation of supporting documents before cheques can be made. Such supporting documents may include goods receipt notes, orders, and invoices etc.
- All such documents should be stamped 'paid by cheque no...........' with date
- All cheques should be signed by at least two persons, with no person being permitted to sign if he is a payee
- No cheques should be made bearer cheques except for the collection of wages or reimbursement of cash funds
- All cheques should be strictly crossed
- The signing of blank cheques must be prohibited
- Special rules for authorising and checking direct debits and standing orders must be followed
- Separating the duties of custody, recording and initiation of cheque payments

6. Purchases and trade creditors

Objectives

- To ensure that goods and services are ordered only in the required quantity and quality and at the best terms available after appropriate requisition and approval
- To ensure that goods and services received are inspected and only acceptable items are accepted
- To ensure that all invoices are checked against authorised orders and receipts of the subject matter in good condition
- To ensure that all goods and services invoiced are properly recorded in the books

Measures

- There should be procedures for the requisitioning of goods and services only by specified personnel on specified forms with space for acknowledgement of performance.

- Order forms should be pre-numbered and kept in safe custody. Issue of blank order form books should be controlled and recorded.
- All goods received should be recorded on goods receipt notes or in a special book.
- All goods should be inspected for proper condition and agreement with order and counted on receipt. The inspection should be acknowledged.
- A listing of unfulfilled orders should be made and investigated at intervals.
- Invoices should be checked for arithmetical accuracy, pricing, correct treatment of VAT, trade discount and agreement with order.
- Total of entries in the invoice register or day book should be regularly checked.
- Responsibility for purchase ledger entries should be vested in personnel separate from personnel responsible for ordering, receipts of goods and the invoice register.
- The purchase ledger should be subject to frequent reconciliation in total or be checked by an independent senior official.
- Ledger account balances should be regularly compared with the supplier's statements of account.
- Cut-off procedures at the year-end are essential.
- A proper coding system is required for purchase of goods and services so that correct nominal accounts are debited.

7. Sales and debtors

Objectives

- To ensure that all customers' orders are promptly executed
- To ensure that sales on credit are made only to bona fide goods credit risks
- To ensure that all sales on credit are invoiced, that authorised prices are charged and that before issue all invoices are completed and checked as regards price, trade discounts and VAT
- To ensure that all invoices raised are entered in the books
- To ensure that all customers' claims are fully investigated before credit notes are issued
- To ensure that every effort is made to collect all debts

Measures

- Incoming orders should be recorded, and if necessary, acknowledged, on pre-numbered forms. Orders should be matched with invoices and lists of outstanding orders prepared at intervals for management action. Sequence checks should be made regularly by a senior official.
- There should be procedures laid down for verifying the credit worthiness of all persons or enterprises requesting goods on credit. A credit limit should be established.

- Selling prices should be prescribed. Policies should be laid down on credit term, trade and cash discounts and special prices.
- Invoicing should be carried out by a separate department. Invoices should be prenumbered and the custody and issue of unused invoice books controlled and recorded.
- All invoices should be independently checked for agreement with customer order, with the goods despatched records, for pricing, discounts, VAT and other details. All actions should be acknowledged by signature or initials.
- Accounting for sales and debtors should be segregated by employing separate staff for cash, invoice register, sales ledger entries and statement preparation.
- Sales invoices should be pre-listed before entry into the invoice register or day book and the pre-list total independently compared with the total of the register.
- Customer claims should be recorded and investigated. Similar controls should be applied to credit notes. At the end of the year, all unclear claims should be carefully investigated and assessed.
- A control account should be regularly and independently prepared.
- All balances must be reviewed regularly by an independent official to identify and investigate overdue accounts, debtors paying by instalments, and accounts where payments do not match with the invoices.
- Bad debts should be written off only after due investigation and acknowledged authorisation by senior management.
- At the year end, an analysis of debtors should be prepared to evaluate the need for a doubtful debt provision.

3.3 INTERNAL CHECK

3.3.1 Definition

Internal check is a method of organising the accounts system of a business concern or a factory where the duties of different clerks are arranged in such a way that the work of one person is automatically CHECKED BY ANOTHER and thus the possibility of fraud, or error or irregularity is minimised unless there is collusion between the clerks. For example, the receipt of cash is entered by the cashier on the debit side of the cash book; this entry is carried to the ledger by another clerk; the statement of account relating to this transaction is sent to the customer by a third clerk and so on. Thus the same transaction has passed through three different hands and the work of one is checked automatically by the other. It is a kind of division of Task. This minimises the possibilities of frauds and errors unless all the three join hands in defrauding their employer.

Internal check has been defined by the Institute of Chartered Accountants of England and Wales as "the checks on day to day transactions which operate continuously as part of the routine system, where the work of one person is proved independently or in complementary to the work of another, the object being the prevention or early detection of errors or frauds."

On the basis of the above definitions, it may be concluded that "*internal check is a system where the work is divided amongst the employees in such a manner that no single individual is allowed to carry on the whole function from the beginning to the end and the work of an individual is being automatically checked by another.*"

The essential elements of an internal check are:
(a) Instituting of checks on day-to-day transactions.
(b) These checks operate continuously as a part of routine system.
(c) Work of each person is made complementary to the work of another.

The objective of such allocation of the duties is that no one has an exclusive control over any transaction.

3.3.2 General Considerations in Framing a System of Internal Check

Following factors are required to be considered in framing a system of internal check:

1. *Work assignment* No single person should be given the total part of a particular work. All dealings and acts of every employee should, in the ordinary course, come under the review of another.

2. *Rotation of employees* The duties of members of the staff should be changed from time to time without any previous notice, so that the same officer or subordinate does not, without a break, perform the same function for a considerable length of time.

3. *Compulsory leave* Every member of the staff should be encouraged to go on leave at least once in a year. Experience has shown that frauds successfully concealed by the employees are often detected when they are on leave.

4. *Separation of inter-related jobs* Persons having physical custody of assets must not be permitted to have access to the books of accounts.

5. *Uses of mechanical devices* To prevent loss or misappropriation of cash, mechanical devices such as the automatic cash register should be employed.

6. *Periodical review* The financial and administrative power should be distributed very judiciously among different officers and in such manners that those which are actually exercised should be reviewed periodically.

7. *Responsibility* Responsibility of each individual must be properly defined and fixed. The work of the business should be allocated amongst various staff members in such a manner that their duties and responsibilities are clearly and judiciously divided.

8. *Safeguards* For stock taking at the end of the year, trading activities should, if possible, be suspended. The task of stock taking and evaluation should be done by staff belonging to several sections of the organisation. It may prove dangerous to depend exclusively on the stock section staff for these tasks since they may be tempted to under and/or overstate the stock.

9. *Supervision* A strict supervision should be exercised to ensure that the prescribed internal checks and procedures are fully operative.

10. *Reliance* No staff member of the business should be relied upon too much. The system must provide for an automatic checking of the work of every employee by another employee.

3.3.3 Objectives of Internal Check

The objects of internal check system can be set forth as under.

1. *Assigning responsibility* To allocate the duties and responsibilities of every employee in such a manner that they may be identified and held responsible for a particular error or fraud

2. *Minimising error or fraud* To minimise the possibility of any error or fraud done by any staff member

3. *Detecting errors or frauds* To detect errors or frauds easily due to independent checking of work done by one employee by another employee
4. *Reducing clerical mistakes* To minimise the possibility of omission of any transaction from being recorded in the books of accounts

5. *Enhancing work efficiency* To enhance the efficiency of the staff, as the management of duties is based on the principle of division of labour

6. *Obtaining confirmation* To obtain confirmation of facts and entries, physical and financial, by the presentation and necessary maintenance of records

7. *Reducing burden of work* To reduce the burden of the work of independent auditor by introducing the internal check system in a scientific way

8. *Exercising moral pressure* To exercise moral pressure on the employees by introducing continuous review process of the total system

9. *Ensuring reliability* To facilitate business control by ensuring the reliability of accounting records and books

10. *Obtaining supervision advantages* To obtain the advantages of supervising the various assets, inflow and outflow of cash and goods of the business

3.3.4 Advantages of internal check

The advantages that can be derived from internal check can be discussed from different points of view as follows:

1. From Business Point of View
2. From the owner's point of view
3.

The advantages from BUSINESS POINT OF VIEW are as follows:

1. *Proper allocation of work:* Rational allocation of work among the different staff members of the organisation brings precision in work.

2. *Control device:* The distribution of work under this system is such that it acts as a control device against unscrupulous employees. The chances of fraudulent manipulation are thus minimised due to the existence of this check.

3. *Speedy work:* As the individual staff is engaged in the same type of jobs for a considerable period of time, it results in the efficient performance of the activities and high speed of work.

4. *Increase in efficiency and skill:* A good system of internal check increases the efficiency of work among the staff due to its proper planning for assigning the right job to the right person.

5. *Easy preparation of final accounts:* Since no individual worker is allowed to handle a job completely and the work is divided among the employees in a proper manner, the books of accounts can be kept up to date; as a result, the final accounts can be prepared easily.

6. *Creation of moral check:* Knowledge of subsequent checking of each employee's work by another acts as a great check to commission of errors and frauds.

The advantages from OWNER'S POINT OF VIEW are as follows:

1. *Reliability on accounts:* If there is a good system of internal check, the owner of the concern may rely upon the genuineness and accuracy of the accounts.
2. *Orientation of accounting:* As the responsibility of each staff is clearly defined and fixed, it develops a system of accounting which is known as responsibility accounting.
3. *Economical operation:* Although it seems that the introduction of well-integrated system of internal check is costly, in actual practice it is observed that the staff patterns are so arranged that the existing staff be properly filled in different operating areas involving no extra cost.

The advantages from AUDITOR'S POINT OF VIEW are as follows:

1. *Facilitation of audit work:* Sound and efficient internal check system may facilitate to a greater extent, the work of the auditor by relying on 'test check'.
2. *Attention to other important matters:* As the auditor gains confidence on the internal check system, he can avoid the basic routine checking work to some extent and can give attention to other important matters.

3.3.5 Shortcomings of Internal Check System

Dependence on each other proves fatal in the quick disposal of the work. If one person is absent, the day-to-day work will be seriously disrupted. This is the main shortcoming of the internal check system.

Following are some more shortcomings of internal check system:

1. *Monotony* Involvement in the same kind of work may result in monotonous attitude on the part of the person who is engaged in the same type of job.

2. *Carelessness* The possibility of some of the responsible and high level officials being complacent increases, as they believe (though it is not always right) that under a sound system of internal check nothing can go wrong.

3. *Collusion* The real purpose of the internal check is bound to fail if collusion among the staff exists in disguise.

4. *Limited application* The application of this system is limited only in big organisations. Its application in small organisations may result in loss of time and cause unnecessary expenditure.

5. *Dependence* Statutory auditors in almost all cases rely on the internal check system. Accordingly they apply test check and not a thorough check.

6. *Possibility of disorder* In the absence of a properly organised system of internal check, there will be chaos and disorder in the working of a business.

3.3.6 Safeguard Against the Shortcomings of Internal Check

The advantages of the internal check system outweigh its disadvantages. Hence the wide acceptability of the system in the conduct of an audit is appreciated. The stated defects of the system, however, may be overcome if the management is careful in its effective implementation. The payment of proper incentives to staff may remove the carelessness of the staff to a great extent. The monotony of a job may be avoided by inter-departmental transfer of the employees. Regarding the collusion, it can be stated that the whole system is bound to fail if the morality of the employees deteriorates. General punishments like fine, termination of service etc. may temporarily check collusion, but without upgrading the morality of the staff, it is not possible to stop collusion permanently.

3.3.7 Internal Check and the Auditor

The basic responsibility of the auditor is to certify the fairness and authenticity of the accounts of the business. For this, the auditor is expected to discharge his duties in such a way as would reveal the actual state of affairs of the business. It is true that an efficient system of internal check can make his work easy and convenient. He may be relieved of detailed checking of the transactions. But to what extent an auditor should depend on the system of internal check is solely a matter of his own discretion. Though the auditor conducts the examination of the accounts independently, he has to depend a lot on the system of the business. Because it becomes practically impossible for the auditor to conduct the examination of accounts thoroughly after the close of the financial accounts.

Before he can decide upon the reliance on internal check system, he will have to take the following steps: -

1) *Seek a statement from his client in this regard.*
2) *Examine the system taking into account the size and nature of the business.*
3) *Examine the system especially from its weakest point to assess the possibilities of errors and frauds.*

If the auditor finds that the system of internal check is defective, he should carry on detailed checking.
An efficient system of internal check can reduce to a great extent the work of the auditor but does not reduce his liability. On the other hand, a defective system makes his work difficult.

Where the system of the internal check is not in operation, it is desirable that the auditor should adopt the detailed checking of transactions irrespective of the type of organisation and the volume of transactions. In order to save his time, if he adopts the method of test checking of few transactions and if errors and frauds are detected later on, the auditor will be held responsible. But where the internal check system is in operation and for this where detailed checking is not necessary, in that case to what extent the auditor would depend on internal check system is a matter of consideration.

If through review the auditor thinks that the system of internal check is adequate and free from errors he can depend on the system, and instead of detailed checking he can resort to test checking. But if he observes any weakness in the system, he should not depend on this and conduct his work extensively and in detail.

So, the auditor is expected to apply proper judgement with reasonable care and skill to appraise the system. Thus, he has to determine to what extent he would depend on internal check system. Hence, it is clear that the internal check system does not reduce the liability of the auditor.

3.4 INTERNAL AUDIT

3.4.1 Definition

Internal audit is the review of operations and records undertaken within a business by specially assigned staff on a continuous basis. Internal audit has been defined as "the independent appraisal of activity within an organization for the review of accounting, financial and other business practices as a protective and constructive arm of management. It is a type of control which functions by measuring and evaluating the effectiveness of other types of controls." Therefore it is clear that internal audit not only includes the verifications of accounting matters but also financial and other matters.

According to the Institute of Internal Auditors, USA. “Internal auditing is an independent appraisal function established within an organisation to examine and evaluate its activities as a service to the organisation.”

As per AAS-7, “internal audit is a separate part of internal control system. The objective of internal audit is to determine whether other internal control systems are well designed and properly operated. Internal auditor is appointed by the management and is part of overall organisation system of internal control”.

So, internal audit can be defined as “an independent appraisal function established by the management of an organisation for the review of internal control system as a service to the organisation. It objectively examines, evaluates and reports on the adequacy of internal control as a contribution to the proper, economic, efficient and effective use of resources”.

In fact, internal audit is a special type of control. It deals primarily with accounting and financial matters. The work of the internal auditor is more or less same as that of an external auditor. The internal auditor has to make an effort to find out the weaknesses of the internal control system in operation and suggest necessary improvements.

3.4.2 Basic Principles of Establishing Internal Auditing in a Business Concern

Following are the basic principles required to be considered before establishing internal auditing in a business concern.

1. *Independent Status* The internal audit department should have an independent status in the organisation. The internal auditor must have sufficiently high status in the organisation. He may be required to report directly to the board of directors.
2. *Scope of audit* The scope of internal audit department must be specified in a comprehensive manner to the extent practicable. In fact, the department must have the authority to investigate from a financial angle every phase of organisational activity.
3. *Clear objectives* It must have an unambiguous and clear understanding of the objectives on each assignment given to it from time to time.
4. *Formation of the department* The management should take care in selecting the staff of the internal audit department. The size and qualification of the staff of the internal audit department should be commensurate with the size of the business organisation.
5. *Time bound programme* The programme of the internal auditor should be time bound with the provision for periodic reporting.
6. *Internal audit report* The copy of the report of the internal auditor should be made available to the statutory auditor.
7. *Follow up action* There must exist a specific procedure to follow up the report submitted by the internal audit department.
8. *Performance of executive actions* The internal audit department should not be involved in performance of executive actions.

3.4.3 Scope and Objectives of Internal Audit

The primary objective of internal audit lies in helping the management attain maximum efficiency by providing an important source of review of operations and records for the assistance of all levels of management.

As per AAS-7, following are the objectives of internal audit:

- Review of accounting system and related internal control
- Examination of financial and operating system
- Examination of effectiveness and efficiency of financial control
- Physical examination and verification

Thus, internal audit carries out a thorough examination of the accounting transactions as well as that of the system according to which these have been recorded with a view to reassuring the management that the accounts are being properly maintained. It also ensures that the system contains adequate safeguards to check any leakage of revenue or misappropriation of property and the operations have been carried out in conformity with the plans of the management.

So, the objectives of an internal audit can be stated as follows:

1. *Accuracy in accounts* To verify the accuracy and authenticity of the financial accounting and other records presented to the management.
2. *Adoption of standard accounting practices* To ascertain that the standard accounting practices, as have been decided to be followed by the organisation, are being adhered to.
3. *Proper authority on assets* To establish that there is a proper authority for every acquisition, retirement and disposal of assets.
4. *Confirmation of liabilities* To confirm that liabilities have been incurred only for the legitimate activities of the organisation.
5. *Analysis of internal check system* To analyse and improve the system of internal check to see whether it is working properly and effectively and whether the system is economical.
6. *Prevention and detection of fraud* To implement such techniques in the conduct of the internal audit so that it can detect and prevent frauds in the accounts.
7. *Provision for new ideas* To provide a channel whereby new ideas can be brought to the attention of the management.
8. *Review of the operation of internal control system* To review the operation of the overall internal control system and to bring material departures and non-compliance to the notice of the appropriate level of management.
9. *Special investigation* To provide scope and make avenues for special investigations for the management.
10. *Review of organisational activities* To review the operations carried out in the organisation to assure the management that they are being carried out in compliance with the management objectives, policies and plans.

3.4.4 Essential Elements of Internal Audit

The essential elements of internal audit are as follows:

1. *Independence* Internal auditing is carried out by independent personnel. Internal auditors are employees of the firm and thus independence is not always easy to achieve.
2. *Staffing* The internal audit unit should be adequately staffed in terms of numbers, grades and experience.

