AUDITING

B R A O U

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BLOCK – I

INTRODUCTION TO AUDITING

Unit – 1 : Introduction to Auditing

Unit – 2 : Classification of Audits

Unit – 3 : Audit Procedure

Unit – 4 : Audit under EDP Environment

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UNIT - 1 : INTRODUCTION TO AUDITING

Contents

1.0 Aims and Objectives
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1.2 Book-keeping, Accountancy and Audit
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1.0 AIMS AND OBJECTIVES

This unit aims at explaining as to what is meant by audit and what are its objectives. It also explains the advantages of audit and the inherent limitations of audit. After going through the unit you will be able to:

- Define audit and know its importance
- Know the difference between book-keeping, accountancy and auditing
- Explain the objectives of an audit
- Explain the advantages of an audit
- Know the limitations of an audit

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1.1 INTRODUCTION

In olden days business organisations were small in size and the number of transactions were also few and it was not very difficult for the owner himself to do the job of book keeping, accounting and verification of all the transactions. The industrial revolution in the 18th century gave birth to huge business houses employing hundreds of people and transactions running into several crores. This also gave birth to the concept of joint stock companies wherein the ownership of a business is spreadover thousands of shareholders. The natural consequence of all the above developments was the modern system of auditing. Today we have reached a stage where audit has become mandatory for most of the business entities.

1.2 BOOK KEEPING, ACCOUNTANCY AND AUDIT

Before we go into the subject of auditing it is essential to know the difference between book-keeping, accountancy and audit.

Book keeping

Book keeping can be defined as systematic recording of the business transactions in the books of original entry and their posting to ledger. To take an example, recording cash receipts and cash payments in the cash book is a book keeping job. Posting the transactions from the cash book or a sales register into a ledger is also a book keeping job.

Accountancy

Accountancy begins where book keeping ends. In other words the job of an accountant starts only after the basic job of book keeping has been done. The job of an accountant involves preparation of financial statements from the books of account. Typically the job of an accountant would involve preparation of a trial balance, preparation of a profit & loss account and a balance sheet and preparation of a cash flow statement. One should remember that in many small organisations the job of book-keeping and accounting is handled by the same person.

Audit

The job of an auditor starts only after the accountant has finished his job. The accountant will prepare the trial balance, profit & loss accountant and the balance sheet and all these financial statements together with the books of account like the cash book, bank book, journal and ledgers as well as the primary records like the cash vouchers, bank vouchers, journal entry vouchers, sales and purchase bills would be given to the auditor for verification. The job of an auditor is to verify the above and express an opinion on the financial statements prepared by the accountant.

1.3 DEFINITION OF AUDIT

The word audit is derived from the Latin word *audire* which means 'to hear'.

Different people have defined auditing in their own way bringing out the essential features of the function.

L R Dicksee defines auditing as 'an examination of accounting records undertaken with a view to establishing whether they correctly and completely reflect the transactions to which they purport to relate'.

A W Hanson defines an audit as 'an examination of such records to establish their reliability and reliability of statements drawn from them'.

J R Batliboi defines audit as 'an intelligent and critical scrutiny of books of account of business with the documents and vouchers from which they have been written up, for the purpose of ascertaining whether the working results of a particular period as shown by profit and loss account and also the financial position as reflected in the balance sheet are truly and fairly determined and presented by those responsible for their compilation.'

Montgomery, an American accountant, defines auditing as ' a systematic examination of the books and records of a business or other organisation, in order to ascertain or to verify, and to report upon the facts regarding its financial operations and the results thereof.'

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To summarise, auditing can be defined as "a systematic examination of the books of account and the underlying evidence so as to satisfy that the Balance Sheet shows a true and fair view of the state of affairs of the business and the profit or loss account shows a true and fair view of the profit or loss of the business entity during the relevant financial period."

The above definition can be broken down into the following parts so as to bring out the essential features of an audit:

Systematic examination of the books of account and the underlying evidence

The job of auditing involves a systematic examination of the books of account of the business entity and this would include books like the cash book, sales and purchase register, journal and the ledger. The books of account are to be examined alongwith the underlying evidence. The underlying evidence would mean the basic records from which the above books have been prepared. Thus underlying evidence for entries in a sales register are the sales bills and delivery challans. Evidence to be verified for entries in a purchase register are the quotations, purchase bills, delivery challans, transport receipts etc.

So as to satisfy that the Balance Sheet and the Profit & Loss Account show a true and fair view

The second limb of the definition says that after examination of the primary records and the books of account an auditor has to satisfy himself that the Balance Sheet and the Profit & Loss Account which have been prepared by the business entity show a true and fair view. The Balance Sheet of a business entity shows the statement of affairs as of a particular date. Hence the true and fair view is of the assets and liabilities disclosed in the Balance Sheet. The Profit and Loss account shows the profit made or the loss incurred by the business entity during the relevant financial year or the financial period and hence the true and fair view has to be of the profit or the loss disclosed.

It is very important to know that the auditor, in his audit report, always expresses his opinion on the truth and fairness of the financial statements. In the later chapters you will learn that the auditor doesnot give a certificate but only expresses his opinion.

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1.4 OBJECTIVES OF AUDIT

What is the objective behind undertaking the audit exercise? As we have seen from the definition of audit, the primary objective of an audit is to express an opinion whether the financial statements i.e. the Balance Sheet and the Profit & Loss Account present a true and fair picture or not.

Let us go into further detail and find out what are the objectives of an audit. For this purpose we can divide the objectives into two parts - (a) Primary Objectives (b) secondary objectives

(a) Primary Objectives : The primary objectives or the primary purpose of an audit is as under:

i. The main purpose of an audit is to examine the books and records and express an opinion whether the Assets and Liabilities shown in the Balance Sheet bring out a true and fair view of the state of affairs of the business. It is also to express an

opinion whether the profit or loss shown in the Profit & Loss Account is true and fair or not.

ii. In the case of audit of Companies the objective is also to find out whether the books of account have been maintained in accordance with the provisions of The Companies Act or not . It is also to find out whether the company has complied with all the applicable accounting standards or not while preparing its financial statements.

iii. In the case of audits undertaken as per the provisions of certain statutes such as the Income tax Act or the Sales Tax Acts, the primary object is also to furnish the information in the audit report as required under the statutes.

(b) Secondary Objectives : The secondary objectives of an audit are as under:

i. An auditor is not required to investigate or carryout an indepth probe into the books of account he is auditing. That is the reason it is said " Auditor is a watchdog and not a bloodhound". However, during his examination of the books and records if he finds any errors or frauds committed by the business entity, it becomes his duty to report on such transactions also.

ii. The auditor is required to also examine the internal controls existing in the organisation and report on any weak areas.

iii. The auditor is also required to report on any window dressing done by the audit entity. Window dressing involves showing of financial position in such a way that it looks better than what it is in reality. A few examples of window dressing could be to show short-term liabilities as long term liabilities, or to overvalue or undervalue assets and liabilities, or to increase both sales and purchases so as to show a higher turnover etc.

1.5 ADVANTAGES OF AUDIT

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As has been mentioned earlier audit has been made compulsory under a number of statutes on fulfillment of certain criteria. This itself goes to show that audit has immense utility. The various advantages of audit to different people and organistions can be stated in brief as below.

For the owners and shareholders

a. Greater reliance can be placed on the audited accounts.
b. Owners and Shareholders can rely upon audited financial statements to make investment and other decisions regarding their investment in the business entity.
c. Disputes over the correctness of profits can be avoided among the partners
d. Shareholders, who donot have control or access to the day to day functions in the company can judge the performance of the company better based on audited accounts.
e. Valuation of shares becomes easy based on the audited acounts.

For the management

a. It helps the management in detecting and preventing errors and frauds.
b. Suggestions made by the auditors can be implemented to strengthen the internal controls and checks.
c. Audit keeps the staff vigilant while preparing the books of accounts and other data.

d. Expert advice of the auditors can help the management in improving the accounting function.
e. Audited accounts, specially in the case of companies, because of their uniform presentation can help in making comparative study of 2 or more companies.
f. Obtaining loans from banks and financials institutions becomes easy based on audited accounts.

For the Government Bodies

a. It helps the tax authorities to arrive at the correct taxable income.
b. Audited accounts can be produced as evidence in a court of law.
c. Audited accounts help the authorities in arriving at the correct amount of subsidies to be granted and other concessions to be allowed.
d. Export incentives can be correctly arrived at on the basis of audited accounts.

For Others

a. Lenders and other creditors can rely upon audited accounts to find out the strengths and weaknesses of the business entity.
b. Audited accounts help in arriving at valuation of businesses for transfers and mergers.
c. Workers can rely on audited accounts for settling their disputes and for wage hikes and bonus.
d. Audited accounts help in increasing the confidence of foreign investors.

1.6 LIMITATIONS OF AUDIT

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We have discussed above that getting books of account audited can have several advantages not only to the owners of the business but also for others. However, it is very important to note that audit has some inherent limitations.

We have discussed earlier that the auditor is a watchdog and not a bloodhound and therefore it would be unwise to expect that he has verified and investigated each and every transaction of the business entity.

The auditor, after examination of the books of account and the underlying evidence is expected to form an opinion and there is an element of judgement involved in this whole exercise. There could be a few transactions which might not come to the notice of the auditor or which are deliberately concealed from his examination. In such a case eventhough the transaction itself can have serious implications on the disclosed Balance Sheet and Profit & Loss Account, the auditor cannot be blamed for the same unless he is found grossly negligent in doing his duty.

Another point to be noted is that the audit process largely depends upon the internal controls and checks in the organisation and there is a possibility that an internal check might be weak in an area and the same is not noticed by the auditor.

On some technical issues like life of an asset for the purpose of calculation of depreciation or revaluation of an asset like building or machinery, the auditor has to rely on the work of another expert such as a chartered engineer or valuer and the auditor has no clue whether the work done by the other expert is correct or not.

On a number of issues the auditor has to depend upon the information and explanations given by the accounting and other staff of the business entity and some times the staff can give misleading information.

Some of the things verified by an auditor are on a test check basis. For eg. Verification of stock-in-trade. And it should be remembered that a test check is not a foolproof system of verification.

1.7 QUALITIES OF A PROFESSIONAL AUDITOR

A professional auditor is a person who is certified to practice auditing. He is expected to possess not only professional qualities, but also good personal qualities. Institute of Chartered Accountants of India has prescribed a professional code of conduct for every member of the Institute. An auditor must be independent, have confidence and must be able to perform his duties efficiently.

An auditor should have the following qualities so that he can discharge his responsibilities as expected from him:

a. Knowledge in Accountancy: He should have thorough knowledge in accountancy. An auditor will be able to verify accounts, provided he knows how to maintain them. It means, he must be fully conversant with the accounting rules, accounting principles, accounting conventions, accounting standards and practices.
b. Grasp over commercial law: He should have a complete understanding of commercial laws, business regulations, sales tax and income tax law and other related business laws.
c. Business procedures and technical knowledge: Business procedures, technical aspects of production, maintenance and other operations, internal management technicalities and other matters must be clearly grasped so that he can easily verify the technical transactions.
d. Independent thinking: It is very essential that an auditor has an independent thinking and does not get carried away because of circumstances or because of influential or wealthy businessmen. He should be able to exercise his powers and discretion in making enquiries and calling for information.
e. Sincerity and Honesty: An auditor should be sincere in his duty as well as to his client. He should always provide the right guidance to his client.
f. Patience and perseverance: The profession of an auditor requires that he should be patient and should persevere in his duties. The very nature of accounting and auditing is a time consuming job and unless an auditor is patient and has the quality of perseverance he will not be able to do his job correctly.
g. Confidentiality: It is very essential that an auditor maintains confidentiality regarding the information he gets about the client during the course of his audit.
h. Decency: He should maintain decency, persistence and above all high standards of moral values. In the case of 'City Equitable Fire Insurance Company Limited' the judge observed that 'if an auditor has, even in one instance, fallen short of the strict duty of an auditor, he cannot, I apprehend, be excused merely because in general he has displayed the highest degree of care and skill'.

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Check Your Progress

1. What is the difference between Accountancy and Auditing?

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2. What are the main objectives of Auditing?

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1.8 SUMMING UP

The word audit is derived from the Latin word *audire*, which means 'to hear'.

Different people have defined auditing in their own way bringing out the essential features of the function.

Auditing can be defined as "a systematic examination of the books of account and the underlying evidence so as to satisfy that the Balance Sheet shows a true and fair view of the state of affairs of the business and the profit and loss account shows a true and fair view of the profit or loss of the business entity during the relevant financial period."

Book-keeping means systematic recording of business transactions in the books of original entry. *Accountancy* comes after the job of book-keeping and it involves preparation of trial balance, profit & loss account and balance sheet from the books of account. The job of auditing comes after the accountant has finished his job.

The primary objective of an audit is to express an opinion on the truth and fairness of the Balance Sheet and the Profit & Loss Account.

There are several advantages of an audit for the owners, shareholders, management, government bodies and others.

It should always be remembered that audit has certain inherent limitations.

The essential qualities, which an auditor should have, include a thorough knowledge in accountancy, grasp over commercial laws, knowledge of business procedures, independent thinking, sincerity and honesty, patience and perseverance and decency.

1.9 ANSWERS TO CHECK YOUR PROGRESS

1. Accountancy is an art of recording, summarizing analyzing and interpreting the transactions in the books of accounts. Where as auditing involves checking and verifying the books of account for ascertaining their accuracy.

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2. The main object of an audit is verification of accounts to ascertain whether they are prepare systematically and according to the requirements of the Companies Act, 1956.

1.10 MODEL EXAMINATION QUESTIONS

A. Answer the following questions in about 15 lines.

1 Explain the difference between book-keeping, accountancy and auditing.
2 What are the objectives of audit?
3 What are the limitations of audit?
4 What are the qualities of a professional auditor?

B. Answer the following questions in about 30 lines

5. Define audit and explain its importance.
6. Discuss the various advantages of audit.

1.11 GLOSSARY

Book-keeping : Book keeping can be defined as systematic recording of the business transactions in the books of original entry and their posting to ledger.

Accountancy : Accountancy involves preparation of financial statements from the primary books of account.

Auditing : Auditing can be defined as "a systematic examination of the books of account and the underlying evidence so as to satisfy that the Balance Sheet shows a true and fair view of the state of affairs of the business and the profit and loss account shows a true and fair view of the profit or loss of the business entity during the relevant financial period."

Window Dressing : Window dressing involves showing of financial position in such a way that it looks better than what it is in reality

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UNIT – 2 : CLASSIFICATION OF AUDITS

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  2.2.8 Government Audit
2.3 Summing up
2.4 Answers to Check Your Progress
2.5 Model Examination Questions
2.6 Glossary

2.0 AIMS AND OBJECTIVES

In this Unit we shall discuss the various types of audits. After going through this unit you will be able to:

- Explain the different types of audits such as statutory audit, internal audit, continuous audit, management audit, social audit and Government audit.

2.1 INTRODUCTION

Depending upon the nature of entity, nature of audit to be done as well as the requirement of audit under the various statutes, audits can be classified into different types. Depending on the type of audit the examination of records, the depth of examination of such records as well as the format of the audit report will vary. We shall discuss some important types of audit now.

2.2 CLASSIFICATION OF AUDITS

2.2.1 STATUTORY AUDIT

A statutory audit is one which is compulsory under the provisions of law. Statutory audit can be further divided into the following types depending upon the particular statute applicable.

A) Audit under the Companies Act
B) Audit under the Income tax Act
C) Audit under the Sales Tax Act
D) Audit under the Banking Regulation Act and Insurance Act
E) Cost Audit
F) Special Audit under the Companies Act

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A) Audit under the Companies Act

All companies registered under The Companies Act of 1956 are required to get their books audited every year and file a copy of such audit report together with a copy of the Balance Sheet and Profit & Loss Account with the Registrar of Companies. This audit has to be done on an annual basis and is compulsory whether or not a company does any business during a financial year.

The Companies Act requires an auditor to issue audit report in the format prescribed under the Manufacturers and Other Companies Auditors Report order of 1988 (generally known as the MAOCARO) and this format is applicable to most of the manufacturing companies and companies carrying on other activities. We shall discuss in detail the other aspects of company audit under the Block 'Company Audit'.

B) Audit under the Income tax Act

Audit has been made compulsory for all business entities satisfying certain criteria, irrespective of whether they are proprietary concerns, partnership firms, companies or other entities. Some important criteria fixed and applicable as of now for compulsory audit are as under:

1 Any business entity having sales, turnover or gross receipts exceeding Rs 40 Lakhs.
2 Any person carrying on any profession (for eg. a doctor, advocate or a chartered accountant) and whose gross receipts from such profession exceed Rs 10 Lakhs.
3 Any business entity wanting to claim certain exemptions for setting up industries, exporting goods out of India, setting up industries in backward area etc.

The above said business entities should compulsorily get their books audited and submit the audit report in the format prescribed under the Income tax Act.

This type of audit is also referred to as Tax Audit.

C) Audit under the Sales Tax Acts

Several states in our country have made audit compulsory for dealers having a turnover above certain limits fixed by the State Government. In the state of Andhra Pradesh dealers having a turnover exceeding Rs 40 lakhs are required to get their books audited under the Andhra Pradesh General Sales Tax Act and submit audit report in the format prescribed under the Act.

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D) Audit under the Banking Regulation Act and Insurance Act

All companies carrying on Banking Activities as well as those companies carrying on Insurance activities are governed by the Bank Regulation Act and the Insurance Act respectively and audit of these entities is done as per the provisions of the above mentioned Acts. The formats of the Balance Sheet, Profit & Loss Account as well as audit reports are different from those applicable to other businesses.

E) Cost Audit

As per the provisions of Section 209 (1) (d) of The Companies Act of 1956 maintenance of cost records is mandatory for the class of companies notified by the Central Government. And as per the provisions of Section 233A of The Companies Act of 1956 audit of cost records is compulsory for the class of companies notified by the Central Government. To give you an example, under these provisions, all companies who are manufacturing bulk drugs or cement are required to maintain cost records and cost audit has also been made

mandatory for them. It is to be noted that such cost audit has to be done by a Practicing Cost Accountant (person having an ICWA degree) and not a Chartered Accountant.

F) Special Audit under The Companies Act

The Central Government can direct a company to get a special audit done either by the company's auditor or any other Chartered Accountant. The audit can be directed if the Central Government is of the opinion

a. that the affairs of the company are not being managed in accordance with sound business principles or
b. that the company is being managed in a way which would cause serious injury or damage to the trade, industry or business or
c. that the financial position of the company is not sound.

The special auditor thus appointed gives his report to the Central Government and not to the shareholders. In addition to the regular reporting requirements, the special auditor is also required to comment on any specific points which the Central Government asks him to give his comments upon.

Within four months of the date of receipt of the audit report the Central Government can take action against the company as it deems fit and proper.

2.2.2 INTERNAL AUDIT

Internal Audit is undertaken mostly by the business entity's own staff to verify the correctness and completeness of the transactions as well as the supporting documents. This audit is undertaken mostly by medium and large size companies even though it is not statutorily required. Internal audit helps in rectification of errors immediately and it also helps in improving the internal controls through continuous suggestions received from the internal audit department. The basic advantages of an internal audit can be summarized as under:

a. any errors committed at the time of book-keeping are rectified before the accounts are taken up for audit by the statutory auditors.
b. Ensures that procedures and systems are correctly followed.
c. Ensures that the supporting documents for any transaction are properly maintained
d. Through continuous suggestions it improves the internal control systems.
e. Major errors and frauds can be detected and avoided as internal audit is undertaken at periodic intervals during the year or on a continuous basis.
f. Management gets an immediate feed back on the operations of the accounting department

2.2.3 CONTINUOUS AUDIT VS PERIODIC AUDIT

Audit in large organisations is undertaken on a continuous basis. This audit could be part of statutory audit or it could be an internal audit. In this type of audit as soon as a transaction is entered in the books of account, it is verified with respect to its correctness as well as to see whether all supporting documents are available or not. This keeps all the records of the organisation updated as well as scrutinised almost on a day to day basis. Continuous audit is undertaken mostly in large organisations where the volume of transactions is very large. It is

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also undertaken in the case of large branches of Banks. This type of audit is also referred to as concurrent audit as the transactions are audited concurrently i.e. as soon as they take place.