3. *Relationships* Internal auditors should foster constructive working relationships and mutual understanding with management, external auditors, any review agencies and where appropriate with an audit committee. Mutual understanding is the goal.
4. *Due care* An internal auditor should behave much as an external auditor in terms of skill, care and judgment. He should be technically up to date and have personal standards of knowledge, honesty, probity and integrity much as an external auditor.
5. *Specific audit planning* On the basis of the objectives of the organisation and the objective of the internal audit of the organisation, the internal auditors should prepare the audit programme in order to cover the specified tasks assigned by the management.
6. *Systems control* The internal auditor must verify the operations of the system in much the same way as an external auditor, i.e. by investigation, recording, identification of controls and compliance testing of the controls.
7. *Evidence* The internal auditor must have similar standards for evidence as an external auditor. He must evaluate audit evidence in terms of sufficiency, relevance and reliability.
8. *Reporting* The internal auditor must produce timely, accurate and comprehensive reports to management on a regular basis.

3.4.5 Advantages & Disadvantages of Internal Audit

Internal audit provides the following advantages.

1. *Prevention of errors and frauds* It helps in the prevention of errors and frauds including misappropriation of cash and goods.
2. *Early detection of errors and frauds* It makes early detection of errors and frauds possible.
3. *Continuous review of internal control system* It undertakes continuous review of the internal control system and, as a result, it is capable of reporting irregularities for enabling corrective action in time.
4. *Assurance regarding accuracy of books and accounts* It checks books, records and accounts to ensure correct recording and their maintenance up to date.
5. *Preparation of interim accounts* It facilitates the preparation of interim accounts.
6. *Early completion of annual audit* It is of great use in early completion of annual statutory audit.
7. *Periodic physical verification* It carries out periodic physical verification of assets like cash, stock, investments and items of fixed assets.
8. *Assistance to the statutory auditor* It can render direct assistance to the statutory auditor by undertaking detailed checking of the accounting data and leave him free to concentrate on more important issues of principle, presentation and policy on accounting.

Disadvantages

Internal audit suffers from the following limitations.

1. *Extra cost* Internal audit system is not possible to be adopted by small organisations because the cost of running an internal audit department is very high.
2. *Biased opinion* Internal audit department employees are the paid-staff of the organisation. In most cases, they have to work according to the directions of the management. So it is not expected that they will provide unbiased opinion about the financial statements.
3. *Possibility of becoming ineffective* If the employees of the internal audit department are not efficient or if the internal audit is not conducted effectively, it will provide no assistance to the management.
4. *Possibility of distortion* If the management is interested to distort financial figures and if it is supported by internal audit department, the users of the financial statements will be totally misguided.
5. *Inefficient staff members* As there is no prescribed qualification for the appointment of internal auditors, less qualified persons may get appointment in the department. They will not be able to discharge their duties properly.

3.4.6 Area of Internal Audit

As per AAS-7, the scope and objectives of internal audit vary widely and are dependent upon the size and structure of the entity and the requirements of its management.

Normally, however, internal audit operates in one or more of the following areas:

1. *Review of accounting system and related internal control* The establishment of an adequate accounting system and related controls is the responsibility of the management, which demands proper attention on a continuous basis. The internal audit function is often assigned specific responsibility by the management for reviewing the accounting system and related accounting controls, monitoring their operation and suggesting improvements thereto.

2. *Examination for management of financial and operating information* This may include review of the means used to identify, measure, classify and report such information and specific inquiry into individual items including detailed testing of transactions, balances and procedures.

3. *Examination of the effectiveness of operations* Generally, the external auditor is interested in the results of such audit work only when it has an important bearing on the reliability of the financial records.

4. *Physical verification* The internal audit generally includes examination and verification of physical existence and condition of the tangible assets of the entity.

3.4.7 Distinction between Internal Audit and External Audit

On accounting matters, the internal and the external auditors operate mainly in the same field and they have a common interest in ascertaining that there is an effective system of internal control to present or detect errors and frauds and to ensure that it is operating satisfactorily and that an adequate accounting system exists to provide the information necessary for preparing true and fair financial statements.

What differentiate the two is on following ground

Particular	Internal Auditor	External Auditor
Appointment	By Company	By Statute
Scope	Defined by Management (Narrow)	Defined by Statute (Broad)
Responsible to	Management	StakeHolders/Statute
Report Format	Not Specific	Specific / Pre-Defined
Report Used by	Management	StakeHolders/Statute
Period of Audit	Normally throughout the Year	Yearly

The wide experience of the external auditor may be of assistance to the internal auditor; while on the other hand the latter's intimate acquaintance with the business concern may be of help to the external auditor. Co-operation in planning of the respective auditors may save unnecessary work, although the external auditor must always satisfy himself as to the work carried out by the internal auditor.

3.4.8 Relying Upon the Work of An Internal Auditor

The statement on AAS-7 describes the scope of reliance by the external auditor upon the work of an internal auditor. The purpose of this statement is to provide guidance as to the procedures, which should be applied by the external auditor in assessing the work of the internal auditor for the purpose of placing reliance upon that work. This statement states that while the external auditor has the sole responsibility of his report, however much of the work of the internal auditor may be useful to him in his examination of the financial statements. The responsibility of the external auditor is not reduced by any means because of the reliance placed on the work of the internal auditor.

As per AAS-7, the external auditor can use the work of the internal auditor after evaluation of the internal audit function. The external auditor should document his evaluation and conclusion in this respect while evaluating the work of internal audit function to determine the extent to which he can place reliance upon

3.6 DISTINCTION BETWEEN INTERNAL CONTROL AND INTERNAL AUDIT

A system of internal control consists of all the measures employed by an organisation for the purposes of

1. safeguarding its resources against waste, fraud and inefficiency,
2. promoting accuracy and reliability in accounting and operational data,
3. encouraging and measuring compliance with the organisational policy, and
4. judging the efficiency of operations in all the divisions of the business.

It is concerned with the plan of the organisation, allocation of duties among the employees and authorising, recording and custody procedures to ensure operation of internal check on the one hand and managerial supervision and review on the other. Managerial supervision and review is accomplished by the sub-system of internal auditing which is a part of the total internal control system.

Though internal audit is a part of the internal control system, it is indeed a significant part as with the introduction of internal audit system, the performance and compliance with management policies and practices are ascertained on a continuous and timely basis and brought to the notice of management. Internal audit also reviews the overall internal control system, its efficiency or redundancy, though it is itself a part of that overall system. In other words, internal auditing, though a part of the total internal control system, is also a significant complement of the system, reviews the system and checks its operations so that the management can be given up-to-date information on the effectiveness of control and the underlying operations.

3.7 DISTINCTION BETWEEN INTERNAL CHECK, INTERNAL AUDIT AND INTERNAL CONTROL

Internal check has been defined by the Institute of Chartered Accountants in England and Wales, as the "checks on day-to-day transactions which operate continuously as part of the routine system whereby the work of one person is proved independently or complementary to the work of another, the object being the prevention or earlier detection of error or fraud." The internal check in accounting system implies the organisation of the system of book-keeping and arrangement of staff duties in such a manner that no one person can completely carry through a transaction, and record every aspect thereof.

Internal audit has been defined by the Institute of Internal Auditors, USA recently of as an "independent, objective assurance and consulting activity designed to add value and improve an organisations, operations. It helps an organisation accomplish its objectives by bringing a systematic disciplined approach to evaluate and improve the effectiveness of risk management, control and governance process." Traditionally internal auditing was considered to be restricted to the examination of the books of accounts of the organisation with a view to ascertaining whether they correctly record the transaction. In fact, a good internal control system should have internal audit as an integral part. The modern concept of internal auditing as given in the aforesaid definition shows that internal auditing has moved significantly ahead by shouldering greater responsibilities to become one of the important management control devices.

It can be seen from the above definitions of both internal check and internal audit that they are parts of overall control system. Internal check operates as a built-in device as far as staff organisation and job allocation aspects of the control system are concerned. On the other hand, the adequacy and operations of internal control on a regular basis is to be reviewed by the management through internal audit system to ensure that all significant controls are operating effectively. Thus, internal check is merely an arrangement of bookkeeping and clerical duties, but internal audit involves evaluating the quality and operation of the various controls.

POINTS TO PONDER

- Internal control refers to the various methods and procedures adopted for the control of production, distribution and the whole system (financial and non-financial) of the enterprise.
- Basic elements of internal control include financial and other organisational plans, competent personnel, division of work, separation of operational responsibility for recording keeping, separation of the custody of assets from accounting, authorisation and managerial supervision and review.
- Internal control can be categorised as organisation, segregation of duties, physical, authorisation and approval, arithmetical and accounting, personnel, supervision and management.
- Advantages of internal control include identification of defects, flexibility, time saving, lesser risk of omission and provision for training facility.
- Disadvantages of internal control include chances of human error, costly, ignorance of unusual activity, collusion, abuse of responsibility and rigidity.
- Evaluation of internal controls is fundamental to an audit. On the basis of evaluation on the effectiveness of the internal control system, the external auditor will decide the extent or degree of his reliance on the functioning on the internal control system.
- Internal control questionnaire is basically a comprehensive list of questions, covering every aspect of the client's system, the answers to which will enable the auditor to assess the internal controls in operation.
- Internal check is arrangement of the duties of the staff members of the accounting functions in such a way that the work performed by a person is automatically checked by another.
- Factors to be considered in framing a system of internal check include work assignment, rotation of employees, compulsory leave, supervision of inter-related jobs, uses of mechanical devices, periodical review, responsibility, safeguards, supervision and reliance.
- Objectives of internal check include assigning responsibility, minimising error or fraud, detecting error or fraud, reducing clerical mistakes, enhancing work efficiency, obtaining confirmation, reducing burden of work, exercising moral pressure, ensuring reliability and obtaining supervision advantages.
- Advantages of internal check can be viewed from three different viewpoints. From business point of view, the advantages include proper allocation of work, control device, speedy work, increase in efficiency and skill, easy preparation of final accounts and creation of moral check. From the viewpoint of the owners, the advantages include reliability on accounts, orientation of accounting and economical operation. From the viewpoint of the auditor, the advantages include facilitation of audit work and attention to other important matters.

- Shortcomings of internal check include monotony, carelessness, collusion, limited application, dependence and possibility of disorder.
- The auditor is expected to apply proper judgement with reasonable care and skill to appraise the internal check system. He has to determine to what extent he would depend on internal check system, as internal check system does not reduce the liability of the auditor.
- Internal audit refers to an independent appraisal of activity within an organisation for the review of accounting, financial and other business practices. It is a separate part of internal control system.
- Basic principles of establishing internal audit in a business concern include independent status, scope of audit, clear objectives, formation of the department, time-bound programme, internal audit report, follow-up action and performance of executive action.
- Objectives behind establishment of internal audit department include accuracy in accounts, adoption of standard accounting practices, proper authority on assets, confirmation of liabilities, analysis of internal control system, prevention and detection of fraud, provision for new ideas, review of the operation of the internal control system, special investigation and review of organisational activities.
- Internal audit performs a number of functions including appraisal function, service to the organisation and other duties.
- Essential elements of internal audit include independence, staffing, relationship, due care, specific audit planning, systems control, evidence and reporting.
- Prevention of errors and frauds, early detection of errors and frauds, continuous review of internal control system, assurance regarding accuracy of books and accounts, preparation of interim accounts, early completion of annual audit, periodic physical verification and assistance to the statutory auditor are the advantages of internal audit system.
- Disadvantages of internal audit include extra cost, biased opinion, possibility of becoming ineffective, possibility of distortion and inefficient staff members.
- Area of internal audit covers review of accounting system and related internal control, examination for management of financial and operating information, examination of the effectiveness of operations and physical verification.
- External audit and internal audit can be differentiated with respect to appointment, scope, approach, responsibility, objectives and independence.
- The statutory auditor can use the work of the internal auditor after evaluation of the internal function, but the responsibility for any deficiency will be of the statutory auditor and he cannot plead that he has relied on the work done by the internal auditor.
- Auditor’s independence means the judgement of the auditor is not subordinated to the wishes or directions of any person who might have engaged him or to his self-interest. The principal advantage of an independent audit lies in the society being able to get an

informed, objective and unbiased opinion on the financial statements of an organisation.

Review Questions

Short-answer 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 is the internal auditor responsible for internal control?
5. How does the internal check system affect the work of an external auditor?
6. What are the precautions to be taken in the application of internal check system?
7. State briefly the matters to be included in the auditor's report in respect of the internal audit system of a large manufacturing company?
8. What are the objectives of internal audit?

Essay-type Questions

1. What do you mean by the term 'internal control'? What are the important features of a good system of internal control?
2. What is internal audit? Distinguish between internal control and internal audit? "The modern concept of internal audit envisages scope of internal audit much beyond financial audit". Explain.
3. 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.
4. Draft a form of questionnaire, that you would use to determine the effectiveness of the client's internal control over payrolls.
5. "In a good system of internal check, the work of one is checked indirectly by the work of another" Explain and discuss this statement with examples.
6. What system of internal check would you recommend for a manufacturing concern to prevent fraud in connection with credit purchase of raw materials.

COMPANY AUDITOR

An auditor is a person who is appointed to conduct an independent examination of books, accounts and supporting vouchers to report on the reliability and fairness of profit and loss account and balance sheet. He is a professional, having specialised 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. 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".

Appointment of Auditors

Various provisions of Companies Act 2013 defines how appointment of the auditors is made:

First Auditor

The appointment of first auditors should be made by the Board of Directors within one month of the date of registration of the company. The auditor or auditors so appointed shall hold office till the conclusion of the first annual general meeting.

But the company may at a general meeting remove such an auditor and appoint another in his place, on a nomination being made by any member of the company, notice being given to the members of the company, not less than 14 days before the date of the meeting.

If the first auditor is not appointed by the directors, within one month of registration, the company in general meeting may appoint the first auditor. 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 the next annual general meeting.

An auditor once appointed may be reappointed in the next annual general meeting or a new auditor may be appointed in his place. It is obligatory on the part of a company to annually make such an appointment, as well as to give, within seven days of the appointment, intimation to every auditor so appointed or reappointed.

Subsequent Auditors

Subsequent auditors of a company are appointed every year by the shareholders in annual general meeting by passing an ordinary resolution. "Every Company shall, at each annual general meeting, appoint an auditor to hold office". The auditor so appointed to communicate his acceptance or refusal to the Registrar of Companies within the period of 30 days of the receipt of appointment order from the company intimating his appointment.

If the auditor so appointed does not accept the appointment, the vacancy can neither be treated as casual vacancy nor a vacancy by resignation. The Research Committee of the Institute of Chartered Accountants of India has clearly expressed this opinion on the strength of the provisions of the Companies Act, which vest the general power with shareholders and the delegation of powers to the Board of Directors is not permitted. Therefore, another general meeting has to be convened to appoint new auditor.

Appointment by Central Government

Where at an annual general meeting, no auditors are appointed or re-appointed, the Central Government may appoint a person to fill the vacancy. Within seven days of the power of the Central Government becoming exercisable, the company shall give notice of that fact to the Central Government. Failure to give such notice will make the company in default with a fine.

Appointment Against a Casual Vacancy

If due to death, insanity or insolvency etc, a casual vacancy of the auditor arises, the auditor appointed against such a vacancy will hold office till the conclusion of the next annual general meeting.

Appointment by Special Resolution

In case of a company in which 25% or more of the subscribed share capital is held whether individually or collectively by:

- a public financial institution or
- a government company or
- any state government or
- any financial or
- other institution established by any provincial or state Act in which a state government holds not less than 51% of the subscribed share capital or

- a nationalised bank or an insurance company carrying on general insurance business

the appointment of the auditor shall be made by a special resolution.

If the company fails to pass a special resolution, it shall be deemed that no auditor has been appointed by the company at its annual general meeting and the Central Government will be empowered to make an appointment.

Appointment of Auditors of Government or Certain Other Companies

The auditor of a government company shall be appointed or reappointed by the Central Government on the advice of the Comptroller and Auditor General of India.

The professional auditor should keep these provisions in mind while accepting an appointment as the auditor of a company since the onus of complying with the provisions of ACT lies with the concerned companies. All the same, it would be necessary on the part of the auditors appointed or re-appointed to ensure, before accepting the appointment/re-appointment, that the company concerned is in fact outside the ambit of Section of the Act.

Tenure of Appointment

An auditor is appointed from the conclusion of one annual general meeting until the conclusion of next annual general meeting. But, if the annual general meeting is not held within the period prescribed by ACT, the auditor will continue in office till the annual general meeting is actually held and concluded. So, if an annual general meeting is adjourned, his tenure will extend till the conclusion of the adjourned meeting.

Re-Appointment of Retiring Auditor

According to the provisions of the ACT, retiring auditor, by whatsoever authority appointed, shall be automatically re-appointed by passing an ordinary resolution except in the following circumstances:

1. Where he is not qualified for re-appointment.
2. Where he has given to the company a notice in writing of his unwillingness to be re-appointed.
3. Where a resolution has been passed at the meeting, appointing somebody else instead of him or providing expressly that he shall not be re-appointed.

4. Where a notice has been given of an intended resolution to appoint some person in the place of retiring auditor, and by reason of death, incapacity or disqualification of that person, the resolution cannot be proceeded with.

The re-appointment will not be automatic. Also, the non-reappointment of the retiring auditor in the annual general meeting is not removal of the auditor. It will be considered simply as retirement.

The auditor will also not been re-appointed in the following two special cases:

1. Where he holds the audit of specified number of companies or more than that on the day of appointment.
2. Where 25% or more of the subscribed capital of the company is held by public financial institution(s), government companies etc. or a combination of them, unless the retiring auditor is appointed by a special resolution.

The rights of retiring auditor are as follows:

1. He has the right to receive the notice of the resolution.
2. He has the right to make a written presentation to the company and requests its notification to members of the company.
3. The auditor has the right to get his representation circulated among the members.
4. He has the right to get his representation read out at the meeting, if it has not been sent to the members because of delay or default on the part of the company.

Ceiling on Number of Audits

The Companies (Amendment) Act, 1974 added two new sub-sections 224 (1B) and 224 (1C) on ceiling on number of audits. The objective of these sections is to prevent concentration of audits in few hands.