The major advantages of a continuous audit can be summed up as under:

a. It ensures complete checking of records
b. It helps in early detection of frauds and errors
c. It helps in presentation of the financial statements at an early date.
d. It helps in preparation of interim account i.e. preparation of Balance Sheet as well as Profit & Loss Account on a quarterly or even on a monthly basis.
e. It helps in improving the internal controls as the auditor would be giving suggestions on a continuous basis.
f. It helps the management in taking quick decisions as the financial statements prepared periodically are audited and more reliable.
g. It has a moral check on all the staff.

On the other hand a periodic audit is one which is undertaken periodically. For eg. on a quarterly basis or on a half yearly basis.

2.2.4 BALANCE SHEET AUDIT

In this type of audit an auditor typically starts with the Balance Sheet. He goes through the Assets and Liabilities items appearing in the Balance Sheet and traces them back upto the original records. In other words the auditor adopts a 'backward process'. This type of audit is effective only where the internal controls are strong. This type of audit is mostly undertaken in the case of Banks where the internal controls are good. To illustrate - in the case of audit of a Bank Branch the auditor would go through the Assets side of the Balance Sheet and pick the item 'Loans given against security of Jewellery'. The auditor would go backwards, go through the loan accounts to find out whether proper documents have been obtained or not. Then he would pick up a few cases and physically verify the jewellery kept as security to satisfy himself that the security is proper and sufficient. Then he would verify the ledger account to see that interest has been debited correctly and recoveries are being made or not. In short what the auditor has done is to adopt a 'backward process' approach i.e. start with a Balance Sheet item and come back upto the basic documents.

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2.2.5 MANAGEMENT AUDIT

In this type of audit the auditor is required to make a detailed and critical study of the management function and objectives and come out with a report on the deficiencies existing in the system as well as to offer suggestions for overall improvement in managerial efficiency. To illustrate - an auditor after studying the functions in the various departments may come out with a report that the stock in trade held by the business organisation for 6 months requirements is very high when compared to the industry average and the same should be brought down to 3 months requirement so as to save on holding cost.

This type of audit is also referred to as efficiency audit.

PREFACE

This book deals with the topics in 'AUDITING' included in the syllabus for the Third Year of the B. Com., Programme offered by the Dr. B. R. Ambedkar Open University. These topics generally cover the 'core' area of the subject to be studied in the third Year of the three years Degree Programme in Commerce (B.Com.). The syllabus is, for the sake of convenience, divided into Blocks each of which comprises a number of Units. Each unit generally covers specific area of the subject. The Units are prepared by specialists in accordance with a format so designed as to enable the student to read and understand them without much difficulty. Each unit begins with a statement of its objectives followed by Unit contents. At the end of each Unit assignment intended to test the student's comprehension of its subject matter is given. Technical terms with which the student may not be familiar are given at the end of each unit under head, 'Glossary'.

Auditing is a systematic examination of accounts and records of a business to find out facts and to ensure that the accounts are properly drawn up so as to exhibit a true and fair view of the state of affairs of the business. This subject deals with the conduct of an audit of business transactions including company audit. Further it deals with the specialized auditing practices.

The purpose of introducing this course is to ensure that the student graduating from the University, will have acquired adequate familiarity in auditing the business transactions.

The University hopes that the material will help the student to get acquainted with the concepts and principles of Auditing.

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2.2.6 SYSTEMS AUDIT

Systems Audit is undertaken to study the existing system in an organisation and give a report on the effectiveness and efficiency of the system as well as to give suggestions on its improvement. To take an example, an auditor would be asked to study the whole system functioning in the 'Purchses Department' of a business entity. The auditor who go into detail about the system in the following manner.

a. How are the indents received for making purchases of different items. Who authorises them and on what basis.
b. Once the indents are received does the purchase department place tender or receive quotations from various suppliers ?
c. Once the tenders are placed how are the tenders opened
d. On what basis are the quotations approved
e. Is the purchase department verifying whether the suppliers are fulfilling all the terms and conditions agreed to in the tenders and quotations.
f. Are Material Received Notes (MRN) prepared and the material verified for quantity and quality.
g. How are the payments authorised to the suppliers.

The auditor would examine the entire flow of transactions as above and would prepare a 'systems audit report' commenting on the deficiencies of the system and his suggestions for improvement of the same. This type of audit can be restricted to one particular area as is given above or it can be done for the entire business organisation covering all the areas.

2.2.7 SOCIAL AUDIT

Business entities primarily work for earning profits and rewarding the owners for the risk and effort put in by them. But, apart from this, they also have the moral responsibility to make some valuable contribution to the society in general. Business organisations who are committed to social upliftment and environmental protection are devising methods to measure the contribution made by the enterprise to the society. In India this kind of reporting is not common as it is in the preliminary stages of development. Only after standards are laid down to present the 'social accounts' methods would be developed to audit such accounts. To illustrate a case of how social accounts are presented the following can be considered :

Social Accounts of Rose & Co for the year ended 31-03-2002

Hospital benefit provided to staff and their family	Rs	10.02 lakhs
Educational facilities provided	Rs	3.20 lakhs
Amount spent on social forestry	Rs	4.30 lakhs
Amount spent on digging of borewells for use in township	Rs	1.05 lakhs
Total of social benefits provided	Rs	18.57 lakhs

2.2.8 GOVERNMENT AUDIT

Audit of all the Government Departments is done by the Office of the Comptroller and Auditor General of India (C & AG). For instance audit of the Indian Railways or the Postal

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Department would be undertaken by the C & AG. This audit is done as per the rules and regulations framed for this purpose by the Government.

The basic objectives of a Government audit can be summarised as under:

a. To ensure that all payments are made with prior authority and by a person who is authorised to do so.
b. To ensure that all payments are supported by proper evidence and documents.
c. To ensure that payments are made strictly as per the laid down rules and regulations.
d. To ensure that expenditure is not excessive taking into account the nature of payment and the situation.
e. To ensure that Government property has not been put to use for any unauthorised private purposes.
f. To ensure that all records and registers are maintained up-to-date and as per rules and regulations framed for the particular purpose.
g. Any payments, which are recoverable from an individual or an organisation have been recovered fully and on time.
h. To ensure that there is no pilferage of any Government material.

Check Your Progress

1. What do you understand by continuous audit?

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2. What is statutory audit?

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2.3 SUMMING UP

Depending upon the nature of entity, nature of audit to be done as well as the requirement of audit under the various statutes audits can be classified into different types.

Statutory Audit : Audit which is compulsory and is carried out as per the provisions of any particular act is known as a statutory audit. Thus, there could be a statutory audit under the Companies Act, under the Income tax Act, under the Sales Tax Act , Cost Audit or audit under the Banking Regulation Act or Insurance Act.

Internal Audit : Audit carried out mostly by the business entity's own staff and which is not mandatory is called internal audit.

Continuous Audit Vs Periodic Audit : Audit carried out on a day to day basis or as and when a transaction takes place is called continuous audit. On the other hand audit carried out at a periodic interval - say every quarter or every half year - is called a periodic audit.

Balance Sheet Audit : In this type of audit an auditor typically starts with the Balance Sheet. He goes through the Assets and Liabilities items appearing in the Balance Sheet and traces it back upto the original records. In other words the auditor adopts a 'backward process'.

Management Audit : In this type of audit the auditor is required to make a detailed and critical study of the management function and objectives and come out with a report on the deficiencies existing in the system as well as to offer suggestions for overall improvement in managerial efficiency.

Systems Audit: In this type of audit systems in an organisation are studied and a report is prepared on the deficiencies in the system and suggestions are given on improvements.

Social Audit : An audit of the social accounts of an entity is termed as a social audit. Social accounts of an entity would reflect the contribution of the entity to the society in general.

Government Audit : Audit of the Government departments is termed as Government Audit and this is done by the office of the Comptroller and Auditor General of India (G & AG).

2.4 ANSWERS TO CHECK YOUR PROGRESS

1. Continuous audit is the process of checking and verifying the books of account of the concern continuously though out the year. It is required where internal check is not up to the mark and where the number of transactions is large. With the help of continuous audit we will be able to detect frauds and errors immediately.

2. When audit of accounts of concern is conducted under a statute, it is known as statutory audit. This audit is carried out by a qualified auditor only.

2.5 MODEL EXAMINATION QUESTIONS

A Answer the following questions in about 15 lines.

1 What is meant by an Internal Audit and what are its advantages.

2 What is the difference between a continuous audit and a periodic audit.

3 Discuss the following types of audits in brief:
   a. Balance Sheet Audit
   b. Management Audit
   c. Social Audit
   d. Systems Audit

B Answer the following questions in about 30 lines.

4. Discuss what is meant by statutory audit and the various types of statutory audits.

5. What is a Government Audit and what are its objectives.

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2.6 GLOSSARY

Comptroller & Auditor General : One who does audit of Government departments

Chartered Accountant : One who holds the degree of Chartered Accountancy and is eligible to do audit of financial records of an entity under different statutes. He is not eligible to do a cost audit.

Cost Accountant : One who holds the degree of ICWA and is eligible to do cost audit. He is not eligible to do any other kind of statutory audit.

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UNIT - 3 : AUDIT PROCEDURE

Contents

3.0 Aims and Objectives
3.1 Introduction
3.2 Audit Procedure
    3.2.1 Audit Engagement Letter
    3.2.2 Knowledge of client's business
    3.2.3 Organisation structure and key personnel
    3.2.4 Preparation and study of Master File
    3.2.5 Preparation of Current File
3.3 Audit Programme
3.4 Audit Techniques
3.5 Preparation of Audit Report
3.6 Summing up
3.7 Answers to Check Your Progress
3.8 Model Examination Questions
3.9 Glossary
3.10 Sample Audit Programme

3.0 AIMS AND OBJECTIVES

This Unit is aimed at explaining the procedures involved in an audit. After going through the unit you will be able to explain

- The entire process of auditing
- What is an audit programme
- Master file and Current file
- Audit techniques

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3.1 INTRODUCTION

To put it in one simple sentence, audit procedure begins with appointment of the auditor and ends with the auditor giving an audit report. Everything which happens between the above two events can be termed as audit procedure. An audit procedure can be explained by dividing the subject into smaller parts as under:

3.2 AUDIT PROCEDURE

3.2.1 Audit Engagement Letter

Before taking up any audit work the first thing an auditor would do is to obtain a proper audit engagement letter or an appointment letter. Before accepting any audit the auditor would satisfy himself that his appointment would be as per law and would be within the limits as are prescribed under the Companies Act.