According to Section 224 (1B), an individual cannot be the auditor of more than 20 companies at a time. Further, out of these 20 companies, not more than 10 should be companies having a paid-up share capital of Rs. 25 lakhs or more. In case of a partnership firm of auditors, the ceiling is 20 companies per partner of the firm and if a partner is also a partner in any other firm, the overall ceiling in relation to such a partner will be 20.

So now the Limit of 20 Companies includes: -

a) Public Companies

b) Private Companies having paid up capital of Rs. 100 crores or more

Remuneration of Auditor

1. In case of an auditor appointed by the Board of Directors or the Central Government, his remuneration may be fixed by the Board of Directors or the Central Government as the case may be.
2. In all other respect, it must be fixed by the company in general meeting or in such manner as the company in general meeting may determine.

'Remuneration' includes any sum paid by the company in respect of the auditor's expenses in carrying out his duties. Obviously, the general meeting can disperse without deciding the amount of the remuneration of the auditor. However, it must provide the manner in which the remuneration can be determined. If an auditor renders services other than the audit work, he will be entitled to get additional remuneration for such work. A special disclosure of all amount paid to the auditor in whatever capacity is required to be made in the Profit and Loss Account.

Where the auditor is re-appointed in the next annual general meeting, the amount fixed for the previous year continues to be the remuneration of the auditor unless specific changes are made.

Qualification of an Auditor

Companies Act prescribes the qualification and disqualification of Company Auditors.

"a person shall not be qualified as auditor of a company unless he is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949".

It further provides that a firm whereof all the partners practicing in India are qualified for appointment as auditors may be appointed by firm's name to be the auditor of the company. In this connection, it may be noted that under the Chartered Accountants Act, 1949 only a chartered accountant having a certificate of practice can be engaged in the public practice of the profession of accountancy. Therefore, only a practicing-chartered accountant can be appointed as an auditor of a company.

Disqualification of an Auditor

Companies Act provides the criteria or conditions for disqualification of auditors. According to it, none of the following shall be qualified for appointment as an auditor of a company:

1. A body corporate;
2. An officer or employee of the company;
3. A partner or an employee of an officer or employee of the company;
4. A person who is indebted to the company for an amount exceeding Rs. 1,000 or who has given any guarantee or provided any security in connection with the indebtness of any third person; and
5. A person holding any security of the auditee company when such security carries voting right.

A person shall not be qualified for appointment as an auditor of a company if he is, disqualified for appointment as an auditor of any other company, which is that company's *subsidiary or holding company or a subsidiary of that company's holding company*.

If the auditor ceases to be a member of the Institute of Chartered Accountants of India or adjudged as having unsound mind or is an undischarged insolvent, he attracts disqualification.

If after his appointment, an auditor becomes disqualified subject to any of the points listed above, he shall be deemed to have vacated his office as such.

Removal of Auditors

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.

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 service of the first auditor appointed by the Board and supposed to hold office till the conclusion of the first annual general meeting can be terminated beforehand by way of passing a resolution in a general meeting. However, the removal of any subsequent auditor before the expiry of his term is difficult in the sense that it requires the approval of the Central Government. So, the Central Government has to be convinced about the unsuitability of the existing auditor to continue as auditor.

The Companies Act lays down clear procedures about the removal of auditors:

Removal Before the Expiry of the Term

1. It is provided that the company can remove in a general meeting the first auditor appointed by the Board of Directors.
2. It is provided that except the first auditor, auditors appointed could be removed before the expiry of the term in a general meeting, only after obtaining previous approval of the Central Government.

Removal After the Expiry of the Term

The auditor can be removed after the expiry of his term of office, as per the procedures laid down in the ACT. According to the section, for removal of a retiring auditor or appointing another auditor in his place, the following procedures must be observed:

1. Special notice must be given by a member of the intended resolution to be passed at an annual general meeting.
2. On receipt of such a notice, the company shall forward a copy thereof to the retiring auditor.
3. The retiring auditor then may make written representation to the company not exceeding a reasonable length and request their notification to the members of the company.

The company shall, unless the representations are received by it too late to do so

1. state the fact of the representation in any notice of the resolution given to members of the company and
2. send a copy of the representation to every members of the company to whom notice of the meeting is sent.

If a copy of the representation is not sent as aforesaid, because they are received too late or because of the company's default, the auditor may require that the representation shall be read out at the meeting. However, these are not required, if the Company Law Board is satisfied that the above rights are abused by the auditor.

Removal as per 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 mention 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.

Auditor's Rights, Duties and Liabilities

The auditor of a company has statutory rights, duties and liabilities under the Companies Act.

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 of the partnership firm as the case may be. But the Companies Act, 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.* that any resolution precluding the auditor from of 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:

Right of Access to Books and Vouchers

The Companies Act, 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.

Right to Obtain Information and Explanations

The Companies Act, 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. Corresponding to the right to ask for information and explanations, The Act also makes it obligatory for the concerned officers of the company to furnish without delay the relevant information to the auditor.

Right to Visit Branch Offices and Access to Branch Accounts

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.

Right to Receive Branch Audit Reports

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.

Right to Receive Notices and to Attend General Meeting

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.

Right to Make Representation

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. 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.

Right to Sign Audit Report

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.

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].

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, it he is not held guilty by the law.

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 [*Homer vs. Quitler*].

Right of Lien of Company Auditor

The right of 'lien' means right of one person to retain the property of another person who owes money to the former. The right of lien of an auditor of a limited company indicates his right to retain documents and records of the company for his unpaid fees. The Companies Act is silent about the right of lien of auditors on clients' documents and records. Also there are many conflicting legal judgments regarding this issue. The Institute of Chartered Accountants of England and Wales has issued a guideline in this regard. Based on that guideline, the auditor's lien can be discussed under the following heads:

Lien on Books of Accounts

In the case, *Herbert Alfred Burleigh vs. Ingram Clark Ltd.* (1901), it was held that while an auditor acts as an accountant preparing books of accounts, he should have lien on such books of accounts for unpaid fees. But if he merely audits the books of accounts, he will not enjoy any right of lien on them.

But allowing auditor to enjoy right of lien on books of accounts prepared by him, which make it mandatory for every company to keep its books of accounts at its registered office or at such other place in India as the directors think fit. So, the auditor's lien would not be upheld on books of accounts, which the company has to keep in its possession as per the provisions of the Companies Act.

Lien on Working Papers

Audit working papers are those documents and records, which the auditors prepare in connection with his audit work. In fact, this question of ownership in respect to the working papers arose in the case of *Sockockingky* vs. *Bright Graham & Co.* (1938) in England. The question was whether the auditor had a right to retain the working papers as if it were their own property even after the payment of the audit fees. The court delivered judgment in favour of the auditors on the ground that they were independent contractors and not agents of the client.

Lien on Communication Documents

An auditor may communicate with third parties either as an agent on behalf of the client or independently in connection with his work. In this case, the communication documents will belong to the client. However, if the auditor makes correspondence with third parties not as an agent, but as a professional discharging his duties, the correspondence with the third parties will be his property.

Lien on Client's Money

The auditor should not have any lien on client's money, which may be kept with him. This is simply because he does not work on the money. He may be required to keep the money as a trustee only. So, if the auditor appropriates client's money towards his outstanding fees, he will be held liable.

General or Special Lien

An auditor has only lien on the particular document in respect of which he has rendered his professional service, but he has not yet been paid. He cannot have general lien, i.e., he cannot retain other documents with which he has not been concerned.

Duties of a Company Auditor

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

Statutory Duties

1. *Duty to Report*
   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*
   The Companies Act specifies 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 in sub-section (1A), unless he has any special comments to make on any of the items referred to therein.
3. *Duty to Follow CARO*
   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.

Other Duties Under the Companies Act

The auditor has the following other duties under the Companies Act:

1. Duty of the auditor or a partner of a firm of Chartered Accountants practicing in India to sign audit report.
2. Duty of the auditor to report on prospectus on the accounting part.
3. Duty to assist the inspector appointed by the Central Government to investigate the affairs of the company.
4. 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.
5. Duty to certify the statutory report of the company in respect of shares allotted, cash received in respect of such shares and the receipts and payments of the company.

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.

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.

Duty of an Auditor Regarding Mandatory Accounting Standards

According to the decision of the Council of the Institute of Chartered Accountants of India, 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 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.

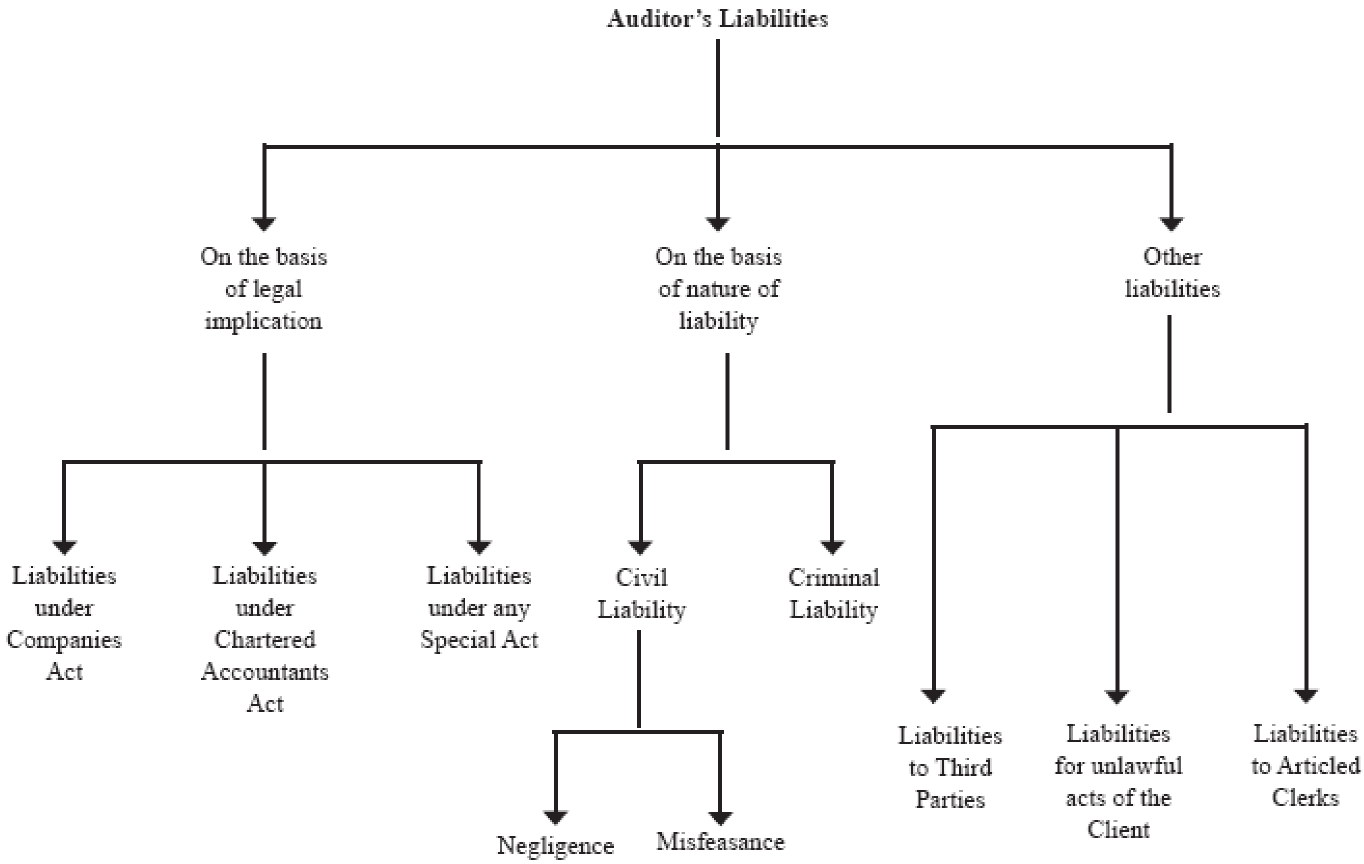
The Companies Act also states that the auditor's report shall state whether the company's balance sheet and profit and loss account comply with the Accounting Standards.

Duty to the Profession Itself

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

Liabilities of 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:

Liabilities on the Basis of Legal Implications

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

Liabilities Under the Companies Act

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

1. *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.

2. *Mis-Statements in the Prospectus*
He shall be liable with regard to mis-statements in the prospectus of the company. 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.

3. *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.

4. *Intentional False Evidence*
He shall be liable if he gives false evidence intentionally upon any examination upon oath or solemn affirmations, authorised under this Act or in any affidavit, deposition or solemn affirmations, in or about the winding up of any company under this Act.

5. *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.

6. *Willful Default in Report Making*
He will be held liable if he willfully makes a default in making his report to the shareholders.

7. *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.

8. *Authorising False Statement in the Prospectus*
If he authorises the issue of the prospectus of a company containing a false and untrue statement, he will be held liable.

9. *Party to the Issue of Prospectus*
He may be held liable if he is party to the issue of prospectus including statement purporting to be made by him as an expert, unless he is not interested in the formation or promotion or in the management of the company.

10. *Inducing Fraudulently to Invest Money*

He will be liable if he induces a person fraudulently to invest money by knowingly or recklessly making a statement or promise, which is false or misleading, or if he dishonestly conceals the material fact.

Liabilities Under the Chartered Accountants Act

The liability of Chartered Accountant, acting as an auditor, may be in the form of disciplinary proceedings under the Chartered Accountants Act, 1949. It may 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 in practice
(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 members to the Disciplinary Committee. The latter holds the enquiry and reports its findings to the Council. In case the Council finds, on the basis on its report that the member is guilty of professional misconduct, it gives chance to the member to explain his conduct. On the basis of hearing, the Council takes necessary fictions. But if the misconduct on the part of the member is other than that specified in the First Schedule of the Chartered Accountants Act, 1949, the Council has to refer the case to the High Court with its recommendations thereon.

Liabilities Under Any Special Act

In addition to the Companies Act and the Chartered Accountants Act, the auditor is also held liable under different special Acts, which are stated below:

1. As per The Banking Companies Act, 1940, if an auditor in any return, balance sheet or other document, willfully makes a statement, which is false in any material particular, knowing it to be false, or willfully omits to make a material statement, he will be held responsible.

2. An auditor of a banking company may be publicly examined in the winding up proceedings. On such examination, the High Court may make an order, if he is not found fit to act as an auditor, that he will not act as auditor of any company for such period not exceeding five years as may be specified in the order.

3. As per The Life Insurance Corporation Act, 1956 an auditor may be sentenced to imprisonment or fine, or both, if he gives a false statement knowingly in any return, report or other such forms to be issued under the Act.

4. As per The Indian Penal Code, if any person including auditor issues or signs a certificate required by law to be given or signed, or relating to any fact of which such certificate is by law admissible in evidence, knowing or believing that such certificate is false in any material point, he shall be punishable in the same manner as if he gave false evidence.

5. As per The Income Tax Act, 1961, if any person including 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 either knows to be false or does not believe to be true, he shall be punishable.

Liabilities on the Basis of Nature of Liability

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

Civil Liability

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

1. *Liability for Negligence*

   An auditor is appointed to perform certain duties. To the extent of his duties as an auditor, he acts as an agent of his client. In this capacity, he must exercise reasonable care and skill to perform his duties for which he is employed. <u>If he acts negligently on account of which the client has to suffer loss</u>, the auditor may be held liable and may be called upon to make good the damages, 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. In fact, fraud and other irregularities may not be disclosed by an annual audit and even a detailed audit may not discover certain types of fraud. Under such circumstances, whether the auditor will be held responsible that depends on the fact that whether the auditor should have been able to discover that fraud if he applies reasonable care and skill. If he could, he will be held responsible, otherwise not.

2. *Liability for Misfeasance*

The term 'misfeasance' implies breach of trust or breach of duty. An auditor 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 duties of a company auditor have been statutorily laid down in the Companies Act. If the auditor does not 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 of The Companies Act, the court might assess damages against delinquent director or other officers of the company, including an auditor for misfeasance or breach of trust. In the case of an auditor, who also comes within the definition of officer in Section 2 (30) for the purpose of this section, if he is guilty of neglect of duty or misfeasance, so as to causes loss to the company in any way, proceedings may be taken under this section against him either independently or other officers or jointly with them.

Criminal Liability

An auditor of a company can be held guilty of criminal offences, if he willfully makes a false statement in any report, return, certificate or balance sheet.

As per Section of The Companies Act, "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 a statement *(a) which is false in any material particular, knowing it to be false or (b) omits any material fact, knowing it to be material, he will be held liable on criminal offence"*.

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

Other Liabilities

The other liabilities of an auditor may include the following:

Liability to Third Parties

There are several persons who completely rely upon the financial statements entitled 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 the auditor and the third parties. Since they do not appoint him, he owes no duty to them and hence there is no question of any liability to them. He cannot be held liable unless he owes any duty to the persons, who hold him able 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 the auditor if the report of the auditor is of such a nature as amounts to fraud.

Liability for Unlawful Act of the Client

An auditor may obtain knowledge about the unlawful acts or defaults committed by his client during the course of his audit. The question arises whether he should inform the proper authorities about it and whether he can be held liable if he does not do so. It is a difficult question 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 unnecessarily injures the confidence of his client on him. If required, he should terminate his association with the client rather than open himself to such liability.

Liability to Article Clerks

The auditor may be held liable to his article clerks in the following circumstances:

1. If he does not act honestly with his article clerk.
2. If he removes any of his article clerks without any prior notice.
3. If he does not pay the required amount of monthly stipend to the article clerks.
4. If he gives a false certificate of payment of stipend to his article clerks.

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

Chapter 4
Investigation

Contents

4.1 INTRODUCTION

In addition to regular audit of the books of accounts of an enterprise, there may be the requirement of thorough examination of the accounts and records of past several years to fulfill certain objectives from time to time. In order to carry out thorough examination of books of accounts and records of an enterprise, investigation is undertaken. Investigation implies an enquiry into the accounts and business records to attain certain specific objective. In most cases, the purpose of such enquiry is to ascertain the true financial position of the concern or its normal profit-earning capacity or the extent of fraud. Thus, investigation is a special type of examination of accounts and records carried on by an investigator with a pre-determined objective according to the requirement of the situation and entail something beyond the verification of accuracy of figures in the financial statements.

4.2 DEFINITION

An investigation may be defined as a *special examination of and enquiry* into books of accounts and other related records with a view to establishing a fact or to evaluating a state of affairs or to determining causes for a happening in a business. For example, an investigation may be conducted into the accounts of a firm whose business is to be acquired by a company or investigation may be required to establish the extent of a suspected fraud.

In the opinion of Taylor and Perry, ‘’investigation involves enquiry into facts behind the accounts, i.e. into the technical, financial and economic position of the business organisation.”

So, investigation is a special type of examination of accounts and records carried on by the investigator with a pre-determined purpose in accordance with the necessity of the situation and are concerned with something more than the verification of accuracy of the figures of the financial statements.

4.3 OBJECTIVES OR PURPOSES OF INVESTIGATION

The need of investigation may arise in many cases, but these are some of the circumstances where investigation is most frequently called for:

1. For purchasing any business

Investigation can be conducted by a person on behalf of his client, when the client intends to purchase an existing business.

2. For admission of a new partner

Investigation into the affairs of a partnership firm can be made by any person on behalf of the incoming partner of an existing partnership business.

3. For seeking avenues of investment

In order to measure the financial solvency position of any business, investigation can be done. The financial solvency is measured through investigation on behalf of a person who seeks avenues of investment.

4. For granting loan or financial assistance

Investigation can also be undertaken on behalf of a bank or other financial institutions proposing to extend or grant loans to its client or alter the terms and conditions of the same.

5. For suspected fraud

If the owner or the management suspects fraud, they can appoint an investigator to detect the fraud activated by the employees.

6. For abnormal fluctuation of profit

Investigation can be conducted on behalf of the owner or the management of a business in order to ascertain the reason of abnormal fluctuation in profit in the organisation.

7. For settlement of tax liability

Investigation can be undertaken for the settlement of tax liability or in some cases for the detection of undisclosed income of the assessee.

8. For settlement of insurance claim

In case of fire or other hazards, the organisations have to submit claim to the insurance company to recover the loss. The insurance company can appoint an investigator to determine the exact amount of loss for settlement of claim.

9. For valuation of goodwill and shares

The shares and goodwill of the business are required to be valued on different occasions. In order to calculate the fair value of shares and goodwill, investigation can be undertaken.

10. For judging sickness of a business unit

Government may consider to take over a sick industrial unit and for this purpose, it may give appointment to an investigator to investigate into the affairs of the sick unit.

11. For the provisions of the Companies Act

The Companies Act provide regulations for the investigation of any company under different specific situations.

12. For justifying negligence of the auditor

In some cases, the auditor is held liable for negligence in his duty. But before accusing auditors for negligence, the case has to be properly investigated.

13. For complaint by the shareholders

Investigation can also be undertaken by the management on the basis of complaints made by the shareholders.

4. For the affairs of a trust

Investigations are sometimes required to be conducted on behalf of the beneficiaries of any trust into the affairs of a trust for suspected fraud.

15. For the liquidation of the business

Investigation of suspected fraud or misfeasance against the Directors on behalf of the liquidator of a company could also be undertaken.

4.4 FEATURES OF INVESTIGATION

"An investigation is an examination of accounting records undertaken for a special purpose; in effect it is an audit of which the scope is limited or extended in accordance with the requirement of the particular purpose. Its objective is usually to discover and display the facts in such a manner as will enable the parties for whom it is undertaken to draw conclusions and make their decisions accordingly."

On the basis of analysis of the above definition, the following inherent features of investigation can be identified:

- Investigation is normally conducted with certain specific objectives.
- It involves critical examination and verification of specific records.
- There are no statutory provisions or rules prescribed for investigation except in case of companies. It is voluntary and contractual in nature.
- It is not only confined to examination of financial aspects of an organisation, but also concerned with the policy matters.
- It is undertaken with certain suspicion, depending on the nature of the objective for which it is undertaken.

- In most of the cases, the future courses of action have to be outlined by the investigator.
- In addition to the detailed analysis and study of the books of accounts and records, personal examination of individuals may also be undertaken.
- The scope of investigation may be limited to a certain specific objective or extended to cover a number of objectives according to the requirements of the situation.
- The investigator reports to the person/s who is/are responsible for his appointment.
- In the report, the factual information has to be given in analytical as well as descriptive manner.

4.5 TERMS OF REFERENCE

In the case of a private investigation, e.g. one undertaken on behalf of a prospective purchaser of a business, the investigating accountant must obtain precise instructions from his client as to his terms of reference the purpose of investigation, the amount of detailed work required etc. These terms of references must be set out clearly in a letter of engagement.

In the case of investigation governed by statute, e.g. reports for prospectus, the reporting accountant must be fully conversant with the statutory regulations and must also obtain necessary instructions where that would be applicable.

4.6 WORKING METHODS

Having clearly established the purpose of the investigation, the investigator will first make such preliminary inquiries as are necessary to ascertain the information that is required to enable him to plan his investigation.

He will then draft an outline report, detailing the headings, which he will use in his final report. These will vary according to the nature of investigation being undertaken, but if a business were being investigated on behalf of a prospective purchaser, the headings could be as follows:

- The business and its history
- Management and the staff
- Sales and marketing
- Purchasers and suppliers
- Trading results as per audited accounts

- Future prospects and trends
- Assets and liabilities
- Conclusions and recommendations

After drafting the outline report, the investigator will undertake the detailed work necessary to complete the investigation. This will normally be mainly composed of interviews and discussions with relevant persons and work on the accounts and records, but on every investigation he will need to exercise his judgment as to exactly understand the work to be undertaken. Detailed working papers will be prepared and from those working papers the final report will be written. These working papers must be carefully preserved. In the event of a dispute arising and negligence being alleged against the investigating accountant, these working papers would be vital evidence in litigation. When the investigation is completed, the draft report will be finalised.

4.7 DUTIES OF AN INVESTIGATOR

The procedures to be followed in an investigation depend on the nature of investigation, its purpose and the circumstances of the case in which the investigation was undertaken. In all the cases of investigation, certain precautionary measures are required to be taken by the investigator. These measures are considered as the duties of the investigator, which he should follow in discharging his duties in conducting investigation. These duties are given below.

1. Obtaining written instruction about scope and objectives of investigation

Before starting an investigation, the investigator should obtain from the client clear written instruction about the scope of his work and purposes of investigation. If the client is interested to impose any restriction or limitation to his work, he should also get it in writing so that he may exactly determine the scope of his work and the nature of his duties.

The period to be covered in the investigation should also be confirmed by the investigator from his client clearly in writing. The period is very important because the investigator can accordingly restrict his examination of transactions and records to that period only.

2. Framing investigation programme

Based on the objectives, scope and period to be covered, an effective investigation programme should be chalked out. The investigation programme should be flexible, so that the investigator may make required changes in the programme during actual investigation. Such flexibility in the programme is necessary, since many steps in an investigation depend on the results of the earlier steps.

3. Collection of information about the business

It is not possible for the investigator to give correct interpretation and reporting of the fact, if he does not have the detailed knowledge of the activities of the enterprise for which he is to conduct investigation. So, before starting his work of investigation, the investigator should collect all relevant information about the activities of the enterprise.

4. Enquiry about the reputation of the enterprise

The investigator should make enquiries and collect information about the reputation of different individuals working in the organisation. Information should also be obtained about the goodwill of the enterprise. This information will help the investigator a lot in preparing his report.

5. Taking expert advice

The investigator should take the assistance of experts during the course of his examination, if required, and consult experts on matters in which his knowledge is not adequate.

6. Reliance on accounts and records

If the books of accounts and required records have been properly maintained and the accounts have been audited, the work of the investigator becomes simplified as he is entitled to rely upon the audited accounts and properly maintained records.

So, usually the investigator should avoid duplication of work and concentrate more on such procedures as will be more purposeful for investigation. But the fact that the investigator has depended on the audited books of accounts should be included in the investigation report.

7. Preservation of working papers

It is the duty of the investigator to maintain his working papers properly. A complete record of work carried out, records examined, relevant information and evidence collected etc. should be kept in his file together with important statements, schedules and documents. These working papers will help him at the time of finalisation of report. These working papers can also be valuable documents in his defense, in case the affected parties subsequently challenge his findings.

8. Maintenance of secrecy and confinement to purpose

The investigator should always keep in mind the purpose of investigation, as the purpose of investigation will determine which records and figures should be examined in detail, which need not be examined, for which cases detailed checking may be avoided, what information he should seek from sources other than books and records and what procedures should he adopt in his investigation work. On the other hand, secrecy is the basic necessity of any investigation. So, the investigator should keep the details of the investigation very secret.

9. Maintenance of minimum standard of work

The investigator must be honest and he should approach his work with reasonable care, skill and diligence. He should not allow himself to be influenced by others, as total independence is required in investigation. So, the investigator should always keep himself free from the influence of interested persons.

10. Proper and correct reporting

The investigation report should be clear and unambiguous. The investigator should analyse the data and evidence collected by him. He must take great care to see that his report does not contain any wrong information. So, before signing his report, he should carefully check the content of his report with preserved working papers and notes. This is very important as incorrect report may mislead his client and invite legal action against him.

4.8 INVESTIGATION REPORT

The report on the investigation must be carefully prepared. It should be simply worded, very clear in its meaning and as concise as practicable in the given circumstance. It must, however, give full consideration to all the factors affecting the decision to be made.

The form of the report will normally be an introduction setting out the terms of reference and the nature of the enterprise being investigated. A main section will be there setting out the facts ascertained and detailing the work performed, and a final section setting out the conclusions and the recommendations. It should be remembered that the main points of the report are not obscured by details; any voluminous statistics should be relegated to appendices and referenced to the relevant part of the report.

Investigation report should contain all important and relevant matters. He must present in his report what is essential, ignoring what is not essential. Facts and only facts should be presented and nothing based on estimates should be given. The investigator should mention in his report the instructions given to him by his client with regard to the investigation. He must mention the limits, if any, put in the scope of his work.

4.9 QUALITIES OF AN INVESTIGATOR

An investigating accountant should combine sound auditing techniques, considerable experience, sound judgment and a good understanding of a variety of business enterprises. Because of the demanding nature of the work, it will usually be found that partners and senior staff will personally perform a higher proportion of the work on investigation than on audits.

The investigator must approach his work methodically. He must work honestly and diligently. He must keep the interest of his client at the top and must work with a feeling of some service to the client. The subject of the investigation is highly technical in nature and usually a senior accountant with profound knowledge and experience suitable for the job. <u>He need not be a chartered accountant</u>, but he must have sound knowledge of accounting and auditing and practical knowledge about the various affairs of different types of enterprises. He must be a man of competence and ability to understand different critical matters clearly. He must possess the ability to grasp things easily and express them in clear words. While conducting the investigation, he must exert utmost care, skill and reasonable diligence keeping in mind all through the purpose of investigation.

4.10 DIFFERENCE BETWEEN INVESTIGATION AND AUDITING

The difference between audit and investigation is outlined in Table below.

Points of difference	*Audit*	*investigation*
1. Interested parties	Audit is conducted on behalf of the shareholders or proprietors.	Investigation is usually carried out on behalf of outsiders who intend to purchase the business or who wish to lend money and thus want to know the earning capacity or the financial position of the concern.
2. Legal aspects	Audit is compulsory for a corporate business according to the Companies Act.	Investigation is not compulsory.
3. Inter-dependence	Audited accounts are not audited again except in case of special audit u/s 233 A.	Investigation may be conducted even though the accounts have been audited.
4. Duration	The audit of accounts is usually for a year or six months.	Investigation may cover a period extending over three to seven years.
5. Depth of work	Audit is a kind of test checking.	Investigation is a thorough examination of the books of accounts.

6. Subject matter	Audit includes an examination of the books of accounts.	Investigation is not only an examination of accounts, but also inquiry into other factors, i.e. it goes beyond the books of accounts.
7. Computation of net profit	Audit is not concerned with the alteration of figures and introduction of adjustments to have net profits from different points of view.	Net profit or the actual earning capacity of the concern is ascertained by making certain adjustments in the net profit as calculated.
8. Purpose	Audit is conducted to know the TRUE AND FAIR view of the books of accounts.	Investigation is conducted to know the financial position and the earning capacity of the concern.

Chapter 5

Company Audit

5.1 INTRODUCTION

A company is said to be an artificial person created by law having a separate legal entity distinct from its shareholders. It cannot be directly managed by its owners, i.e., shareholders, because they are very large in number having small holding and also scattered over a wide area. As such, the management and control of the affairs of the company is done by other persons generally known as directors. Hence, it becomes essential for a company to appoint an independent and qualified person, i.e., an auditor, to verily and certify the truth and fairness of the financial statements.

5.2 PRELIMINARIES BEFORE COMMENCEMENT OF COMPANY AUDIT

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

1. Ensuring That His Appointment Is in Order
2. Inspection of Statutory Books and Documents
3. Inspection of Contracts
4. Study of Previous Year's Balance Sheet and Auditor's Report
5. Study of Internal Control System in Operation

Ensuring That His Appointment Is in Order

Before accepting the offer for appointment as auditor in a company, the auditor should ensure himself that his appointment is made according to the provisions of Sections of the Companies Act and whether all the formalities being maintained by the company before giving him the appointment as auditor.

The auditor will go through the following:

1. He should see whether his appointment has been made according to Section of the Companies Act. For this purpose he will obtain a copy of resolution adopted at board meeting or the shareholders meeting as the case may be.
2. If he is appointed in place of a retiring auditor, he will enquire whether due notice was served to the retiring auditor. He will get informed from retiring auditor about the circumstances under which he has retired and whether he should accept the appointment. This is a professional requirement as per Chartered Accountants Act, 1949.
3. He should, within thirty days of receipt of appointment letter, inform the Registrar in writing that he has accepted or refused to accept the appointment.
4. If he is appointed to fill the casual vacancy caused by the death of the previous auditor, he will get the copy of the minutes of the board meeting in this regard and also get the confirmation of death of the previous auditor.
5. He will see that if the company has failed to appoint or re-appoint any auditor in the annual general meeting, the Central Government has appointed him to fill the vacancy.
6. If he is appointed due to the resignation of the previous auditor he must see that he has been appointed in a general meeting of shareholders. The board of directors will have no right to appoint him under such circumstances.
7. He will verify whether his remuneration has been fixed according to the provisions of the Companies Act.

Inspection of Statutory Books and Documents

1. ***Documents***

   Before the auditor commences the work of audit, he should examine the following documents:

   1. Memorandum of Association

      The auditor will go through the following points:

      a. To see whether the activities of the company are consistent with the 'objective clause'.
      b. To check whether the amount of share capital is within the limit of authorised capital.
      c. To observe whether there is any amendment to memorandum and if so, whether legal formalities have been complied with.

   2. Articles of Association

      The auditor will go through the following points:

      a. The issue of share capital and its subdivisions.
      b. The payment of underwriting commission and brokerage on shares.

c. The amount of minimum subscription.
d. Date and amount of call.
e. Appointments, duties and powers of auditors in addition to statutory powers and duties.
f. Appointment and remuneration of directors.

The above are the list of few examples, which are available in the Articles of Association. The Articles may contain several other items and the auditor should go through each item very carefully. If he does not go through the Articles and consequently fails to audit properly, he will be held liable as was held in the case of *Leeds Estate Building and Investment Society Ltd. vs. Shepherd* (1887).

2. ***Prospectus***

In case of newly started company and company that has preferred to go in for public issue, the auditor will examine the prospectus to see the matters like whether shares can be issued at a discount; the amount payable on application, allotment and calls, underwriting commission and brokerage etc.

3. ***Certificate of Incorporation and Certificate of Commencement***

These certificates are required to be examined to see whether the company has been duly incorporated and it has started its business, in case of public limited company, after getting commencement of certificate.

4. ***Books and Registers***

The following is the list of books and registers required to be maintained by the companies:

a. Register of Members
b. Index of Members
c. Register and Index of Debenture Holders
d. Register of Mortgage and Charges
e. Register of Investments
f. Foreign Register
g. Register of contracts with companies and firms in which the directors are interested
h. Register of directors, managing director, manager and secretary
i. Register of director's shareholdings

j. Register of Loans
k. Minute Books

Inspection of Contracts

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

a. contracts with the vendors of any property,
b. contracts with the brokers and underwriters for their commission, and
c. contracts with the promoters for the preliminary expenses, etc.

Study of Previous Year's Balance Sheet and Auditor's Report

The auditor should inspect the previous year's Balance Sheet to verify the opening balances of the current year. Moreover, according to the Companies Act, the corresponding figures of the previous year have to be given in the Balance Sheet of the current year. The auditor should also study the audit report of the previous year(s) in order to identify the problem areas of the company.

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.

5.3 Specific Provisions for Accounts In The Companies Act

The provisions in the matter of books of account, which a company is required to maintain, are contained in Section of the Companies Act, 1956. They are briefly summarised as follows:

1. Books to be maintained

Every company shall keep at its registered office proper books of accounts, with respect to the following.

1. All sums of money received and expended by the company and the matters in respect of which the receipt and expenditure takes place

2. All sales and purchase of goods by the company
3. The assets and liabilities of the company, and
4. In the case of a company pertaining to any class of companies engaged in production, processing, manufacturing or mining activities, such particulars relating to utilisation of material and labour or to other items of cost as may be prescribed in such class of companies as required by the central government to include such particulars.

2. Place of preservation of books

All the books are usually required to be kept at the registered office in India. All or any of the above stated books of accounts might be kept at such other place instead of registered office in India as the Board of Directors may decide. The company must file with the registrar a notice in writing giving the full address of the other place.

3. Books of branch offices

Where a company has a branch office, whether in or outside India, the company shall be deemed to have complied with the aforementioned provisions, if the company maintains proper books of account relating to transactions affected at the branch office and also arranges to obtain from the branch proper summarised returns, at intervals of not more than three months, for being kept at the registered office or the other place.