3.2.2 Knowledge of the client's business

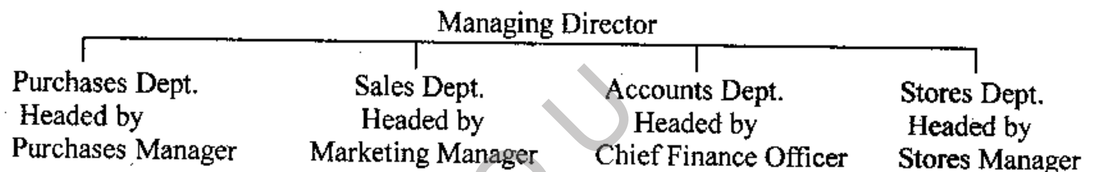
It is very important for an auditor to precisely know what is the nature of business of the client. For this purpose he would have a detailed discussion with the staff members as well as the top management. By doing this he would try to grasp not only the different business activities of the client but also any peculiarities of the business as well as the impact of the same on the accounting systems and practices.

Take the example of a software development company. Development of software in many cases takes a few months time. It could take an year also. In such a situation the business entity cannot afford to bill for the entire software at the end of the project or on completion of the software. What the company will do is, breakup the software in different modules and as soon as a module is completed billing would be done. This is referred to as milestone billing. Unless the auditor knows about this system of work and billing he would not be in a position to do a good job.

3.2.3 Organisation Structure and Key Personnel

Along with the client's business the auditor would also try to understand the organisation structure and the key personnel involved in different departments. The auditor would note down the powers of the key personnel specially in relation to passing of vouchers, authorization of payments, authorization of purchases etc.

A simple organization structure with key personnel would appear as under:



Further, the powers given to the key personnel could be as under:

The Purchases Manager is authorized to make purchases directly upto an amount of Rs. 10,000 per item. Any purchases exceeding this amount would require approval of the Managing Director.

The Marketing Manager is authorized to give quantity discounts upto 5 % of sales value. For any discounts above this the Managing Director's permission would be required.

The Chief Finance Officer is authorized to sign on cheques for payments below Rs.50,000. All cheques above this amount would be signed by the Managing Director.

3.2.4 Preparation and study of Master File

After going through the above steps the next step for the auditor is to prepare a master file and study the contents of the same carefully. The master file is also referred to as the *permanent file*. The master file would contain the following documents.

a. Name, address, telephone, fax and e-mail address of the client.
b. Copy of letter of engagement

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c. Clients instructions specially when the audit is not a statutory audit. In other words if the audit is an internal audit or a special audit the auditor has to make a note of the points on which the management wants him to give special attention.
d. Description of business and history of the client's organisation.
e. Organisation chart
f. Location of branches, godowns etc.
g. Names, designations and powers and functions of key personnel.
h. Copy of Memorandum & Articles of Association in case of a company. Copy of partnership deed in case of a firm. Copy of by-laws in case of a society etc.
i. Copy of audit report and financial statements for the previous year.
j. Notes on discussions with top management.
k. Internal control questionnaires and flow charts.
l. Schedule of accounting policies followed.

3.2.5 Preparation of Current file

As the audit progresses the auditor would build a *current file* containing the following documents.

a. Copy of signed financial statements.
b. Audit notes
c. Audit programme
d. Copy of internal audit report
e. Check lists
f. Audit memoranda given to the client and explanations given by the staff
g. Bank reconciliation statements
h. Confirmation letters obtained from debtors and creditors.
i. Important points which would have a bearing on the next years audit.
j. Extracts from meetings of Board of Directors and General Body Meetings.
k. Notes on changes in accounting policies.
l. Points for making audit qualifications and notes to accounts
m. Suggestions to management on improvement of internal controls, accounting systems, compliance with legal provisions, overhead and other cost cutting methods.

3.3 AUDIT PROGRAMME

A very important piece of document prepared before undertaking the actual audit work is the audit programme. An audit programme is a detailed statement setting out the scope of audit, number of days allotted to complete each function, names of audit staff who would be allocated the different areas of audit and finally the remarks of the audit assistants.

A sample audit programme is given in Annexure I at the end of this unit.

A glance at the audit programme indicates that the audit work has been divided into different parts like audit of cash receipts and payments, audit of bank receipts and payments, audit of sales, purchases, journal entries, debit and credit notes, inventory, ledger scrutiny and finalization. Against each type of work the programme also gives the scope of audit work. For instance cash receipts and payments are to be vouched for the entire 12 months, whereas the scope of audit for sales is limited to first and last 3 months.

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The audit programme also indicates the number of days allotted to different works. For instance it is estimated that vouching of cash receipts and payments would take 2 days and vouching of purchases would take 3 days.

The various advantages of having an audit programme can be summarised as under:

a. It ensures that all necessary work has been done and nothing has been omitted.
b. The auditor is in a position to know about the progress of the work made by his assistants.
c. A uniformity of the work can be attained as the same programme will be followed at subsequent audits.
d. The auditor can exercise effective control over his staff.
e. Clerks engaged in an audit can be changed with minimum dislocation and waste of time.
f. It serves as a guide to juniors in regard to their duties.
g. It defines a responsibility for the work done.
h. It furnishes evidence of the thoroughness of the audit in case of charge of negligence against the auditor for not having done some work.
i. It facilitates the final review before the report is signed.

The sample of audit programme is shown below:

SAMPLE AUDIT PROGRAMME

Nature of work	Scope	No of days allotted	No of days taken	Done by whom	Remarks
Cash Receipts & Payments	12 Months	2			
Bank Receipts & Payments	6 Months	1			
Sales	First & Last 3 Months	2			
Purchases	12 Months	3			
Journal Entries	12 Months	2			
Debit & Credit Notes	Last 3 Months	1			
Inventory	10 Days at Random	1			
Ledger Scrutiny	-	2			
Finlisation	-	2			

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3.4 AUDIT TECHNIQUES

The auditor's duty is to gather evidence, evaluate the same and express opinion on the financial statements of a concern. The techniques by which an auditor obtains evidence are known as audit techniques. Different kinds of audit techniques are discussed as under:

Inspection of records

The most important and primary duty of any auditor is inspection of various records and documents which form evidence for the final statements of accounts. These records could be anything ranging from cash vouchers, purchases bills to correspondence with the customers or suppliers. The auditor can verify any of these things or all these things depending upon the audit programme drawn by him for verification of different items. This is also referred to as examination of vouchers or vouching and the technique is so important that for a layman whenever the word audit is mentioned it means only vouching.

Documentary evidence has to be examined by the auditor with reference to its genuineness or in other words authenticity, appropriateness and proper recording. The auditor has to satisfy himself on the above fronts when he is verifying a particular document.

The extent of records to be verified depends on the importance of the area of audit as well as the auditors judgement about the internal control systems existing in that area. Thus in one particular audit the auditor may decide to verify all cash transactions but in another audit he may decide to verify only 3 months transactions. Depending upon the extent of verification and nature of verification vouching can be divided into the following three categories.

Routine checking

This could involve verification of all the transations in a routine manner. Thus an auditor may take up all the cash receipts and cash payments and verify them all in a routine fashion.

Test checking

This could involve verification of a few transactions on a test basis. The auditor may pick up a sample and verify the transactions in that sample thoroughly. Thus an auditor may pick up all purchase transactions for the month of March and verify them thoroughly starting from verification of the purchases indents, then verification of the tender documents, verification of the system for opening of tenders, verification of the quotations, placing of purchases orders, verification of receipt of material based on the material receipt notes, verification of purchase bills received and finally tracing the payments made to the suppliers. This method of thorough verification is also referred to as indepth verification or indepth vouching and is applied on a selected sample data.

In test checking selection of sample data may depend again on the nature of transaction, judgement of the auditor regarding the controls existing and the importance of the transaction. The auditor may choose to adopt random sampling method wherein the sample is selected at random, or a selective sampling or judgement sampling method wherein the sample is picked up by judging the importance or relevance of the transaction.

Surprise checks

The auditor may decide to carryout a surprise check with respect to certain transactions. For instance in the case of a Bank audit the auditor will go to the Bank without prior intimation and count the physical cash existing and match it with the cash as per the books of account.

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In the case of a manufacturing concern he may go to the stores department, pick up a few items for physical counting and match them with the book stock. This technique of auditing has a very important advantage because the client's staff will always be on their toes to keep the documents upto date and if there is any error or fraud it would come to light immediately.

Confirmation from outside parties
Another important technique of audit adopted is obtaining confirmation from outside parties. Thus an auditor may decide to obtain confirmation of balances from all debtors and creditors and ask the company to send letters to the parties with a direction that replies should be sent by parties directly at the auditor's address. Any discrepancies in the balances would be brought to the notice of the staff and they would be asked to prepare reconciliation statements.

Ledger Scrutiny
A very important audit technique, which is generally not discussed by many books on auditing is the technique of ledger scrutiny. In this technique the auditor would go through the ledger accounts and try to find out any unusual items or anything which gives rise to a doubt. Thus while going through the ledger account under the head ' minor repairs to machinery' if the auditor comes across an entry running into several lakhs of rupees he would immediately call for the particular voucher, examine it thoroughly to find out whether it is a case of wrong posting, or a case of wrong entry of amount, or a case of fraud where huge amount has been siphoned off.

In fact this technique is very widely used by the senior audit personnel even after the junior staff has done the routine checking. Ledger scrutiny has to be done by an expert having not only thorough accounting knowledge but also thorough knowledge about the client's nature of business and the accounting system. Practical experience shows that this technique is a very powerful tool available to an auditor to detect any errors or frauds. This technique saves a lot of time as this is a much faster way of covering a large area of accounts.

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Physical Verification
An auditor may choose this method of audit to verify certain transactions like the cash balance or investments or for verification of the stock. While verifying the stock the auditor may not physically verify all the items of stock but would restrict his verification to a few items on a test check basis. For rest of the items he would observe the method of physical verification followed by the accounting staff and find out whether it is effective or not.