4. Method of accounts

Proper books of account shall not be deemed to be kept with respect to the matters specified therein:

1. If they are not kept such books as are necessary to give a true and fair view of the state of affairs of the company or branch office, as the case may be and to explain its transactions and
2. If such books are not kept on accrual basis and according to the double entry system of accounting.

5. Inspection of books of accounts

The books of accounts and other books and papers shall be kept open for inspection by any director during business hours.

6. Period of preservation

The books of accounts of every company relating to a period of not less than eight years immediately preceding the current year together with vouchers relevant to the entry in such books of accounts shall be preserved in good order. In case of a company incorporated less than eight years before the current year, the books of accounts for the entire period preceding the current year shall be preserved.

7. Penalty

If the managing director or manager and, in the absence of any of them, any director of the company fails to take reasonable steps to secure compliance with the requirements of law aforementioned or by a willful act causes any default by the company, he shall be punishable for each offence with imprisonment for a term which may extend to six months or a fine or both.

Chapter 5
New Areas of Auditing

Contents

5.1 INTRODUCTION

Auditing in its modern form has adopted a multidimensional approach. At present, the scope of auditing is not restricted to only financial audit under the Companies Act. The purpose of auditing has been extended to cost accounts, managerial policies, operational efficiencies, system applications, social implications of business organisations and environmental aspects too. Even non-business organisations avail the services of qualified auditors and get their accounts audited. At present, the field of audit also covers the following:

1. Checking cost accounting records and verifying the cost accounting principles that have been adopted in preparing and presenting cost accounting data, i.e. cost audit.
2. Comprehensive examination and review of managerial policies and operational efficiency, i.e. management audit.
3. Checking the performance of the organisation and comparing it with the overall performance of the industry in which the organisation belongs, i.e. performance audit.
4. Critical examination and analysis of the contribution of the organisation for the benefit of the society, i.e. social audit.
5. Evaluation and measurement of efficiency of the human resources in the organisation and comparing it with the expected utilisation of the human resources as a whole, i.e. human resource audit.

5.2 COST AUDIT

As per Section of the Companies Act, the central government may, if it considers necessary, direct by an order that a COST ACCOUNTANT within the meaning of the Cost and Works Accountants Act, 1959 shall conduct the cost audit in such manner as may be specified.

Thus, the central government may order an audit of cost accounts for specified companies and that audit is to be conducted by a cost accountant. This cost audit is in addition to the financial audit conducted by an auditor appointed under Section of the Companies Act. If the central government orders for the cost audit, it requires the company concerned to conduct cost audit every year till further orders.

Definition

Cost audit was first time introduced in 1965 in India. Cost audit is an effective means of control in the hands of management and it is a check on behalf of the shareholders of the company, consumers and the government.

In fact, cost audit is an audit process for *verifying the cost of manufacture or production of any article*, on the basis of accounts as regards utilisation of material or labour or other items of costs, maintained by the company.

According to the definition provided by the Institute of Cost and Works Accountants of London, "*Cost audit is the verification of the correctness of cost accounts and adherence to the cost accounting plans*."

Smith and Day define cost audit as "the detailed checking of costing system, techniques and accounts to verify correctness and to ensure, adherence to the objectives of cost accounting."

So, from the above-mentioned definitions, we can say in simple words "cost audit is the detailed checking as well as the verification of the correctness of the costing techniques, systems and cost accounts".

Objectives

Every branch of study or knowledge has got its objectives. It is quite natural that cost audit should have some objectives. Without objectives, no branch of study can be developed.

Following are the main objectives of cost audit:

1. To detect any error or fraud which might have been done intentionally or otherwise
2. To ensure that the cost accounting procedures which have been laid down by the management is strictly followed
3. To verify the accuracy of costing data by checking the arithmetical accuracy of cost accounting entries in the books of accounts
4. To have full control on the working of costing department of the organisation and to suggest ways and means for its smooth running
5. To introduce an effective internal cost-audit system in order to reduce the burden of detailed checking work of the external auditor
6. To help the management in taking correct and timely decisions on cost of production and cost variations

7. To verify the adequacy of the books of accounts and records relating to cost
8. To value accurately the value of work-in-progress and closing stock
9. To advise the management for adoption of alternative courses of action by preparing cost plan
10. To report to appropriate authority as to the state of cost affairs of the organisation

Advantages & Disadvantages of Cost Audit

Advantage of Cost Audit

From the discussion of the objectives of cost audit, it appears that it not only serves the management of the business and the shareholders but it also serves the consumers as well as the society in a broader sense. The advantages of cost audit can be described in the following way:

1. ***To the management***

    1. It helps in controlling different elements of cost.
    2. It can assess the profitability of the organisation.
    3. It helps to have a better inter-firm comparison.
    4. It is a basis of evaluation of the inter-divisional performance.
    5. It helps in obtaining licenses for either expansion or diversification of the various product lines of the business.
    6. It can also check to control high inflationary trend of cost.
    7. It helps the management in finding out the correct cost of production.
    8. It can increase the productivity by detecting the weaker areas of cost of production.
    9. The inefficiencies of the employees working in the cost department may be revealed.
    10. Errors and frauds may be detected through efficient conduct of cost audit.

2. ***To the shareholders***
    a. It gives guarantee of the proper maintenance of cost records.
    b. It can stop the capital erosion by constant watch on better plant utilisation, discontinuing uneconomic product lines and elimination of wastage.

c. Through cost audit, the <u>decision makers</u> get timely and proper information, which results in better performance by the organisation.
d. Cost audit also ensures <u>fair return</u> to shareholders on their investments.

3. ***To the consumers***

1. Cost audit helps in the fixation of fair prices.
2. It helps the consumers indirectly in increasing their standard of living.

4. ***To the government***

a. It forms a basis for the assessment of income tax.
b. It helps the government in fixing and regulating prices.
c. It gives guidelines to improve working of uneconomic industrial units.
d. It gives information to the government regarding fraudulent intentions of any company.

5. ***To the society***

a. Cost audit provides guidelines to the industries for improving its workings and thus renders a great service towards the society.
b. It saves the customers from exploitation by revealing them the actual cost and to know whether the market price of product is fair or not.
c. It helps the industries to improve their efficiencies and production and to reduce the prices of the product.

Disadvantages of Cost Audit

Cost audit may have some limitations. In fact, these limitations do not relate to the objectives for which it has been introduced. It may arise due to its limited scope of application in the related field of operation. However, cost audit is criticised on the following grounds:

1. It introduces unnecessary <u>interference in the normal working</u> of companies.
2. It leads to <u>duplication of work</u> because large areas of working of financial and cost audit are common.

3. It may be considered as a burden to the company because of the additional cost to be incurred on cost audit.
4. Conduct of cost audit by outsiders may be harmful to the interest of the company itself as the secrecy in cost accounts may not be maintained.
5. By introducing cost audit in certain industries, more restrictions have been imposed on the functioning of the organisations by the government.

Cost-audit report

The auditor appointed under that section is expected to conduct the audit in such manner as may be specified in the order issued by the central government. Further the cost auditor must forward his report to the central government and to the company within 120 days of the closing of the year to which the audit is related. The report is to be given in the form prescribed for the purpose.

The central government has issued Cost Audit (Report) Rules, 1968 specifying the form of the report and the additional information, which should be included therein in the form of annexure. The rules have also set down the various points on which the auditor should make his observations and give his conclusions. The rules have been superceded by a Cost Audit (Report) Rules, 1996.

The auditor must further report on the adequacy of cost accounting records maintained by the company as prescribed by the government, to confirm that they give a true and fair view of the cost of production, processing, manufacturing or mining activities, as the case may be. If the auditor's report contains any qualification, the company must furnish to the central government full explanation on any such qualification within 30 days of the receipt of such report.

In the cost audit report, the cost auditor is supposed to mention the following points:

1. Whether proper records of fixed assets, in details are mentioned or not
2. Whether the assets have been properly revalued during the year and what was the basis of revaluation
3. Whether all the assets are properly verified and discrepancies, if any, are properly dealt with in the books of accounts
4. Whether Proper accounting records as required have been kept or not

If there is any additional information that the auditor would like to furnish, he may include in the annexure to the report.

5.2.1 Distinction Between Financial Audit and Cost Audit

Points of difference	*Financial audit*	*Cost audit*
1. Concept	Financial audit is an audit of **financial accounts**, supporting vouchers or documents and financial statements.	Cost audit is an audit of **cost accounts**, cost statements and cost accounting plans.
2. Inter-relationship	It is not necessary for a financial auditor to examine cost accounts except for the purpose of valuation of inventory.	As the source of cost accounts is financial accounts, the cost auditor has to make a detailed checking of expenses.
3. Objectives	The primary objective of financial audit is to check whether necessary accounts, records and documents have been maintained by the concern and whether the profit and loss account and the balance sheet give a **TRUE AND FAIR VIEW** of the profit and loss and state of affairs respectively.	The primary objective of cost audit is to verify whether **COSTS HAVE BEEN ASCERTAINED** on the basis of cost accounting principles, whether cost records have been properly maintained and whether the cost of production and sale has been correctly worked out.
4. Nature	Financial audit is somewhat a **post-mortem** examination. It looks back to the past.	Even though cost audit also refers to the past, it creates **thinking for the future**. It is therefore forward-looking to a great extent.

5. Verification of stock	The financial auditor has only to see whether all categories of stock have been included in the accounts in true quantities and values.	The cost auditor has not only to check the cost of each item of stock, but also to check whether the stocks are maintained at proper level or not.
6. Purpose	Financial audit is essentially an audit on behalf of the **proprietors or shareholders**.	Cost audit is a tool in the hands of the **management**. Statutory cost audit is, however, conducted as per order of the **Central Government**.
7. Compulsion	Financial audit is **compulsory** for each company in each financial year as per the Companies Act.	As per the Companies Act, statutory cost audit is only required for the year if it is so **ordered by the Central Government.**
8. Submission of report	The financial auditor submits his report to his clients. In case of company, such report is required to be submitted to the **Shareholders**.	Cost auditor also submits his report to his clients. In case of statutory cost audit, such report is required to be submitted to the **Central Government**.

5.2.2 Phases or Stages of Cost Audit (⬇)

The stages or phases of the cost audit may be classified under two broad categories. These include efficiency audit and propriety audit.

(a) Efficiency or Performance Audit

Definition

The efficiency audit provides the ***means to appraise the performance of the enterprise and diagnose the weaknesses or ills of the enterprise***. Therefore, efficiency audit may be defined as that part of cost audit, which determines whether the resources of the business flow into remunerative or paying channels. Thus, efficiency audit is concerned with the diagnosis and review of the organisations environment, measuring return on investment, cash flow performance etc. and comparing these measures with the standard and determining the management system of control and techniques.

In other words, efficiency audit makes an appraisal of how efficiently different activities of the business, consisting of both operational and financial activities, have been performed and it prescribes the remedies for shortcomings or inefficiencies. Hence, efficiency audit is also known as 'performance audit'.

Objectives

Efficiency or performance audit involves an appraisal of the performance of a business concern. Performance audit mainly looks into operational and financial performance and overall performance of a business. The performance audit does not end in finding out good or bad points, it must tell the management the reasons of the bad points so that the management can take appropriate remedial measures.

The main purposes of the efficiency audit are as follows:

1. To determine the <u>operational weaknesses</u> and general ills of the organisation
2. To highlight or to <u>evaluate the important facts</u> in each of the functions analysed
3. To evaluate and <u>compare the optimum return on capital</u> employed in the business
4. To ensure that the <u>investment techniques</u> aim at giving optimum levels
5. To ensure the improvement of <u>organisational efficiency</u>.

Steps

Efficiency audit can be conducted by following the steps as follows:

- Diagnosis of weak areas of the business
- Study of the business environment for the marketability of its products
- Profitable utilisation of physical assets
- Effective utilisation of human resources
- Review of functional and operational efficiency of the business

Scope

Performance audit involves an **appraisal of the performance or efficiency of an enterprise**. Performance audit reviews how efficiently various plan have been formulated and how far the actual performance meets the target as planned. Performance audit *analyses the variances of actual expenditure from the budgeted figures*. It also checks the results of capital investments and tries to find out how efficiently the capital has been utilised. Performance audit is, therefore, a check of efficiency of the different aspects of an organisation. It helps the management to improve the overall performance of the organisation.

The important aspects of an organisation, which a performance auditor evaluates, include the following:

- Sales value and sales quantity
- Actual production and total cost of production
- Levels of inventory and its management
- Capital employed and its utilisation
- Profitability of the concern
- Solvency and liquidity position of the concern.

By comparing the actual figures with the budgeted figures, standards and figures of the past periods, by proper analysis of the data and by inter-firm comparison, performance audit evaluates the performance of the organisation.

Advantages & Disadvantages of Performance Audit

Advantages

Performance audit has the following advantages:

1. Performance audit gives an insight into the quality of performance. Performance audit gives us the idea as to whether the goals and objectives of the organisation have been kept in view and whether the plans and budgets have been followed in the operation of the business activities.
2. Due to the existence of performance audit, all employees of the organisation become aware of efficient discharge of duties, otherwise the performance auditor will detect their inefficiencies. This moral check on employees is of immense value to the organisation.
3. The defects and limitations in plans, budgets and standard setting are also detected in performance audit. On the basis of audit observations, these defects and limitations can be eliminated.
4. By conducting performance audit, the errors, defects and inconsistencies in different areas of management can be identified. So, proper actions can be taken to remove these defects and inconsistencies.
5. The performance auditor gives the management proper advice for the removal of existing defects and inefficiencies and in that way helps the management to improve future performance of their activities.

Disadvantages

The performance audit has the following limitations:

1. Performance audit is a post-mortem audit, i.e. examination of the events of what have already been occurred. In reality, this practice does not give better result.
2. If the management control system of the organisation is effective, there cannot be any necessity of performance audit.
3. Conducting of performance audit requires high cost. So, this type of audit is not suitable for small organisations.
4. In performance audit errors and defects are highlighted long after it occurrs. Such errors or defects may not be in existence when it is reported to the management.
5. Performance audit creates an unhealthy atmosphere in the organisation due to the competition among the employees in achieving the desired performance.

(b) Propriety audit

Definition

The term 'propriety' means '**JUSTNESS**' or '**RIGHTNESS**'. When this term is applied in the area of auditing, it signifies the *audit of rightness of expenditure incurred or the rightness of optimum result or rightness of selecting alternative plan of action.*

Therefore, 'propriety audit' may be defined as an appraisal of rightfulness of executive actions and plans. In the conduct of propriety audit, the role of cost auditor resembles the advisory function rather than executive function. So, propriety audit refers to the assessment of rightness of plans and policies of management in connection with various financial events or transactions of the business.

Functions

The function of the cost auditor in the context of propriety audit may be stated as follows:

1. To check that expenditure incurred is planned
2. To appraise whether those expenditures are likely to give optimum result
3. To see that the size and channels of expenditure are rightful and expected to give optimum result
4. To see that any alternative plan of action can bring about an improvement or current operation as well as return from capital expenditure

In case of company form of organisations, there is separation of ownership from management. The persons entrusted with the responsibility of management come for a short period of time. After the expiry of their tenure of service, they leave the organisation without taking any responsibility for the adverse effect on business of their past activities which might have been undertaken for their self interest only. In this context, the propriety audit is of great help as it acts as a restriction on undertaking any transaction for personal benefit of an executive. That is why, the government has also amended the Companies Act requiring the auditor to report not only on the fairness of the financial statements but also on the propriety of transactions of some particular nature.

Objectives

The objectives of propriety audit are to check the following:

- Whether there is a revenue leakage
- Whether funds have been misappropriated
- Whether there is wastage or misuse of any kind
- Whether legal or financial conditions have been overlooked or flouted in dealing with the affairs of the company
- Whether adequate safety of assets has been ensured
- Whether transaction have been entered into for the interest of the entity

Advantages & DisAdvantages OF Propriety Audit

Advantages

Propriety audit has the following advantages:

1. In propriety audit wastes, misuse of assets and frauds are detected. So, guilty persons can be punished. The loopholes in the internal control systems of the organisation can also be adequately plugged to minimise these in future.
2. If financial considerations or standards of propriety are flouted in any decision, propriety audit brings these to the notice of the authority. So, decision-makers always remain very alert and well-judged decisions result in the organisation.
3. This audit also checks whether or not all the activities of the organisation have been carried on prudently, profitably and in the best interest of the organisation. If anything is pointed out adversely in the audit report, appropriate corrective action can be taken against it.
4. If any asset of the organisation is inadequately protected, propriety audit brings this to light. Accordingly, measures can be taken to protect the asset from loss or damage.
5. Inefficiency, extravagance, personal interest on any matter, etc. are detected in propriety audit. So, adequate preventive measures can be taken against these features.
6. Propriety audit may cause useful corrections in financial and general administration. For this, administrative efficiency of the organisation may increase.
7. Without the consideration of propriety in some important matters, financial audit and cost audit will be of little value. These audits can be really effective when propriety audit in certain areas becomes part of them.
8. The shareholders of a company or the proprietors of a business are the maximum beneficiaries from propriety audit, because propriety audit in commercial organisations mainly serve their interests.
9. Not only the shareholders or the proprietors, but also all those connected with the business are benefited from propriety audit as this audit keeps an eye on financial discipline in the day-to-day management of the business, which is also beneficial to the society at large.
10. Propriety audit is indispensable in government departments and in government or public transitions, because their activities, transactions, expenditure and decisions are supposed to be in public interest.

5.2.3 Traditional Audit and Propriety Audit

Points of difference	*Traditional audit*	*Propriety audit*
1. Objective	In traditional audit, **all business transactions are checked** with the help of vouchers and documents to ascertain whether the financial statements prepared gives a true and fair view of the financial result and financial position of the enterprise.	In propriety audit, the matters to be observed are whether the transactions entered into and all the business activities including the decision taken by the management are in **conformity with the standards of propriety**.
2. Fund utilization	It is **not the purpose** of traditional audit to discover wastes and misuse of fund.	Discovery of **wastes and misuse of fund** is the main purpose of propriety audit.
3. Accepted standard	If an expense is duly approved by the appropriate authority and supported by valid vouchers, it meets the accepted standard of traditional audit.	Mere approval and existence of supporting vouchers against an expense will not satisfy the auditor in propriety audit. The auditor has to verify whether the expense is necessary and the amount incurred is reasonable or not.
4. Function	It is not within the function of traditional audit to see whether the business is being managed **prudently and profitably**.	It is the function of the propriety audit to see whether the business is being managed **prudently and profitably**.

5. Verification of assets	In traditional audit **all assets described in the balance sheet are verified** in respect of existence, title, custody and value of the assets.	In propriety audit what is particularly required to be seen in the case of assets is whether all the **assets are adequately protected or not**.
6. Detection of fraud	Detection of **fraud and misappropriation of fund is not the primary object** of traditional audit. It is a secondary object only.	Detection of **fraud or misappropriation of fund is one of the primary objects** of propriety audit.

5.3 MANAGEMENT AUDIT

It has been advocated in recent years that accountants should become more concerned with the efficiency of their clients, rather than concentrating their attentions almost exclusively on the accuracy of accounting records and financial statements relating to past periods. This could entail a professional firm's undertaking what has become known as management, operations or efficiency audit in addition to fulfilling its basic statutory duties.

Management audit ***reveals irregularities and defects in the working of management and suggests the ways to improve the efficiency of the management.*** It concentrates on results and does not examine whether procedures have been followed or not.

Definition

Management audit is an audit to examine, review and appraise the various policies and functions of the management on the basis of certain standards. It attempts to evaluate the performance of various management processes of an organisation.

According to Taylor and Perry, "***management audit is the comprehensive examination of an enterprise to appraise its organisational structure, policies and procedures in order to determine whether sound management exists at all levels, ensuring effective relationships with the outside world***".

According to the Institute of Internal Auditors, management audit is"a future oriented, independent and systematic evaluation of the activities of all levels of management for the purpose of improving organisational profitability and increasing the attainment of the other organisational objectives".

So, from the above definitions, it can be simply stated that "***management audit is that type of audit which examines, reviews and appraises the various policies and actions of the management on the basis of established norms and standards.***"

Objectives

The following are the main objectives of management audit:

1. To reveal any irregularity or defect in the process of management and to suggest improvements to obtain the best results
2. To assist all levels of management from top to bottom through constant watch of all operations of the organisation
3. To review the performance of the management through close observation of inputs and outputs
4. To assist management in achieving co-ordination among various departments
5. To assist management in establishing good relations with the employees and to elaborate duties, rights and liabilities of the entire staff
6. To recommend changes in the policies and procedures for a better future
7. To ensure most effective relationship with the outsiders and the most efficient internal organisation
8. To recommend for better human relation approach, new management development and overall organisational plans and objectives

Importance

Management audit is concerned with assessment of efficiency and soundness of management to lead the business to its goal. It critically reviews all aspects of management performances and prescribes ways and means for its improvements.

Management audit is very important for its usefulness and is outlined as follows:

1. ***Reviews plans and policies*** In an organisation, the management holds periodical meetings for the review of their performance and for the assessment of their operations to know as to whether these are performed according to the plans and policies adopted by them. But if the plans and policies are defective, the assessment will be of no use. Hence, there should be some independent review of the plans and policies as formulated by the management. The functions are performed by the management auditors.

2. ***Identification of management weaknesses*** Management audit properly spots the inefficiencies and weaknesses of the management. It assesses the soundness of plans adopted and the adequacy of control system for making the plans successful.

3. ***Proper advice to the management*** Management audit does not rest simply on identifying diseases. To make proper prescription for removal of these diseases is one of the major functions of management auditors.

4. ***Advising the prospective investors*** Management audit can also be useful to a prospective investor who is considering to make a big investment in an organisation. The management auditor engaged by him can collect such information from the organisation as will be useful in evaluating the investment decision.

5. ***Taking over of sick industry*** Before deciding to take over a sick organisation, the government can order a management audit in that organisation and learn the actual causes of sickness. On the basis of the recommendations from the management auditors, the government can take proper steps accordingly.

6. ***Helping in foreign collaboration*** In case of industrial collaboration, the foreign collaborators can collect useful information about the management and the future of the collaborating unit through management audit and can take right decision.

7. ***Guides the bank in sanctioning loan*** Before granting loan or participating in the equity capital of a company, a bank or financial institution may get management audit conducted to ensure that their investment in the company would be safe and secured in the hands of the management.

8. ***Guard against shortsighted project*** As the tenure of the directors is very short, they become prone to taking decisions keeping in view only short run profit ignoring its adverse effect on the company in the long run. Management audit can act as a guard against such possibility.

Scope (⬇)

The following are the important areas that come within the normal terms of reference of management audit:

1. Whether the basic aims and objectives of the enterprise are being fulfilled in practice
2. Whether the enterprise is being successful in adapting itself to technological change
3. Whether the management structure is suitable
4. ‘Whether management is efficient at all levels and to what extent economies are possible
5. Whether the policies with regard to staff recruitment and training are adequate, and whether staff morale is satisfactory

6. Whether there is a proper communication system both upwards and downwards throughout the enterprise including a proper management information system
7. Whether the enterprise's share of the market is increasing or declining and how it compares with its main competitors
8. Whether the return on capital employed is satisfactory and how it compares with other companies in the same industry
9. Whether the management has been able to establish good relations with the employees and how it compares with other companies
10. Whether its relationship with the outside world is effective and whether its corporate image in the eyes of outsiders is satisfactory

Steps (⬇)

Management auditors are appointed for getting their suggestions for improving efficiency of the entire organisation or the specific areas assigned to them. Management audit, therefore, comprises three basic steps. These are as follows:

- Examination of management performance
- Reporting defects and irregularities
- Presenting suggestions for improvement

These basic steps can further be broken down into the following stages:

1. Study of the activities
2. Detailed diagnosis
3. Determination of purpose and relationship
4. Looking for deficiencies
5. Analytical balance
6. Testing of effectiveness
7. Searching for problems
8. Ascertainment of solutions
9. Determination of alternatives
10. Seeking out methods of improvement.

The auditors conducting management audit begin their work with discussions with the management executives and employees, then they note down their findings and make out their probable recommendations on the basis of those findings. Finally, they submit their final report along with their recommendations.

Advantages & Disadvantages

Advantages

The importance of management audit can be conceived of if the advantages of the management audit can be studied properly. There is no denying the fact that the management audit is result-oriented. It provides us the following advantages:

1. It helps the management in preparing plans, objectives and policies and suggests the ways and means to implement those plans and policies.
2. The inefficiencies and ineffectiveness on the part of the management can be brought to light.
3. The techniques of management audit are not only applicable to all factors of production, but also to all elements of cost.
4. Proper management audit techniques can help the business to stop capital erosion.
5. It increases the overall profitability of a concern through constant review of solvency, profitability and efficiency position of the concern.
6. It helps the top management in arriving at correct management decisions without any delay.
7. It helps the management in strengthening its communication system within and outside the business.
8. It can help management in the preparation of budgets and resources management policies.
9. It can also help the management in training of personnel and marketing policies.

Disadvantages

The disadvantages of management audit can briefly be stated as follows:

1. The introduction of management audit technique involves heavy expenditure.
2. Managers will hesitate to take initiative, as the management auditor will always pinpoint some shortcomings in the action.
3. Managers will always try to keep the records up-to-date rather than improving efficiency and reducing the costs.
4. Due to ineffectiveness and inefficiency of the management auditor, in all cases, management audit cannot provide result-oriented service.
5. Management auditors are sometimes engaged in some activities detrimental to social objects of auditing, for example, evasion of tax.

Appointment

A group of auditors should be appointed to conduct management audit, as it is not expected that an individual auditor should have all the expertise in all fields of management to conduct this type of audit effectively. Hence a group is formed taking experts from each area of management field for this purpose. The internal auditors must also be included in this group as they are familiar with internal affairs of the organisation and management.

Management audit involves an appraisal of activities of the management of the organisation. So, the auditors must study the organisational activities and its plan of action in detail. Not only that, the management auditors should get full co-operation from the top-level management to enable them to conduct the audit effectively. But the effectiveness of management audit will depend on the scope of audit, which the management has to decide.

Qualities of management auditors

The task of performing the management audit cannot be assigned to an ordinary person. The management auditor should have sufficient experience and knowledge about the functions of management. In fact, he should have the ability to understand different management activities of the organisation viz. internal control system, production planning and control, personnel management techniques etc. The different qualities that the management auditor should possess are stated below:

1. The management auditor should have the ability to understand the problems of the organisation.
2. He should have a clear understanding as to the nature, purposes and objectives of the organisation.
3. He should have the ability to determine the progress of the organisation.
4. He should be tactful in dealing with different employees and officers of the organisation.
5. He should have pleasing and dynamic personality.
6. He should have general understanding of different types of laws, particularly the Income Tax Act and the Companies Act.
7. He should have a sound knowledge in preparing various reports, presented to management.
8. He should be able to assess and examine the internal control system of the organisation.

9. He should be familiar with various principles of management, viz. planning, control, management by exceptions etc.
10. He should have a good knowledge of financial statement analysis techniques like fund flow analysis, ratio analysis, standard costing etc.

Management auditor's report

After conducting management audit, the management auditors are required to prepare a report to be submitted to the management of the organisation. On the basis of findings and definite information, the auditors prepare a report making recommendations for improvement in the functioning of the management. He should not hesitate in criticising the management. His recommendations should be constructive and adequate for the improvement of the overall efficiency of the management.

Nevertheless the report must be clear and unambiguous, either making the point that efficiency is such that no change is advocated, or if reorganisation is considered advisable, then the management auditor must be sufficiently confident of his own ability to have assessed the situation that he can make adequate proposals which will lead to improvement and increased profitability.

Difference between management audit and cost audit

Cost audit is the detailed checking as well as the verification of the correctness of the costing techniques, systems and cost accounting data.

On the other hand, management audit is the detailed examination of an organisation to appraise its organisational structure, policies and procedures of management in order to determine the existence of effectiveness of management system in the organisation.

Difference between management audit and financial audit

Management audit is an examination of efficiency of management at all levels throughout the organisation in order to ascertain whether sound management prevails, thus facilitating the most effective relationship with the outside world and the most efficient organisation.

On the other hand, financial audit is an audit of financial accounts, supporting vouchers or documents and financial statements.

5.3.1 Difference between management and cost audit

Points of difference	*Management audit*	*Cost audit*
1. Scope of audit	Management audit is a **comprehensive review** of all aspects of management functions.	Cost audit is the **verification of correctness** of cost accounting data, costing techniques and system.
2. Legal compulsion	Management audit is **not a statutory requirement.**	In certain industries cost audit is compulsory and a **statutory requirement.**
3. Qualification of auditor	The management auditor must be a person having **wide expertise in the field of management and accountancy**.	The cost auditor must possess **prescribed qualifications** as per the provisions of the Companies Act.
4. Area of audit	The management auditor critically examines the **policies, procedures and the techniques** of management adopted and report on their effectiveness.	The cost auditor checks the **cost accounting data** only.
5. Periodicity	It covers wide area of activities of the management and may be for **more than one financial year**.	The cost audit is conducted for every **financial year** separately.

6. Submission of audit report	There is **no time limit** for the submission of management audit report.	There is a **stipulated time limit** within which cost audit report has to be submitted.
7. Regularity	Management audit is **not a regular feature**. Whenever need arises, the management may decide to conduct management audit.	It is a **regular feature** and required to be conducted year after year.
8. Accountability	The management auditor is **accountable to the management** only.	The cost auditor is **accountable to the shareholders** as well as to the central government.

5.3.2 Difference between financial and management audit

Points of difference	*Financial audit*	*Management audit*
1. Concept	Financial audit is an **examination of financial accounts** and financial statements.	Management audit is a comprehensive and constructive examination of the **efficiency of management** at all levels throughout the organisation.
2. Objectives	The primary objectives of financial audit are to ascertain whether all the **transactions have been properly accounted** for in the books of accounts and whether the	The primary objectives of management audit are to make an **evaluation of the efficiency of management** at different levels and make useful

	financial statements of the concern give a true and fair view of the financial result and financial position.	suggestions for removal of inefficiencies of management functions.
3. Continuity	Financial audit is required to be done every year.	Management audit is not required to be conducted every year.
4. Scope	The scope of financial audit is quite **narrow**.	The scope of management audit is much **broader**.
5. Efficiency of employees	The efficiency of employees is not assessed in financial audit.	The efficiency of the employees is assessed in management audit.
6. Auditor	Only professional accountants are competent to perform financial audit.	Management audit can be performed by a group of experts, consisting of management experts, professional accountants, engineers etc.
7. Cost involvement	Financial audit involves less cost.	Management audit is quite costly.
8. Duration	Financial audit covers the accounts of only one year.	Management audit covers accounts and other aspects of management activities for a number of years.

5.4 HUMAN RESOURCE AUDIT

Concept of human resource

Of all the elements that result in profit generation of an organisation, the most important factor is the **HUMAN RESOURCE FACTOR**. The growth and development of the organisation including increase in productivity, profitability and expansion of the organisation is dependent on the performance and efficiency of all the workers and employees of the organisation in general and the dynamism on the part of the top management in particular. All these human factors, which contribute to the growth and expansion of the business, either directly or indirectly, may be termed as 'human assets or human resources'.

Concept of human resource accounting

Touche Ross and Co., a Canadian CPA firm has introduced for the first time the concept of human resource accounting as a part of its management information system in the belief ***that a good human resource accounting system can provide information of vital importance for both short term as well as long-term decision-making and performance measurement***.

According to Eric Flamholtz, "***accounting for people as an organisational resource involves measuring the costs incurred by business firms and other organisations to recruit, select, hire, train and develop human assets***".

Concept of human asset audit

The decision of the investor to invest in the company is greatly influenced by the working of the managerial staff of the company. So, disclosure of information regarding human capital in the annual report of the company may help a lot to the investors in forming an opinion whether to invest or not. This may remove the standing criticism of the financial reporting that 'one of the outstanding omissions is information concerning the human capital employed'.

But before including human capital employed as a part of annual account it has to be ensured that the human capital as included is reliable and computed on the basis of generally accepted principles for the valuation of human capital. In order to get reliable value of human resources, the necessity of human resource audit is felt. The human resource audit examination should not relate to the rightness to the process of valuation of the asset, but it should see that the information upon which the calculations are based upon are reliable and authentic.

So, the definition of human resource audit may be given in the following way: "Examination of the human asset figure that appears in the balance sheet through checking, inspecting and appraising the various facts and figures which are based on the estimated value of human assets is called human resource audit."

Steps for human resource audit

Following steps may be suggested for the purpose of audit of human resources:

1. The nature of the organisation should be thoroughly examined to know whether it is a firm of professionals or of the general business.
2. Interview with the top managerial personnel should be taken to acquire information regarding the valuation of human resources.
3. It should be seen that provision for depreciation of human assets has been adequately provided.
4. It should be confirmed that the correct value has been placed in the balance sheet.
5. The internal control system as regards various information of human resources should be reviewed to evaluate its effectiveness.
6. It should also be ensured that all contingencies that have the effect on the valuation of human resources are duly considered in the value measurement of human resources.

Problems of human resource audit

Though the auditor is not an expert for the human resource valuation, he has to be intimately connected with the measurement of human resources. For this, the auditor has to appraise the values that are placed in the balance sheet either in the form of investment against human resources or in the form of net value of human assets. But there are certain problems, which may be encountered by the auditor while verifying the value of human resources. These are as follows:

1. It is not possible to determine the value of an individual with perfection. Therefore, the audit procedure under this system of audit is bound to give unrealistic approach to the direction.
2. It is difficult for the auditors to measure the value of the employees who are trained by the methods suggested by the accountants or the valuers.
3. As there is a scope for a subjective judgment in valuing the resource, the audit procedure may not give the guarantee as to the reliability of the data.
4. It is difficult for the auditor to collect the required correct information upon which the human resource valuation is based.
5. As the concept of audit under the name, 'human resource audit' has not attained much popularity and its use is not found so far widely in organisations, the auditor may be put into the dilemma as to the course of action to be followed for the purpose of audit.

Advantages of human resource audit

In spite of the existence of various problems that stand on the way of conducting an efficient audit of human resources, the audit procedure adopted for this purpose may provide the following advantages:

1. The audited figure may be taken by the management as reliable for taking any decision on the matter.
2. The actual audit of this figure may help the auditor to give his audit report about the true and fair view of the state of affairs of the business.
3. It may invite the investor to invest more funds in the business.
4. Thorough enquiry as to allocation of resources amongst various competiting opportunities made by the company can be made possible through this system of audit.
5. The audit of human asset may rightfully justify whether expenditure incurred in this regard is reasonable.
6. The audited figure of human resource may form a valuable basis in the preparation of social accounts.

5.5 OPERATIONAL AUDIT

Definition

The dictionary meaning of the term 'operation' means '**working**' or '**performs functions**'. Therefore the term 'operational audit' implies audit of the working of the business or it may be defined as an audit of functions performed by the business.

According to Federal Financial Officers' Institute, Canada, "operational audit is a systematic independent appraisal activity within an organisation for a review of the entire departmental operations as a service to management".

On review of the definitions, it appears that at present the scope of application of operational audit has been extended in financial and accounting areas too in addition to other areas of operations in an organisation.

Objectives

The objectives of operational audit in particular may be stated as follows:

1. To appraise or evaluate the objectives of the business and see whether they are properly set.
2. To evaluate the policies of the company to judge whether they are adequately framed or not.
3. To analyse the measure of devices as laid down in the policies for the accomplishment of objectives.
4. To determine the work force of the organisation and ensure that the productivity of the available work force is satisfactory.
5. To evaluate the structure of the organisation to know the rights, duties and responsibilities of different persons engaged in different operations.
6. To appraise or evaluate the different control techniques used by the organisation for the satisfactory completion of the operations.