Verification of investments is done by verifying the share scrips for investment in equity shares, verification of fixed deposit receipts for investment in Fixed Deposits with Banks or other financial institutions, verification of debenture certificates for investment in debentures or bonds.

Ratio Analysis
Another powerful audit technique, which is of immense use in all audits is the technique of 'ratio analysis'. Ratios can be worked out almost for every segment of the business and for every area of the financial statements. Some of the very important and widely used ratios are the gross profit ratio, net profit ratio, expenses to sales ratio, stock to turnover ratio, debtors to turnover ratio. These ratios are worked out by the auditor and then these are compared with the industry standards as well as similar workings for the earlier years in the

auditee's case itself. Any wide deviations in these ratios are further investigated to find out if any accounting errors have happened any where.

To take an example an auditor works out the gross profit ratio and arrives at a figure of 35 %. This would mean that the business is making a gross profit of Rs 35 on every Rs 100 of sale made by it. Then the auditor would go into individual items to find out whether this ratio is correct or not. Now, on analysis if he finds that there are only 3 items in which the business is dealing and on all these three items the client is getting a fixed margin of say 20 % of gross profit, it is an indication that somewhere a big mistake has taken place. Because, if the individual gross profit margin is only 20 % the financial statements cannot show an overall gross profit ratio of 35 %. The auditor would further probe into the accounts to find out the mistakes. In the above example a comparison can also be made with the Gross Profit shown in earlier years.

The importance of ratio analysis can be further judged from the fact that now the tax audit report format (as per the provisions of section 44AB of the Income-tax Act) makes it mandatory to give certain ratios in the audit report itself.

Comparative Analysis

The auditor would ask his audit staff or the accounting staff of the client to prepare a comparative statement of the expenses and the revenues. Comparative figures would be for a year to year comparison, or a comparison of figures on a half yearly basis or a comparison of the figures with the industry averages, if the same are available. Any wide deviations in the comparative analysis would compel the auditor to further make an in depth study of the individual transactions. Thus if an auditor sees that the current year expenditure on printing and stationery is higher by 80 % as compared to the last year figure, he would immediately try to find out the reasons for the same.

3.5 PREPARATION OF AUDIT REPORT

The product of the entire process of audit is the audit report. Contents of the audit report would depend upon the nature of audit. Thus in the case of a statutory audit of a company the report has to be in a fixed format together with a statement on the requirements as per MAOCARO Order 1988. For the audit under the Income tax Act or the Sales tax Acts fixed formats have been given by the Government and all the points need to be covered as per the format. If it is an internal audit the format is not fixed but the auditor is expected to comment in detail on all the discrepancies found, unusual items founds as well as give his suggestions for improvement in the internal controls and systems.

Contents of the audit report, qualifications in the audit report, disclaimer of opinion and other related matters have been discussed in details in the Unit titled ' Audit Report'.

Check Your Progress

1. What is audit programme?

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2. What is master file?

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3.6 SUMMING UP

Audit procedure begins with appointment of the auditor and ends with the auditor giving an audit report.

Before applying the various audit techniques the auditor would first make sure that he has an audit engagement letter, which authorises him to carryout the audit. After that he would try to understand the nature of business of the client, his organisation structure, key personnel working for the organisation and prepare the master file or the permanent file. He would also prepare the current audit file containing important documents and the audit notes.

Different kinds of audit techniques include inspection of records, routine checking, test checking, surprise checks, physical verification, obtaining confirmations from outside parties like the debtors and creditors, ratio analysis, comparative analysis etc.

After obtaining sufficient evidence and proper examination of the same the auditor would go on to prepare the audit report. Format of the audit report would depend on the nature of audit.

3.7 ANSWERS TO CHECK YOUR PROGRESS

1. Audit programme is a plan for the auditing of the accounts to be carried out by auditor and his staff.

2. This file is also known as permanent file. This file contains important information about the client such as copy of the Memorandum & Articles of Association, organisation structure and key personnel, etc.

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3.8 MODEL EXAMINATION QUESTIONS

A. Answer the following questions in about 15 lines

1. What is meant by an audit programme and what is its importance.

2. Discuss the following audit techniques briefly:

    a) Test checking and surprise checks
    b) Ledger scrutiny
    c) Ratio analysis and comparative analysis

B. Answer the following questions in about 30 lines

3. Discuss the various techniques of audit in detail.

4. Discuss the following and their significance in relation to an audit
   a. Master file or permanent file
   b. Current file

5. Discuss the various steps involved in audit procedure

3.9 GLOSSARY

Audit Engagement Letter : Appointment letter given to the auditor which enables him to carryout the audit.

Permanent file or Master file : This file contains important information about the client such as copy of the Memorandum & Articles of Association, organisation structure and key personnel, nature of business of the client, notes on discussions with the top management, etc

Current file : This file contains the audit notes, errors and rectifications carried out at the instance of the auditor, copies of draft accounts, check lists, copy of internal audit report, bank reconciliation statements etc.

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UNIT - 4 : AUDIT UNDER EDP ENVIRONMENT

Contents

4.0 Aims and objectives
4.1 Introduction
4.2 The EDP Environment
    4.2.1 Components of a computer system
4.3 Features of an EDP Environment
4.4 Audit of Computerised Accounts
4.5 Summing up
4.6 Answers to Check Your Progress
4.7 Model Examination Questions
4.8 Recommended Books
4.9 Glossary

4.0 AIMS AND OBJECTIVES

This unit aims at discussing the fundamentals of audit under EDP environment. It starts with explaining the broad features of a computer system. Thereafter the features of EDP environment are discussed and finally the basic principles governing audit of computerised accounts. After going through this unit you will be able to understand:

- what is an EDP environment
- what are the different components of a computer system
- what are the features of EDP environment
- what are the principles governing an audit under EDP environment

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4.1 INTRODUCTION

We have seen in the earlier units as to what is meant by auditing, what are its advantages and what are its limitations. When we talk about auditing a picture emerges in our mind of an auditor going through voluminous books and registers, huge files containing vouchers, bills and receipts. As a student of auditing you should also know that the world is changing very fast and in today's world in many places manual accounting is giving way to computerised accounting. Most of the large and medium business organisations are already using computers extensively and in this changed scenario the work of the auditor also undergoes a lot of change. He has to understand the functioning of a computer, make use of different audit techniques so as to satisfy himself about the truth and fairness of the financial statements.

4.2 THE EDP ENVIRONMENT

Let us first try to understand what is an EDP (Electronic Data Processing) environment.

The last 20 years have seen a tremendous growth in the use of computers. Earlier, computers were being used only for scientific and defence applications. But with the introduction of

PCs (Personal Computers) there has been a revolution in usage of computers. Today you see computers everywhere - you see them in a railway reservation counter, on a hotel billing counter or in a departmental store. Today a number of organisations have started maintaining their accounts on computers. This is a new challenge for the auditor as the methods and techniques used in auditing such accounts have also to undergo a number of changes. Several new techniques have been introduced to take care of auditing in this new environment. Let us first see what are the features of EDP systems.

4.2.1 Components of a computer system :

Components of a computer system can be divided into two parts - Computer Hardware and Computer Software.

A) Computer Hardware

This refers to the physical parts of a computer system. These include **input devices** like the keyboard, mouse or the magnetic card readers. All these are called input devices because these devices are used to feed in the data. In other words if any entry has to be made one of these devices would have to be used.

Then there are **storage devices** like the main memory [also referred to as the random access memory (RAM) as it is accessible at random], Hard disk, floppy diskette, magnetic tape etc which are all permanent storage devices.

Computer hardware also includes **output devices**. As the meaning suggests these devices give us the output. The output could be in the form of a visual as we see on the computer monitor or a printout. Output devices include the monitor (also called the visual display unit) , printer etc.

Apart from the above devices the computer has a **Central Processing Unit** (CPU) which is the most vital part as it does all the data processing work. A CPU will receive data either from a keyboard, mouse etc, process it, and give the results or the final output as a display on the screen or as a printout on a sheet of paper. For eg. - if cash receipts and cash payments are fed into the computer through an input device - say a keyboard - , the CPU of the computer processes it and the final output in the form of a cash book is displayed on an output device - say monitor or a printer - and then the same data as well as the final cash book can be stored on a permanent storage device - say on a hard disk or on a floppy diskette.

B) Computer Software

In our above example we discussed that once the cash receipts and cash payments are fed into the computer, the CPU processes it and displays the final output in the form of a cash book. How is the data processed ? The data is processed with the help of a computer programme. And this computer programme is known as the computer software. Computer software is in the form of a code written in a programme language. There are many programming languages like BASIC, COBOL, C++ etc.

Broadly speaking, there are two types of computer software, systems software and application software. Systems software is the software which enables the computer to function. MS-DOS and UNIX are examples of systems software. On the other hand

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application software is that software which enables a computer to perform a specific application. In our above example we said once cash receipts and cash payments are fed into the computer it can generate a cash book with the help of a software. The software which processes the cash transactions and displays a final cash book is an application software. Application software could be accounting software, payroll preparation software etc.

4.3 FEATURES OF AN EDP ENVIRONMENT

An EDP environment is quite different from a traditional manual accounting environment in many ways. An auditor has to first understand the different features of an EDP environment. The main features of an EDP environment can be discussed as under:

Organisational Structure

An auditor should understand that the number of persons doing an accounting job in an EDP environment is smaller in number as compared to a manual accounting environment. Because of a smaller number of people handling a large job, the internal controls have to be much stronger as there is every possibility of the staff altering the data or the programmes.

No Visible Audit trail

In a traditional audit where accounts are kept manually the auditor will always have a visible audit trail for any given transaction. Thus if the auditor wants to verify the purchase transactions he would start with copies of tenders and quotations received, verify the orders placed on the suppliers, verify the purchase bills in the purchases register. From there he would track the entries in the suppliers ledger as well as the general ledger. Thus at every stage there is a visible trail. On the other hand in an EDP environment there is no visible audit trail. Transactions, in an EDP environment, may not follow the above sequence, there may not be source documents available and many a times all the above transactions might by done on a simultaneous basis. Because of a lack of audit trail the auditor will have to rely on other techniques to verify the transactions.