Scope of audit

The approaches of operational audit may be classified under the following two broad heads:

1. ***Organisation*** In the related field of organisational areas, the auditor of operation is concerned with the following aspects:
    1. Examination of the administration of different departments of the organisation
    2. Examination of various functions within the organisation
    3. Evaluation of the performance of the employees of the organisation
    4. Anticipation of future performance of the organisation through preparation of budget
    5. Improvement of the product of the organisation
    6. Improvement of the organisational structure of the concern

2. ***Function*** As to the functional approach of the operational audit, it is important to note that the auditor in operation is concerned with the following:
    1. All activities of the organisation from the beginning to its end
    2. The performance of workers working in operational areas
    3. Appraisal of function through all the units involved in the process of operation
    4. Examination of workflow
    5. Assistance to management through overview
    6. Evaluation of plans and procedures adopted by the management

Advantages & Disadvantages

Advantages

The advantages of operational audit may be stated as below:

1. It increases the productivity and profitability of the organisation.
2. It can alert the management before resulting losses.
3. It can characterise both financial and operating areas by the state of mind of the auditor.
4. It protects the interest of the shareholders.
5. It can train up inefficient employees working in different key operating areas of the business.
6. It may protect capital erosion through constant watch and review of different operating areas.

Disadvantages

1. The application of this system of audit involves greater amount of cost.
2. The required qualities as are expected from the auditor may not be found in actual practice.
3. If the auditor's report is ignored, the auditor cannot function properly.
4. The operational audit programme, unlike the financial audit programme, is difficult to prepare.

5.6 FORECAST AUDIT

Definition

The term 'forecasts' are derived through a combination of **judgment and science** in which history, plans, reactions, aspirations, constraints and pressure all play a part. Forecasts are based on management's assumptions of future events, some of which are explicit and some of which are implicit. But, there is no assurance that the forecast will be achieved.

So, forecast audit may be defined as a ***critical examination and review of the forecasts of profit, sales and cash flow of the organisation made by the management*** for the general understanding of all concerned, interested in the affairs of the business, by applying reasonable care, skill and judgment.

Objectives

There is no doubt that **budgeting and planning** help the management to ensure a better control on the financial aspect of the organisation. However, a *higher control is required to ensure the potentiality of the planning*. This is possible through 'forecast audit', which ensures the following:

1. It can stop capital erosion mainly arising from payment of dividend and tax out of inflated as well as unrealised profit.
2. It ensures the continuity of the organisation by regular check up of the different key areas of the accounting processes.
3. It can strengthen the 'integrity of the capital structure' of the business.
4. It can alert the business against any uncertainties.

Steps in confirming the forecasted figures

For the purpose of confirming the forecasted figures as prepared by the management, the auditor should verify the same with reference to the following:

1. ***Determination of the range of probabilistic consideration*** The auditor should check the probabilistic consideration with reference to the authenticity of the available information, which justifies the probabilities.

2. ***Adhering to the generally accepted accounting principles*** The auditor should verify those forecasted figures by reference to principles of accountancy.

3. ***Exercise of reasonable care and skill*** It is the reasonable care and skill which form the basis of judgment power. With the aid of this judgment power, the auditor may check the reliability of information upon which is based the forecast figure.

4. ***Better information system*** All channels of information should be thoroughly examined and verified to form a basis for information, which is the basic of forecast figure.

5. ***Adhering the objectives of the business*** The auditor should see that the forecast figures are not contrary to the objectives and plans of the organisation.

6. ***Proper documentation*** The auditor should check whether the forecasting provides proper documentation of both the forecast and the forecasting process.

7. ***Comparison*** The auditor for the purpose of attaining precision and designing the forecast model should compare the forecast with the results attained. This may enable him to take corrective steps to verify the figures more accurately and efficiently.

8. ***Approval*** The auditor should examine properly whether the financial forecast bears proper authorisation from the top management.

Problems of conducting forecast audit

The problems that are faced by the auditor in the conduct of the forecast audit can be stated as follows:

1. The inherent risk in the conduct of an audit is an important problem of forecast audit.
2. The ambiguity in the client's instruction relating to the liability of the auditor.
3. The exercise of reasonable care and skill in estimating the forecast figure, which is based on subjective and objective consideration, is really very difficult to concentrate upon.
4. Another problem lies with the fact that the auditor has to make his report on the available information furnished by the organisation.
5. It is really very difficult to examine the concept of 'materiality' relating to an item that is included in the profit forecast. It is a fact that there is no boundary line to judge what is material and what is immaterial.
6. Another problem is that the estimation always depends upon the assumption of which forecast is made. But some assumptions inevitably will not materialise and unanticipated events and circumstances may occur.

5.6.1 Difference between annual audit and forecast audit

Points of difference	*Annual audit*	*Forecast audit*
1. Nature of audit	The auditor conducts the audit work on the **past records**.	The auditor conducts his audit work on the **future events**.
2. Audit report	The audit report is **realistic**.	The audit report is **unrealistic**.
3. Supporting evidence	Effective checks can be made possible on the supporting documents.	There is no supporting evidence on which checks are to be made.
4. Liability of auditor	The liability of the auditor is **clearly defined**.	It is **difficult to define the liability** of the auditor.
5. True and fair view	The use of the words **true and fair view** in audit report justifies the propriety of happenings.	The auditor cannot certify the uncertainties as being true and fair.
6. Risk factor	The risk factor in the conduct of an audit of this type is **minimum**.	It involves **greater amount of risk**.
7. Audit approach	The audit work approaches through the **books of accounts**.	The audit work approaches through the **evaluation of the administrative control**.

5.7 SOCIAL AUDIT

Concept of social responsibility

Corporate entities are now regarded as a great social force. They are not expected to be only engaged in profit earning activities and paying dividend to the shareholders. They have an important role to play in the social well-being. They have high responsibility to the society. Such responsibilities can be identified in two directions as follows:

1. ***Internal social responsibility*** It includes the following:

    1. Extending staff benefits comprising indirect monetary benefits like provident fund, gratuity, bonus, insurance, leave salary, medical benefits, housing facility, recreation and entertainment for employees and workers and other benefits
    2. Keeping the environment of the factory and its surrounding area clean and non-hazardous
    3. Paying the statutory dues in time
    4. Supplying quality products at fair prices
    5. Giving fair return to investors commensurate with risk

2. ***External social responsibility*** It includes the following:

    1. Community development through creation and maintenance of roads, parks, playgrounds and provision for drinking water facilities
    2. Tree plantation for the improvement of environment
    3. Growth and expansion of the business and thereby creating new job opportunities
    4. Setting up plants in backward areas

Concept of social accounting

In recent years a school of thought has developed a new concept, which advocates that as large companies have responsibilities to persons other than their shareholders, information relevant to such groups should be provided.

For instance, it has been suggested that information should be given dealing with such matters as follows:

- Remuneration of employees and fringe benefits
- Retirement arrangements for employees
- Health and safety measures
- Staff training programmes
- Industrial relations
- Pricing policies in respect of goods and services provided
- Quality control over products sold
- Integrity of advertising campaigns
- Pollution controls
- Energy conservation

Social accounting is a system of accounting, which indicates how and in what way a business organisation performs the above-mentioned obligations for the society. So, social accounting can be defined as "***a method of measurement and reporting, internal and external, of the information concerning the impact of an entity and its activities on society***".

According to the National Association of Accountants of USA (NAA), social accounting is the "***identification, measurement, monitoring and reporting of the social and economic effects of an institution on society. It is intended for both internal managerial and external accountability purposes and is an outgrowth of changing values that have led society to redefine its notion of a corporation's social responsibility***".

Concept of social audit

The term 'social accounting' and 'social audit' are used sometimes in the literature interchangeably. But social accounting is concerned with the development of measurement system to monitor social performance, and social audit is the use of an independent auditing system to verify a firm's records of social performance. '***Social accounting is the process of determination of social performance of an organisation', while 'social audit' is the enquiry into the corporate social accounting records by an outside agency that can opine with a view to attestation and authentication of such results and reports***.

So, social audit may be defined as "*assessment of the performance of an industry as a whole vis-à-vis its total responsibility*." But social responsibility now a days is not a total concept relating to an industry. Each organisation forming part of an industry is considered to have specific social responsibility. Social audit may, therefore, be rightly defined as "the assessment of social performance of an organisation."

Objectives of social audit

Social audit is a very new and growing area of audit. Modern accountants have developed several approaches and techniques for the effective conduct of social audit. Social audit techniques, in fact, are to be framed by the accountants taking the following objectives of social audit into consideration:

1. To make an assessment of social performance by an organisation
2. To inform the management of an organisation of the accuracy and fairness of its social accounts
3. To evaluate the socio-economic contributions made by an industry
4. To bring to light for public knowledge how far an organisation has discharged its responsibility to the society
5. To advise the management in the preparation of social accounts
6. To evaluate with the help of financial data various social actions of an organisation and describe them in properly analysed form in the absence of socio-economic performance statement
7. To check whether various social actions of an organisation have been evaluated under proper categories like products, employees, local community, environment, public in the social income statement
8. To examine the correctness of 'value added statements' when the contribution of an enterprise to the national economy is described through such statements
9. To verify the assets shown in the social balance sheet and check their values
10. To examine the correctness of amount shown as social equity in the liability side of the social balance sheet

Importance

Social audit is a new concept and has emerged out of the growing awareness of the responsibility of the business towards the society. In the changing socio-economic scenario, the social audit has assumed a special significance. In fact society now demands something more from the auditing profession. Apart from expecting the traditional services from audit, i.e. ensuring reliability and fairness of accounts, the society now requires audit to become social oriented for safeguarding the interest of various elements of the society. So, social audit is very important in the present business environment. The importance of social audit can be stated in the following way:

1. ***Assessment of social contribution*** Social audit assesses the social performance of a business enterprise. Only through social audit one can get a correct picture of the contributions made by an enterprise to the society.

2. ***Presentation of annual social accounts*** In order to conduct social audit, social accounts are also required to be prepared. Attention is given at present for the development of suitable social accounting system with standards for measurement of social performance and presentation of annual social accounts.

3. ***Guide to the management*** The social auditors may guide the management in the measurement of social performance, proper keeping of social accounting records and presentation of social statements. Their specialised knowledge may be of immense value to the management.

4. ***Contribution of the industry*** Social audit has also an important role to play in relation to an industry, as it can successfully assess the overall contribution made by an industry to the society and the national economy.

5. ***Allocation of scarce resources*** To ensure effective allocation of scarce resources, evaluation of different social projects should be done from the viewpoint of their social costs and social benefits. This evaluation is done through social audit.

Social audit in India

When the central government issued manufacturing and other companies (auditor's report) order in 1975 and when it is implemented as social audit by company law board by the introduction of Section 227(4A) of the Companies Act, 1956, it becomes compulsory for the company auditor to give report on several additional matters of social importance. A number of audit experts described these steps by the central government as the introduction of social audit in India. But it is not at all a social audit, as social audit is not an audit for expressing auditor's opinion on the matters of internal control, propriety and compliance. However, this can be considered a right step in keeping the companies aware of their social responsibility and accountability to the society.

For the first time in India, the Tata Iron and Steel Company published the report of their social audit committee in the year 1980. The committee had to make an assessment of the social performance of the company in the light of specific provision contained in the Articles of Association regarding its responsibility to the society. But the report of the committee was mere description of socio-economic contributions made by the company. No socio-economic activity-wise operating statement showing costs and benefits of various social actions was prepared.

In India, audit of social accounts is not yet in practice and the term 'social audit' is still in a conceptual stage in our country. There are two basic reasons for this situation:

1. There is no statutory provision in any act attempted to make it compulsory the keeping of social accounting and conducting the audit thereof.
2. In our country, no standard for the preparation of statement of social performance and socio-economic operating statement have yet been developed.

So, in India, the concept of social audit is still a vision in reality.

5.8 TAX AUDIT

Definition

Statutory audit is conducted mainly keeping in view the information requirement of the shareholders. But there are also other parties who are interested in the financial information of the organisation. One such interested party is the tax authority, who wants to know the correct income of the assessee for the tax provisions point of view. With this objective, the Income Tax Act of 1961 has included a number of provisions, which require audit of statements prepared for tax purposes.

So, the term 'tax audit' refers to the audit of income and expenses or specific claims of deductions and exemptions that are required to be computed as per the provisions of the Income Tax Act. Tax Audit is a specific requirement under the Income tax Act. It is required in addition to financial audit, which does not fulfill the specific requirement of the tax authority.

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 accountant as defined in the explanation to Section 288(2) of the Income Tax Act can conduct a tax audit under any of the provisions of the act. A person eligible for the appointment as auditor of a company is also included in the definition of accountant. A chartered accountant, to conduct tax audit, must however be a practicing chartered accountant holding a certificate of practice as required under the Chartered Accountants Act, 1949.

In the case of companies, the tax audit can be conducted by the statutory auditor or by any other chartered accountant in practice.

The appointment of tax auditor can be made by the management of the organisation. Thus, in case of a company, the Board of Directors or the officer so authorised by it can appoint the tax auditor. Similarly, a sole proprietor or a partner of a firm or any other authorised person can appoint the tax auditor.

Compulsory tax audit under Section 44AB

Since the assessment year 1985–86, certain provisions under Section 44AB of the Income tax Act, 1961 was inserted to provide that certain persons have to get compulsory tax audit of their accounts. This section provides that every person ***(a) carrying on business, if his total sales or gross receipts in the previous year exceeds Rs. 100 lakhs, or (b) carrying on profession, if his gross receipts exceeds Rs. 50 lakhs in the previous year***, shall get his accounts of the previous year audited by an 'accountant' before the 'specified date' and obtain before that date the report of such audit in the prescribed form duly signed and verified by such accountant.

So, unlike statutory audit, tax audit under this section is not confined to company only. The approach of tax auditor is similar to that of statutory auditor. He applies the same generally accepted principles for conducting audit and can rely on the technique of selective verification. However, he is to keep in mind the requirement of Income Tax Act and various judicial pronouncements in this area of application.

Penalty for non-compliance

Section 271B of the Income tax Act, 1961 prescribes a penalty of a sum equal to 0–5% of the total sales or gross receipts, as the case may be, or Rs. 1,00,000, whichever is lower, for a person, where he fails to get his accounts audited as per Section 44AB or to furnish such report with his return of income. But, if a person can show reasonable cause against his failure, no such penalty may be imposed.

Tax audit report

The tax auditor is required to express his opinion in the tax audit report about the tax computation method adopted by the enterprise. He has to express in his report the following:

1. Whether or not the financial statements give a true and fair view of the profit or loss and the state of affairs, if the accounts of the assessee are not subjected to audit under any other law
2. Whether or not the prescribed particulars contained in the statement annexed to the audit report are true and correct

Rule 6G of the Income Tax Rules prescribe the formats in which the auditor has to submit his audit report. The various formats are as follows:

1. ***Form 3CA+ 3CD*** In the case of a person who carries on business or profession and who is required under any other law to get his accounts audited, the tax auditor has to give his report in Form 3CA and annex with the audit report a statement of particulars in form 3CD.

2. ***Form 3CB+ 3CD*** In the case of a person who carries on business but whose accounts are not audited under any other law, the tax auditor has to give the audit report in Form 3CB and annex thereto a statement of particulars in Form 3CD.

5.9 FORENSIC AUDIT

Companies (Auditors' Report) Order, 2003 requires auditors to report, amongst others, ***whether any fraud on or by the company has been noticed or reported during the year. If yes, the nature and the amount involved are to be indicated.*** In this context, the techniques of forensic auditing have gained importance.

Definition

The term ‘forensic auditing’ has not been defined anywhere. However, since the object is to relate the findings of audit by gathering legally tenable evidence and in doing so the corporate veil may be lifted to identify the fraud and the persons responsible for it.

Forensic auditing aims at legal determination of whether fraud has actually occurred. In the process, it also aims at naming the person(s) involved with a view to take legal action.

Forensic audit involves examination of legalities by blending the techniques of propriety, regularity and investigative and financial audits. The objective is to find out whether or not true business value has been reflected in the financial statements and in the course of examination to find whether any fraud has taken place.

Objectives

Objective of forensic audit is to find whether or not a fraud has taken place. Forensic auditor shall have to examine voluminous and in totality, records and witnesses, if permitted by law. Proper documentation is vital in substantiating the findings. The outcome shall focus on the following, in case of frauds:

- Proving the loss
- Proving the responsibility for the loss
- Proving the method/motive
- Establishing guilty knowledge
- Identifying other beneficiaries

Application

Forensic accounting and audit may be applied in the following areas besides fraud detection:

- Conducting due diligence especially for segment-wise profitability analysis
- Business valuation
- Management auditing
- Assessing loss before settling insurance claims

Techniques

Forensic auditing should focus on significant transactions both as reflected in the financial statements and off balance sheet items. The techniques used mainly are as follows:

1. ***For financial statement items***

    1. *Critical point auditing*. This technique aims at filtering out the systems of fraud from regular and normal transactions in which they are mixed or concealed. For this purpose, financial statements, books, records etc. are analysed mainly to find out the following:

        1. Trend-analysis by tabulating significant financial transactions
        2. Unusual debits/credits in accounts normally closing to credit/debit balances respectively
        3. Discrepancies in receivable or payable balances/inventory as evidenced from the non-reconciliation between financial records and corresponding subsidiary records
        4. Accumulation of debit balances in loosely controlled accounts
        5. False credits to boost sales with corresponding debits to non-existent personal accounts
        6. Cross debits credits and inter account transfers
        7. Weaknesses/inadequacies in internal control/check system

2. ***For off-balance sheet transactions*** There are certain transactions which are neither discussed prima facie in the financial statements nor suitable disclosures made. Since these are intangible in financial statement, the auditor may not consider these as significant or material, no statement/qualification is normally made in auditor's report. These may encompass the following:

    1. Significant purchases/sales of raw materials and/or finished goods with only a particular dealer or group companies of such vendor
    2. Pattern of consumption of major raw materials/components, indicating excess consumption

3. Over/under invoicing for capital goods, raw materials/components or services as compared to normal prices for the same
4. Alteration of contractual terms, to pass on otherwise accrued benefit, to holding/group companies
5. Diversion of funds through group companies and setting off such debits as expenditure in accounts with proper authorisation before closure of accounts to avoid detection
6. Cost over-runs in major capital expenditure without corresponding benefit or convincing reasons
7. Justification for non-maintenance of certain basic records, on technical grounds, but with intention to defraud.