Easy access to the data

In an EDP environment the data, and many a times the programmes also are accessible very easily and hence the risk of unauthorised use is always there. The auditor has to see whether there are proper security measures like use of passwords and restricted entry to computer installations or not.

Internal Controls

Most of the internal controls in an EDP environment are incorporated in the computer software itself. Thus the auditor will have to test these controls for their reliability and efficacy. Testing would be done by feeding in the test data and checking the computerised output with the manual results prepared for the test data. Care has to be taken in selecting the test data in such a manner that all key areas of internal control are covered.

Consistent performance

One of the biggest advantages of a computer is that it is a consistent performer. The same set of transactions, even if they are processed 1000 times, would yield exactly the same result. This is not possible with human beings. The above advantage can also become a disadvantage if there is an error in the programming. Because, in such a case, all the 1000 times the transactions would give an incorrect result.

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Loss of Data and programmes
Large volumes of data and programmes can be stored on computers and floppy diskettes which occupy a small space. But then the danger of losing such data because of a computer error, power failures, theft of hardware and other such things is very large.

Computer Viruses
One of the features of an EDP environment is the danger of computer viruses hitting the system. Computer viruses are also computer programmes but these programmes are devised to either destroy or corrupt the data files and programme files. Viruses get copied on to other systems or floppies automatically and can play havoc by suddenly becoming active and destroying major chunk of data or programmes. Business entities making use of computers should always be watchful to see that viruses do not get into their systems. This is generally achieved by making use of anti-virus programmes and having strict security measures.

4.4 AUDIT OF COMPUTERISED ACCOUNTS

We have already discussed the special features of an EDP environment. Approach of an auditor to the computerised accounts is also different from the approach he adopts for auditing manual accounts. The basic principles governing an audit of computerised accounts are discussed as under:

1 The auditor is expected to have not only an expert knowledge about the general accounting and auditing principles but also a working knowledge about the functioning of a computer system.

2 The auditor has to gather the following information about the EDP environment :

   a. What is the *software being used* by the business entity. Is it a general purpose software or a customised software. How long this software has been in use. Has it been tested fully for any bugs existing, which might give an incorrect output. (Bugs are programming errors which might give wrong output , hinder the processing of data by slowing down or can stop the computer in the middle of processing).
   b. What is the *hardware being used* by the business entity. What are the security measures adopted for safety of the equipment.
   c. Who are authorised to make use of the computer system. Are there passwords and other security measures at every stage of processing of data.
   d. Are *regular backups* taken of the data? And who maintains such backups? Is there any possibility of persons making unauthorised use of it?

3 Most of the *internal controls* in an EDP environment are included in the application software itself. The auditor is expected to verify whether these controls are working efficiently or not. For this purpose he has to put in some test data and find out the results, which should match, with the results arrived at manually.

4 The auditor also has to verify whether sufficient controls are available as far as data entry and programmes are concerned. Data entry should be done only by persons who are specifically authorised to do so. Only a few persons at the top should be authorised to change the programmes. Otherwise this can give rise to manipulations and frauds.

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5 The auditor should verify the controls over processing of data. This would include missing field tests, valid code tests, cross checks and control figures etc.

6 The auditor should verify the final output and he should also put the data to test by using sample data and verifying the final output with the computer generated output.

7 The auditor can also make use of Computer aided audit techniques (CAATs) while doing the audit. CAATs are those audit techniques, which make use of the computer itself for verifying various transactions. A number of CAATs are used now-a-days like Controlled processing or reprocessing and Running of test data etc.

Check Your Progress

1. What are the main features of EDP environment?

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4.5 SUMMING UP

The components of a computer system can be split into two parts. Computer hardware which includes input devices, storage devices, output devices and the CPU. And computer software which is nothing but programmes used to process the data.

The main features of an EDP environment are its organisational structure, lack of audit trails, easy access to data, programmed internal controls, consistent performance and risk of loss of data and programmes.

The basic principles governing an audit under EDP environment are that the auditor should have a working knowledge of computers, he should verify the nature of programmes being used, test the internal controls, test the final output by using sample data, verify the safety and security measures existing in the system, use CAATs.

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4.6. ANSWERS TO CHECK YOUR PROGRESS

1. The main features of an EDP environment are its organisational structure, lack of audit trails, easy access to data, programmed internal controls, consistent performance and risk of loss of data and programmes.

4.7 MODEL EXAMINATION QUESTIONS

A Answer the following question in about 15 lines

1 Explain what is meant by computer hardware and explain different types of computer hardware.

2 Explain what is meant by computer software and what are the different types of computer software.

B Answer the following questions in about 30 lines

3. Explain in detail the features of EDP environment.

4. What are the principles governing an audit under EDP environment.

4.8 BOOKS RECOMMENDED BOOKS

1. Kamal Gupta : Contemporary Auditing (Tata Mc. Graw-Hill Publishing Co. Ltd., New Delhi)

2. B.N. Tandon : Practical Auditing (S.Chand and Co., Ltd., Ram Nagar, New Delhi)

3. Spicer & Pegler : Practical Auditing (Allied Publishers Pvt. Ltd., New Delhi)

4. Dinkar Pagare : Principles and Practice of Auditing (Sultan Chand & Sons, 23, Darya Ganj, New Delhi)

5. T.R. Sharma : Auditing (Sahitya Bhavan, Hospital Road, Agra)

4.9 GLOSSARY

Computer Hardware : Means physical parts of a computer system like the keyboard, monitor, mouse, printer, hard disk etc.

Computer software : Means the programmes used for the functioning of the computer as well as programmes used for various applications.

CPU : Central Processing Unit - This is the unit which processes the data and displays the final output.

CAATs : Computer aided audit techniques - this refers to techniques used for auditing which make use of the computer itself to verify various transactions.

Computer Virus : This is also a computer programme which destroys or corrupts data files and programme files. It has the feature of copying itself onto different systems and floppies automatically.

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BLOCK – II

INTERNAL CONTROL, INTERNAL CHECK AND VOUCHING

Unit – 5 : Internal Control and Internal Check (including cash receipts & payments)

Unit – 6 : Vouching: Vouching of Cash Transactions

Unit – 7 : Vouching of Credit Transactions

Unit – 8 : Vouching of Impersonal Ledger

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UNIT–5 : INTERNAL CONTROL AND INTERNAL CHECK (INCLUDING CASH RECEIPTS AND PAYMENTS)

Contents

5.0 Aims and Objectives
5.1 Introduction
5.2 Definition of Internal Control
5.3 Types of Internal Control
5.4 Objects of Internal Control
5.5 Auditor's position regarding Internal Control
5.6 Internal Audit
5.7 Internal Check
5.8 Objects of Internal Check
5.9 Auditor's duty in regard to Internal Check System
5.10 Internal check regarding Purchases
5.11 Internal check regarding Sales
5.12 Internal check for Cash
5.13 Summing Up
5.14 Answer to Check Your Progress
5.15 Model Examination Questions
5.16 Glossary

5.0 AIMS AND OBJECTIVES

This Unit aims at discussing the meaning and significance of internal control, internal check, and auditor's duty in this regard. On having studied this Unit, you would be able to:

- understand the meaning and significance of internal control and internal check and the auditor's duty in regard there to;
- explain internal control and internal check regarding sales and purchases (including cash receipts & payments)

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5.1 INTRODUCTION

Control is a fundamental managerial function which follows other functions such as planning, organisation and direction. Plans do not lead to automatic accomplishment. In order to achieve the organisational objectives, managers have to exercise control. Internal check is a part of the overall control system adopted by an organisation. The concept of internal control, in this context, is related to accounting and financial transactions. It is necessary to devise some internal means of securing the desired control over accounting for

cash and operations of the business as a whole. Even a relatively small degree of reliance on internal control will normally result in a significant saving in audit time.

5.2 DEFINITION OF INTERNAL CONTROL

The Auditing Guideline on internal control issued by ICAEW defines an internal control system as "the whole system of controls, financial and otherwise established by management in order to carryon the business of the enterprise in an orderly and efficient manner, ensure adherence to management policies, safeguard the assets and secure as far as possible the completeness and accuracy of the records".

W.W.Big regards internal control as "indicating the whole system of controls, financial and otherwise established by the management in the conduct of a business including internal check, internal audit and other forms of control". Howard F Stettler states that 'internal control involves actions taken within an organisation to assist in regulating and directing the activities of the organisation'.

The auditors objective in evaluating and testing internal controls is to determine the degree of reliance he may place on the information contained in the accounting records.

5.3 TYPES OF INTERNAL CONTROL

The internal controls fall broadly into two categories. viz (i) Application Controls and (ii) General controls.

(i) Application Controls are basic controls over the completeness, accuracy and validity of accounting information. They are so called because they are specific to particular accounting applications, e.g., the processing of sales invoices or the preparation of pay rolls. Their essential feature is that they contain a procedure which either prevents or detects and corrects a particular type of accounting error.

Application controls, also called as accounting controls, comprise the plan of organisation and the procedures and records that are concerned with safeguarding of assets and the reliability of financial records. These controls include budgeting control, standard costing, bank reconciliation, self-balancing ledgers, internal auditing etc.,

(ii) General controls are those that determine the environment in which the application controls operate. They include allocation of responsibilities, segregation of duties, authorisation, custody etc.,

Incase of computer – based accounting system, systems development and daily operations, day to day supervision form part of general control.

Application controls may be vitiated by a lack of general controls. General controls can have only an indirect effect on the validity and accuracy of accounting information.

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5.4 OBJECTS OF INTERNAL CONTROL

The following are the objectives of internal control.

(i) to avoid waste, inefficiency and fraud

(ii) to keep intact the resources of the organisation

(iii) to attain greater accuracy and reliability in maintaining the accounts and operating data

(iv) to measure the success in the implementation of business policies

(v) to evaluate the efficiency in all aspects of business activity.

5.5 AUDITOR'S POSITION REGARDING INTERNAL CONTROL

It is the responsibility of the management to introduce a well developed system of internal control. Though the auditor cannot prescribe any rules and procedures for internal control, he is expected to have an expert knowledge about the internal control system applicable to firm. He can evaluate internal controls by a systematic process which include:

a) verifying the control objectives and observing the extent of reduction in testings to be implemented,

b) identifying the extent to which internal control objectives are attained, and

c) assessing the likely degree of audit reliance on the controls.