5.9.1 Distinction between statutory audit and forensic audit

Points of difference	*Statutory audit*	*Forensic audit*
1. Objective	The basic objective of statutory audit is to express opinion as to the true and fair presentation of financial statements.	The objective of forensic auditing is to determine correctness of the accounts or whether any fraud has actually taken place.
2. Techniques	Usually both the substantive and compliance techniques of auditing are adopted.	As techniques of auditing, analysis of past trend and substantive or in-depth checking of selected transactions are adopted.
3. Period covered	Normally all the transactions for the particular accounting period are covered.	There is no such limitation in this type of audit. Accounts may be examined in detail from the beginning.
4. Verification of assets	Under this type of audit, verification of assets relies on the management certificate/representation of management.	Under this type of audit, independent verification of suspected/selected items are carried out.
5. Off balance sheet items	These items are considered to vouch the arithmetic accuracy and compliance with procedures.	Regularity and propriety of these transactions/contracts are examined.
6. Adverse findings	In case of adverse findings, the auditor expresses negative or qualified opinion.	Legal determination of fraud and naming persons behind such frauds are the results of adverse findings.

5.10 ENVIRONMENTAL (GREEN) AUDIT

Environmental audit is an excellent management tool for relating productivity to pollution. The Environment (Protection) Act, 1986 under the Rule 14 requires an industry to submit annual environmental statement by the 30th of September every year, from 1993 onwards, to the relevant State Pollution Control Board. Rule 14 is applicable to any industry or organisation, which possesses or requires consent or authorisation under Water (Prevention & Control of Pollution) Act, 1974, Air (Prevention & Control of Pollution) Act, 1981 and/or Hazardous Waste (Management & Handling) Rules, 1989.

Definition

Environmental audit is the examination of the correctness of environmental accounts. In broader sense, environmental auditing is the examination of accounts of revenues and costs of environmental and natural resources, their estimate, depreciation and values recorded in the books of accounts.

In the words of N. Rajaraman, "***environmental auditing is a series of activities undertaken on the initiative of an organisation's management to evaluate its environmental performance***".

The International Chamber of Commerce defines environmental auditing "as a basic management tool comprising a systematic, documented, periodic and object evaluation of how well environmental organisation, management and equipment are performing with the aim to safeguard the environment".

So, environmental audit is an excellent management tool to assess the activities of an industry from a pollution angle and measure the efficiency and the adequacy of control measures.

Objectives

The following are some of the objectives of environmental auditing:

- To see that the natural resources are properly utilised
- To control the costs incurred on procuring the natural resources and to ensure that they have been properly classified
- To see that natural resources have been properly shown in a nation's balance sheet as they are the nation's valuable assets

- During production process, when natural resources are utilised, some adverse environmental effects are produced and pollution is created. So, the objective of such an audit is to see that proper steps are taken to control or to prevent such adverse effects like pollution
- To ensure that the natural resources are utilised for industrial development and for national progress
- To see that proper steps have been taken for maintaining health and welfare of the community and also for disposal of harmful wastes and social risks

Approach

Establishment of an effective environmental audit programme requires careful planning and attentions to the goals and objectives established for the audit programme of each company.

The requirement of environmental audit will undoubtedly vary from one plant to another and there is not necessarily any one single approach. In principle, such audits are carried out by a small qualified and independent team of experts who would visit a particular plant site basically to check on the environment management and performance of the plant in question. Since there is a process of self-analysis for the industry, the industries themselves can conduct this audit under the guidance of expert professionals. Environmental audit software can also assist the industry in performing this task.

The following steps are required to be followed while approaching towards environmental audit:

Step 1: Preparatory activities The first step is to constitute a multidisciplinary audit team having expertise in general environmental matters (policy, regulations, environmental management) as well as in specific environmental issues (ecology, environmental toxicology, fate and behaviour of potential containment), abatement technologies and operational aspects.

After forming an audit team, the next task is to enable the team to assemble pre-visit information. The industry records would contain background information on the nature of the operations and environmental matters relevant to the plant. For example, the production details, water cess payable, energy consumption, and raw materials related information are available in the industry records. On the basis of information available, the audit team will identify the main areas for consideration, develop a visit programmme and allocate specific tasks to team members.

So, preparatory activities related tasks include the following:

1. *Imparting education on environmental audit.* Imparting education to management and plant personnel on environmental audit is the primary task. To ensure the success of an audit programme, support and commitment of the senior management should be obtained. Management should realise that environmental audit is one of the very important pragmatic tools.
2. *Review of background information:* Gathering and reviewing of background information relating to the corporate environment as a whole and also awareness of acts and rules, consent compliance, performance of pollution control system, solid waste management, safety measures etc. is needed. In other words, the objective and scope of environmental audit should be unambiguously outlined.
3. *Composition of audit team:* Being a multi-disciplinary approach, environmental audit depends upon involving right people for the task. The audit team may include engineers and technologists, biologists and personnel from other industries doing similar activities. Experienced environmental engineer should act as coordinator.
4. *Time frame*: Time frame for the audit should be carefully formulated so that all the activities are completed within a reasonable time.
5. *Preparing the questionnaire*: To conduct the audit, necessary questionnaires and other tools should be designed to collect and analyse the relevant information. In other words, appropriate audit tools should be designed and tested before the commencement of actual audit.

Step-2: On site visit The key elements of the visit are inspection of the facilities and interviews with the employees. The interview includes senior, middle and junior level staff of relevant departments. It has been helpful to conduct interviews in accordance with protocol before hand, using a flexible checklist.

The audit studies the process flow sheet and carries out a material balance for water and raw material used. Each process is to be broken up into individual sub-processes. The quantities and water entering and leaving the process are estimated from

- the chemical process engineering calculations,
- the plant records, or

- actual measurement conducted at the site.

The objective for preparing material balance is to relate water and raw material usage to per unit production. Similarly, air, solid and hazardous wastes generated are also estimated for individual processes. The quantities of various types of pollutants, thus estimated, are summed overall and the processes to arrive at a figure for pollution is generated per unit of each product. Based upon the above, it is possible to detect inefficiencies in production processes and undue wastage of raw material and water. Therefore, productivity of the industry can be related to pollution generation and resource utilisation.

So, on site activities related tasks include

- Interviewing site personnel working at various sites
- Inspecting the site, the operations and the equipments
- Reviewing safety measures
- Reviewing operating and administrative records and documents etc.

As with statutory and cost audit, environmental management also needs a functional internal control system. These internal controls are incorporated in a facility's environmental management system. They include the organisational monitoring and record keeping procedures, formal planning documents for the prevention and control of accidental release, internal inspection programmes, physical controls such as containment of released materials and a variety of other control system elements. The audit team gains information of all significant control system elements from numerous sources through use of formal questionnaires, observations and interviews.

Step-3: Post-visit activities Post-visit activities related tasks include the following:

- Identifying and evaluating waste reduction options and develop waste reduction action plan
- Determining potential solutions and preparing recommendations
- Preparing the interim audit report
- Assigning the responsibilities for corrective actions and establishing time-scales
- Implementing corrective actions
- Conducting follow-up to the corrective actions.

Based upon the plant visit and the information collected, an interim audit report is prepared. A typical environmental audit report contains the following:

- General information of the industry
- Water budget, i.e. quantity used in production processes, cooling water, domestic water etc.
- Raw materials balance for processes and consumption per unit produced
- Air and water pollution generated from various processes
- Solid and hazardous wastes generated from various processes and disposal techniques used for them
- Cost analysis of pollution prevention
- Future investment for environmental protection and abatement of pollution

Step-4: Final report preparation Within a short time, the audit team produces an interim report for comments by the site management. Recommendation and findings are discussed in a group discussion. The final report is then prepared and submitted to the industry.

Stages of environmental audit

As green consciousness is growing and developing, more companies are beginning to evaluate both, its commercial implications and the impact of their operations. The environmental audit is essentially a management tool. It implies that companies should not wait for restrictive legislation to bring about changes.

Environmental audit comprises the following stages:

- Existing legislative requirements, health and safety practices and forthcoming regulatory developments are analysed
- Internal procedures and external requirements are examined, compared and constructed. The implications of external requirements on production processes and equipments are assessed and the impact in terms of waste and emission are evaluated
- The organisation structure, administration and communication process of the company are analysed to determine the extent to which management is informed of the environmental impact of the company's activities. Gaps are identified and remedies suggested.

Environmental audit practice in India

The development of environmental audit can be traced back to the early 1970s. Oil spill off the British South Coast, Bhopal Gas Leak, Chernobyl disaster, pollution of different rivers etc. has led to increased concern in industrial environmental management. The United States Environmental Protection Agency published their environmental audit policy in 1986, followed by International Chamber of Commerce booklet on Environmental Auditing (1988) and UNEP published their technical report on Environmental Audit.

In India, recognising the importance of Environmental Audit and its procedure was first notified under the Environment (Protection) Act, 1986 by the Ministry of Environment of Forests. Under this Act, every person carrying on an industry, operation or process requiring consent under Section 25 of the Water (Prevention & Control of Pollution) Act, 1974 or under Section 21 of the Air (Prevention & Control of Pollution) Act, 1981 or both or authorisation under the Hazardous Wastes (Management and Handling) Rule of 1989 issued under the Hazardous (Protection) Act, 1986 is required to submit an environmental audit report. The environmental audit report has been renamed as Environmental Statement in 1993. This statement is required to be submitted to the concerned Pollution Control Boards.

The environmental statement should not be treated as a substitute for environmental audit, rather as a database for environmental audit. The analysis of the data and necessary suggestions for improvement in the environment and efficiency is not outlined in the environmental statement. Most of the developed countries like the USA, the UK, Canada, Australia etc. have already taken up environmental audit for their corporate sector. As of now, any disclosures on the environmental matters in the annual report of an Indian company are voluntary in nature. Environmental audit is conducted by a very limited number of companies in India.

Differences Between Various Areas of Audit

Contents

5.2.1 Distinction Between Financial Audit And Cost Audit

Points of difference	*Financial audit*	*Cost audit*
1. Concept	Financial audit is an audit of **financial accounts**, supporting vouchers or documents and financial statements.	Cost audit is an audit of **cost accounts**, cost statements and cost accounting plans.
2. Inter-relationship	It is not necessary for a financial auditor to examine cost accounts except for the purpose of valuation of inventory.	As the source of cost accounts is financial accounts, the cost auditor has to make a detailed checking of expenses.
3. Objectives	The primary objective of financial audit is to check whether necessary accounts, records and documents have been maintained by the concern and whether the profit and loss account and the balance sheet give a **TRUE AND FAIR VIEW** of the profit and loss and state of affairs respectively.	The primary objective of cost audit is to verify whether **COSTS HAVE BEEN ASCERTAINED** on the basis of cost accounting principles, whether cost records have been properly maintained and whether the cost of production and sale has been correctly worked out.
4. Nature	Financial audit is somewhat a **post-mortem** examination. It looks back to the past.	Even though cost audit also refers to the past, it creates **thinking for the future**. It is therefore forward-looking to a great extent.

5. Verification of stock	The financial auditor has only to see whether all categories of stock have been included in the accounts in true quantities and values.	The cost auditor has not only to check the cost of each item of stock, but also to check whether the stocks are maintained at proper level or not.
6. Purpose	Financial audit is essentially an audit on behalf of the **proprietors or shareholders**.	Cost audit is a tool in the hands of the **management**. Statutory cost audit is, however, conducted as per order of the **Central Government**.
7. Compulsion	Financial audit is **compulsory** for each company in each financial year as per the Companies Act.	As per the Companies Act, statutory cost audit is only required for the year if it is so **ordered by the Central Government.**
8. Submission of report	The financial auditor submits his report to his clients. In case of company, such report is required to be submitted to the **Shareholders**.	Cost auditor also submits his report to his clients. In case of statutory cost audit, such report is required to be submitted to the **Central Government**.

5.2.3 Traditional Audit And Propriety Audit

Points of difference	*Traditional audit*	*Propriety audit*
1. Objective	In traditional audit, **all business transactions are checked** with the help of vouchers and documents to ascertain whether the financial statements prepared gives a true and fair view of the financial result and financial position of the enterprise.	In propriety audit, the matters to be observed are whether the transactions entered into and all the business activities including the decision taken by the management are in **conformity with the standards of propriety**.
2. Fund utilization	It is **not the purpose** of traditional audit to discover wastes and misuse of fund.	Discovery of **wastes and misuse of fund** is the main purpose of propriety audit.
3. Accepted standard	If an expense is duly approved by the appropriate authority and supported by valid vouchers, it meets the accepted standard of traditional audit.	Mere approval and existence of supporting vouchers against an expense will not satisfy the auditor in propriety audit. The auditor has to verify whether the expense is necessary and the amount incurred is reasonable or not.
4. Function	It is not within the function of traditional audit to see whether the business is being managed **prudently and profitably**.	It is the function of the propriety audit to see whether the business is being managed **prudently and profitably**.

5. Verification of assets	In traditional audit **all assets described in the balance sheet are verified** in respect of existence, title, custody and value of the assets.	In propriety audit what is particularly required to be seen in the case of assets is whether all the **assets are adequately protected or not**.
6. Detection of fraud	Detection of **fraud and misappropriation of fund is not the primary object** of traditional audit. It is a secondary object only.	Detection of **fraud or misappropriation of fund is one of the primary objects** of propriety audit.

5.3.1 Difference Between Management And Cost Audit

Points of difference	*Management audit*	*Cost audit*
1. Scope of audit	Management audit is a **comprehensive review** of all aspects of management functions.	Cost audit is the **verification of correctness** of cost accounting data, costing techniques and system.
2. Legal compulsion	Management audit is **not a statutory requirement.**	In certain industries cost audit is compulsory and a **statutory requirement.**
3. Qualification of auditor	The management auditor must be a person having **wide expertise in the field of management and accountancy**.	The cost auditor must possess **prescribed qualifications** as per the provisions of the Companies Act.
4. Area of audit	The management auditor critically examines the **policies, procedures and the techniques** of management adopted and report on their effectiveness.	The cost auditor checks the **cost accounting data** only.
5. Periodicity	It covers wide area of activities of the management and may be for **more than one financial year**.	The cost audit is conducted for every **financial year** separately.

6. Submission of audit report	There is **no time limit** for the submission of management audit report.	There is a **stipulated time limit** within which cost audit report has to be submitted.
7. Regularity	Management audit is **not a regular feature**. Whenever need arises, the management may decide to conduct management audit.	It is a **regular feature** and required to be conducted year after year.
8. Accountability	The management auditor is **accountable to the management** only.	The cost auditor is **accountable to the shareholders** as well as to the central government.

5.3.2 Difference Between Financial And Management Audit

Points of difference	*Financial audit*	*Management audit*
1. Concept	Financial audit is an **examination of financial accounts** and financial statements.	Management audit is a comprehensive and constructive examination of the **efficiency of management** at all levels throughout the organisation.
2. Objectives	The primary objectives of financial audit are to ascertain whether all the **transactions have been properly accounted** for in the books of accounts and whether the financial statements of the concern give a true and fair view of the financial result and financial position.	The primary objectives of management audit are to make an **evaluation of the efficiency of management** at different levels and make useful suggestions for removal of inefficiencies of management functions.
3. Continuity	Financial audit is required to be done every year.	Management audit is not required to be conducted every year.
4. Scope	The scope of financial audit is quite **narrow**.	The scope of management audit is much **broader**.
5. Efficiency of employees	The efficiency of employees is not assessed in financial audit.	The efficiency of the employees is assessed in management audit.

6. Auditor	Only professional accountants are competent to perform financial audit.	Management audit can be performed by a group of experts, consisting of management experts, professional accountants, engineers etc.
7. Cost involvement	Financial audit involves less cost.	Management audit is quite costly.
8. Duration	Financial audit covers the accounts of only one year.	Management audit covers accounts and other aspects of management activities for a number of years.

5.6.1 Difference Between Annual Audit And Forecast Audit

Points of difference	*Annual audit*	*Forecast audit*
1. Nature of audit	The auditor conducts the audit work on the **past records**.	The auditor conducts his audit work on the **future events**.
2. Audit report	The audit report is **realistic**.	The audit report is **unrealistic**.
3. Supporting evidence	Effective checks can be made possible on the supporting documents.	There is no supporting evidence on which checks are to be made.
4. Liability of auditor	The liability of the auditor is **clearly defined**.	It is **difficult to define the liability** of the auditor.
5. True and fair view	The use of the words **true and fair view** in audit report justifies the propriety of happenings.	The auditor cannot certify the uncertainties as being true and fair.
6. Risk factor	The risk factor in the conduct of an audit of this type is **minimum**.	It involves **greater amount of risk**.
7. Audit approach	The audit work approaches through the **books of accounts**.	The audit work approaches through the **evaluation of the administrative control**.

5.9.1 Distinction Between Statutory Audit And Forensic Audit

Points of difference	*Statutory audit*	*Forensic audit*
1. Objective	The basic objective of statutory audit is to express opinion as to the true and fair presentation of financial statements.	The objective of forensic auditing is to determine correctness of the accounts or whether any fraud has actually taken place.
2. Techniques	Usually both the substantive and compliance techniques of auditing are adopted.	As techniques of auditing, analysis of past trend and substantive or in-depth checking of selected transactions are adopted.
3. Period covered	Normally all the transactions for the particular accounting period are covered.	There is no such limitation in this type of audit. Accounts may be examined in detail from the beginning.
4. Verification of assets	Under this type of audit, verification of assets relies on the management certificate/representation of management.	Under this type of audit, independent verification of suspected/selected items are carried out.
5. Off balance sheet items	These items are considered to vouch the arithmetic accuracy and compliance with procedures.	Regularity and propriety of these transactions/contracts are examined.
6. Adverse findings	In case of adverse findings, the auditor expresses negative or qualified opinion.	Legal determination of fraud and naming persons behind such frauds are the results of adverse findings.