5.6 INTERNAL AUDIT

Internal audit is a continuous and systematic process of examining and reporting the operations and records of a concern by its employees. It is an independent evaluation of activity within an organisation, Institute of Internal Auditors defines the internal audit as "the independent appraisal activity within an organisation for the review of the accounting, financial and other operations as a basis for protective and constructive service to the management. It measures and evaluates the effectiveness of other types of control". When a commercial concern grows beyond a certain limit, a team of internal auditors is appointed, whereby all the transactions are audited instantaneously. Internal audit is not a part of or a substitute for statutory audit.

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Objectives of Internal Audit

1. To ascertain whether the standard acçounting practices are strictly followed in the business.
2. To verify the correctness of the recordings of the transactions
3. To facilitate early detection of mistakes and detection of frauds.
4. To check the effectiveness of the internal control and internal check systems and to suggest for their improvement.
5. To undertake special investigations.
6. To advise the management on finance matters and policies.
7. To ensure the authenticity of transactions, records and documents.
8. To examine the use of the assets of the firm and to prescribe measures to safeguard them.

Internal audit should not be confused with internal check. Internal audit is a comprehensive system, while internal check is a part of it.

5.7 INTERNAL CHECK

Internal check is a system adopted to ensure correctness in accounting and to minimise errors and frauds. It is a method of organising the accounts of a business concern whereby the duties of different clerks are arranged in such a manner that the work of one person is automatically checked by another both of them working independently with out involving any duplication of work and thus the possibility of fraud or error of any other irregularity is minimised (unless there is a collusion between the clerks). For example, in the case of cash sales, the sales man is not allowed to deliver the goods nor to receive the cash from the customer. The cashier receives cash, the gatekeeper delivers goods and the accountant makes an entry in the cash book. Thus a single transaction passes through three different persons and thus the work done by one is checked automatically by another. In large-sized organisations, this internal check system results in division of labour, enhances the efficiency and minimises the possibilities of frauds and errors unless all the three employees join hands. Some of the definitions for internal check are given below.

Spicer and Pegler defined internal check as "an arrangement of staff duties whereby no one person is allowed to carry through and to record every aspect of a transaction, so that without collusion between two or more persons, fraud is prevented and at the same time the possibilities of error are reduced to a minimum."

L.R. Dicksee defines internal check as "such an arrangement of book – keeping routine that errors and frauds are likely to be prevented or discovered by the very operation of the book – keeping itself."

According to F.R.M. De Paula "Internal check means practically a continuous internal audit carried on by the staff itself by means of which the work of each individual is independently checked by other members of the staff."

The special committee on Terminology constituted by the American Institute of Accountants in1949 has defined the term 'internal check' as 'a system under which the accounting methods and details of an establishment are so laid out that the accounts and procedures are not under the absolute and independent control of any person –that, on the contrary, the work of one employee is complementary to that of another – and that a continuous audit of the business is made by employees."

Besides the internal check system in operation, the use of some of the automatic devices, e.g., cash registers, time recording clocks, calculating machines, computers, application of Electronic Data Processing will prevent the commission errors and frauds. The management should also take steps to transfer the employees from one section to another from time to time without any prior notice so as to minimise collusion among themselves.

The above definitions and discussion make it clear that the internal check system requires more number of employees and business machines and hence it will be feasible only for big business concerns small firms can't afford for such a system as a single clerk has to handle all the transactions and records.

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5.8 OBJECTS OF INTERNAL CHECK

In the modern large-scale business organisations, the objects of internal check are much broader than the elementary form of internal check adopted in the olden days. The internal check is expected to accomplish the following objectives.

(i) to prevent the commission of frauds and errors by members of the staff.
(ii) to prevent the misappropriation of cash or goods by staff
(iii) to facilitate detection of frauds and errors and to correct them immediately.
(iv) to fix up responsibility on a particular clerk / employee when a fraud or mistake is detected.
(v) to ensure that the accounting system produces reliable, current and adequate information
(vi) to have an accurate record of all business transactions.

5.9 AUDITOR'S DUTY IN REGARD TO INTERNAL CHECK SYSTEM

An auditor, before taking up the audit work of an organization, should verify the internal check system that is in operation in the firm and should ascertain to what extent he can depend on the internal check system.

If there is no internal check system is in operation or where a single clerk / employee has full control over the transactions and books of account, it is necessary for the auditor to check each and every transaction from the beginning to the end. He cannot assume that there is no error.

In case of a big firm where there is internal check system in operation, he should verify the internal check system and its suitability to the nature of transactions in the firm. If he is satisfied, he should apply a few test checks at random and confirm the accuracy of accounts. Test checks may be of three types.

(a) Checking a few transactions here and there at random for the whole of the accounting period,

(b) Checking all transactions for a few selected months say, Jan, April, July etc., or

(c) Checking all transactions relating to a particular aspect, e.g. checking all cash sales or credit purchases for the whole year.

If any mistake or fraud is detected, the auditor should investigate into their nature and cause of such mistakes. He should also assess the possibility and extent of the recurrence of such mistakes.

The auditor should also bring to the notice of the management of the firm, the defects and weaknesses of the existing internal check system and make suggestions for its improvement.

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5.10 INTERNAL CHECK REGARDING PURCHASES

Big business firms maintain separate department for purchases. The purchases department deals with the purchases of goods, raw-material, spares etc. Heads of different departments would send a requisition slips with the details of the items to be purchased, quantity, quality-specifications, approximate price and also mention the dates by which purchases should be made. In turn the head of the purchases department would identify the suppliers and invite tenders / quotations from them. The tenders / quotations with lowest prices and with required quality specifications would be selected and orders will be placed for such goods. The credit terms and other conditions would also be taken into consideration. When the goods are received a responsible officer, quality inspector and store-keeper should be present at the time of unpacking of the goods. After satisfying with the quantity and quality of the goods, such goods shall be shifted to godowns /store-rooms.

The internal check with regard to purchases shall be as follows:

1. Each department has to maintain an 'indent or requisition book' containing provision for the details and specifications to be mentioned.

2. The requisitions / indents from various departments should be received in writing.

3. A responsible official should verify the indents and should place orders for the goods required.

4. Where quotations are called for, a separate file should be maintained for the quotations received.

5. A consolidated and comparative statement shall be prepared for all the quotations received. The lowest quotation of price with required quality specifications shall be selected for placing an order.

6. An order book shall be maintained with printed and numbered forms. Different order books may be maintained for different types of goods. The orders shall be prepared in triplicate. The first copy shall be sent to the supplier, the second copy to the department requisitioning the goods and the third copy to be retained by the purchases department. The possible date of delivery shall be mentioned in the order copies.

7. When the goods are received the cartons should be opened in the presence of a senior officer, quality inspector and the store keeper. After proper inspection, the goods must be shifted to the store-room.

8. The store keeper shall record the particulars of the goods in the Stores Ledger/ Goods Inward Book. A copy of the invoice shall be forwarded to the accountant for making a record in the Purchases Book.

9. The invoices received shall be consecutively numbered and filed, for future verification by auditors.

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10. The accountant shall make payment only after verifying the endorsement made by the senior officer as regards satisfaction in respect of quantity and quality of goods.

11. In case a part or whole of the goods are to be returned, a separate statement shall be prepared by the inspecting officer.

12. For the value of goods returned, the accountant should obtain a credit note from the supplier.

13. The credit notes received shall be properly entered in the 'Purchase Returns Book'.

5.11 INTERNAL CHECK REGARDING SALES

Large-business firms maintain a separate department for sales. It receives orders from the customers, supplies goods to them, prepares invoices and maintains accounts for the goods supplied.

The internal check system as regards sales shall be as follows:

1. The orders received from various customers shall be consecutively numbered and entered in the 'Orders Received Book'

2. The despatch section should take steps to pack the goods as per the order.

3. The goods ready for despatch should be entered in the 'Goods Outward Book' by the gate keeper.

4. The invoice should contain the description of the goods, quantity, price and other particulars. Entries should also be made in the sales day book.

5. Invoice must be prepared by the accounting department in triplicate. Two copies are given to the customer who returns one copy after signing it which will be useful as acknowledgement.

6. Goods returned by customers should be recorded in Sales Returns Book. Credit notes must be prepared and the particulars of the credit note must be entered in the Sales Returns Book.

5.12 INTERNAL CHECK FOR CASH TRANSACTIONS

Another area where internal check is to be applied is cash. Cash is the most vulnerable asset which can be defalcated or stolen. Majority of the frauds take place in regard to cash. Cashiers and their records must be subjected to frequent checks and the internal check system in operation should ensure that the scope for misappropriation of cash does not exist. Even if such a fraud is committed or an error creeps in, the internal check system should disclose it instantaneously. The method of conducting audit depends upon the internal check system in operation. The internal check with regard to cash receipts and cash payments are discussed below.

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Internal Check for Cash Receipts.

Cash is received on different accounts. It is received against cash sales, from customers and from other sources in the form of rents, interests, dividends etc. The internal check system to be adopted, largely depends upon the nature of transactions. The internal check system should be more stringent and tight where liquid cash is handled by the employees than where receipts are in the form of cheques and bank challans.

The following internal check guidelines may be suitable as regards cash receipts.

1. Cash received should be acknowledged by issuing a receipt in a printed form having a counterfoil. The receipts should be consecutively numbered.
2. Receipts should be signed by a person other than the cashier.
3. The unused receipt books shall be kept under lock and key with a senior officer.
4. All the cash receipts are entered in the rough cash book or diary initially.
5. Cheques received also should be entered separately in the diary. If cheques are not crossed, they should be crossed immediately.
6. It is desirable to use automatic tills or cash registers which facilitate checking of receipts.
7. The cash and cheques should be immediately deposited into bank.
8. The cashier should not have access to the ledger or any other book of prime entry.
9. Castings in the cash book should be checked independently.
10. The bank reconciliation statements should be prepared periodically.

Internal Check for Cash Payments

The payments are usually made towards purchases, manufacturing expenses, administrative expenses and selling and distribution expenses.

Besides, the payments are also made for purchase of assets. Hence, there is a need for systematic accounting of each payment. Internal check is very much essential to control and regulate the payments and avoid excess payments and wrong payments, unauthorised payments and payments relating to personal expenses being treated as business expenses.

The internal check system as regards cash payments may comprise the following items.

1. All the payments, except petty expenses, should be made by cheques.

2. Petty expenses should be separately recorded in petty cash book and the imprest system be adopted.

3. For every payment, proper authorisation should be obtained and proper evidence, i.e., receipt, counterfoil etc. should be obtained against the payment made.

4. When cheques are issued, they should be duly crossed with 'A/c Payee' specification.

5. Before making payments to the creditors/ suppliers, their accounts and the balances should be thoroughly verified with invoices and other evidences.

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6. The receipts/ vouchers received from the payees should be consecutively numbered and should be filed securely.

7. Bank Reconciliation statement should be prepared periodically to check the authenticity of the payments.

8. If possible, receipts and payments should be handled separately by different employees.

Check Your Progress

1. What do you mean by internal control?

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2. What are the objectives of internal check system?

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3. Distinguish between internal check and internal audit.

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5.13 SUMMING UP

1. Internal control is a comprehensive system of controls, financial and otherwise, established by the management in the conduct of a business, including internal check, internal audit and other forms of control. It also comprises of administrative and accounting controls.

2. Internal check is a system of organising the accounts of a business concern whereby the duties of different employees are arranged in such a manner that the work of one person is automatically checked by another and thereby the possibility of fraud, error or any other irregularity is minimised.

3. Internal audit is a continuous and systematic process of examining and reporting the operations and records of a concern, by its employees, who may or may not have professional qualifications of audit.

Since cash is the most liquid asset and possibilities of its defalcations and embezzlements are more, there is a need to have a specific internal check system for cash receipts and payments.

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5.14 ANSWERS TO CHECK YOUR PROGRESS

1. Internal control is a comprehensive system of control. It indicates a whole system of financial and other controls that are established by management in the conduct of audit, including internal check, internal audit and other forms of control.

2. The main objective of internal check is to prevent the errors or fraud and to ensure that the accounting system provides accurate and reliable information.

3. In the internal audit a batch of employees (known as internal auditors), specially appointed for the purpose, is engaged to check the records of day to day transactions, while in the internal check, the work and the checking go together being carried by different employees.

5.15 MODEL EXAMINATION QUESTIONS

A. Answer the following questions in about 15 lines.

1. Explain the meaning and objects of internal control.
2. Distinguish between internal check and internal control.
3. Define internal check and explain its objectives.
4. What is the significance of internal check as regards purchases.

B. Answer the following questions in about 30 lines.

5. Explain the meaning of the term 'internal check'. What are the duties of the auditor as regards the internal check in an organisation ?
6. Assuming that you are an auditor for a big business undertaking, suggest an internal check system for its purchases and sales.
7. How would you determine the effectiveness of an internal check system of an organisation ?
8. Identify any four items of cash receipts and cash payments and explain the internal check system as regards those transactions.

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5.16 GLOSSARY

1. **Internal Check** : It is a system under which duties are allocated in such a manner that the work of one employee is automatically checked by another.

2. **Test Checking** : Checking of only a few items, instead of all, selected at random to verify the correctness of the entries with a view to save time and cost.

UNIT – 6 : VOUCHING : VOUCHING OF CASH TRANSACTIONS

Contents

6.0 Aims and Objectives
6.1 Introduction
6.2 Meaning and Significance of Vouching
6.3 Objectives of Vouching
6.4 Voucher
6.5 Points to be considered while Vouching
6.6 Difference between Vouching and Routine Checking
6.7 Vouching of Cash Transactions
6.8 Vouching of Cash Receipts
6.9 Vouching of Cash Payments
6.10 Summing Up
6.11 Answers to Check Your Progress
6.12 Model Examination Questions
6.13 Glossary

6.0 AIMS AND OBJECTIVES

The aim of this unit is to explain the meaning, objectives and significance of vouching and the vouching of cash transactions, i.e., the vouching of cash receipts and cash payments. On having gone through this unit you should be able to explain:

- the meaning and objectives of vouching and
- the points to be considered while vouching cash receipts and cash payments.

6.1 INTRODUCTION

A voucher is a documentary evidence in support of a transaction in the books of account. The act of establishing the accuracy and authenticity of entries in the books of account is called vouching. Vouching is the preliminary work to be carried out by auditors.

6.2 MEANING AND SIGNINFICANCE OF VOUCHING

According to Ronald A. Irish 'vouching is a technical term which refers to the inspection by the auditor, of documentary evidence supporting and substantiating a transaction.' Vouching is not only a preliminary work, it is the essence of auditing. It involves not only verification of the documentary evidence but also ensures that the transaction has been properly authorised, recorded and entered in the books of account. Vouching means testing the truth of the items appearing in the books of original entry. De Paula points out that vouching does not mean merely the inspection of receipts with the cash book, but it includes the examination of receipts with the transactions of a business together with the documentary and other evidence of sufficient validity to satisfy the auditor that such transactions are in order, have been properly authorised and are correctly recorded in books. It is vouching

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that enables an auditor to certify the accounts to be correct, complete and free from errors or frauds. Therefore, it is very important that the auditor should vouch the items with great care and intelligence.

Vouching also means checking of additions, ledger postings, extracting of balances in the ledger etc. In a big business, where internal check system is in operation, the auditor may resort to a few test checks and in small business firms, where internal check is not in operation, the auditor will have to check every entry. The auditor should plan his work appropriately keeping in view the responsibilities. He should assume and he should not be negligent at any stage.

6.3 OBJECTS OF VOUCHING

The following are the objects of vouching:

1. to ensure that all the transactions relating to the business are properly and correctly recorded in the books of account.
2. to ensure that all entries are genuine and supported by documentary evidences, i.e., vouchers.

6.4 VOUCHER

As already stated, a voucher is a documentary evidence in support of a transaction in the books of account. A voucher may be a receipt, counter-foil of a receipt book, an agreement, a resolution passed by Board of Directors or shareholders, an invoice, bank paying-in-slip, etc.

6.5 POINTS TO BE CONSIDERED WHILE VOUCHING

While carrying out vouching, the following points must be considered by the auditors.

1. All the vouchers are consecutively numbered and filed in the order of the entries in the books i.e., they should be chronologically arranged. This arrangement reduces the verification time of the auditors. If they are not in order, the auditor has right to ask the client to arrange them in order.

2. The serial numbers, dates, the names of the parties and the amount of each voucher should be checked by the audit staff.

3. The audit staff should cancel the vouchers immediately after checking. The cancellation may be by way of affixing a stamp, putting a tick mark or affixing the initial of the audit clerk across the face of the voucher, so that it is not removed and reproduced by dishonest employees of the firm.

4. If any voucher is in the name of the proprietor, partner or director, the auditor should pay special attention and ensure that it is a business transaction and not a personal transaction.

5. The vouchers with a value of Rs. 500 or more should bear the revenue stamps.

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6. The vouchers should not contain over writings, corrections etc. If such over writings and corrections are there, they should be attested by proper authority making the voucher.

7. The amount of voucher in figures and in words should be verified. If they differ, proper investigation should be undertaken.

8. Revenue and capital nature of the voucher should be properly assessed and the wrong classification in this respect will affect both the profits and the Balance Sheet.

9. The auditor should obtain the bunch of vouchers relating to a particular period or a set of books at a time from the client for verification and ensure that, if possible, the work relating to that particular period or set of books should be completed in one sitting.

10. The auditor should ensure that he is not taking the help of any member of the client's staff while vouching the entries.

11. Auditor should resort to Test checking only in emergencies and special cases. He should do it only if he is satisfied with the internal check system in operation in the client's firm.

12. Above all, the auditor should exhibit his intelligence, common sense, observation and tact in carrying out the task of vouching.

6.6 DIFFERENCE BETWEEN VOUCHING AND ROUTINE CHECKING

Vouching includes routine checking, but vouching and routine checking have got their own separate significance. Vouching is the checking of entries and verifying the documentary evidence while routine checking is concerned with casting, totalling and posting. Routine checking is mainly concerned with arithmetical accuracy. Vouching is carried out by a senior auditor while routine checking is done by junior audit clerk.

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Missing Vouchers

While carrying out vouching, auditor may find certain vouchers missing. He must prepare a list of missing vouchers and should ask the client to obtain duplicate vouchers. Where duplicate vouchers cannot be obtained, he should obtain necessary certification from the competent officials from the client's firm.

6.7 VOUCHING OF CASH TRANSACTIONS

Cash book is a book of prime entry. It consists all the cash transactions recorded in a chronological order. Cash is a volatile asset and is commonly subjected to embezzlement, defalcation and fraud. Therefore, the auditor should guard himself against such errors and frauds. The vouching of cash transaction in a perfect manner will bring into light the misappropriations and frauds. Thus, the objects of the vouching of cash transactions can be summarized as follows:

(i) to ensure that all the receipts and payments are accounted for.

(ii) to ensure that all such receipts and payments are entered in their appropriate heads of account.

(iii) to ensure that no unauthorized or fraudulent payments are made.

(iv) to verify the cash in hand and at bank.

6.8 VOUCHING OF CASH RECEIPTS

Before commencing the vouching of the cash receipts appearing on the debit side of cash book, the following points should be noted by the auditor.

1. Adequacy of Internal Check

The Auditor should first understand the existing procedures in respect of receipts, making of records, dealing with bank etc. He should verify the adequacy of internal check system. If he is satisfied with the internal check system, he can resort to test checking.

2. Verification of Rough Cash Book

All the business firms, generally, enter their cash receipts in a 'Rough Cash Book' or 'Diary' or 'Day Book' initially and later they are recorded in cash book. Therefore, the auditor should also verify the rough cash book and compare the entries with the main cash book. Auditors will be held responsible for any frauds or errors detected after verification by them.

3. Control over the use of Receipt Book

The auditor should verify whether the 'Cash Receipt Books' are kept under proper control or not. He should note the following in this regard.

(a) All the unused 'Cash Receipt Books' should be kept under the safe custody of a responsible official.

(b) All the receipt books and individual receipts should be consecutively numbered.

(c) The dates, names and amounts on the counterfoils or duplicates should agree with the entries in the cash book.

(d) The discounts allowed should be verified and their conformity with the terms credit should be checked.

(e) All the receipts shall be signed by a responsible officer.

(f) The spoilt cash receipt forms which are cancelled should not be destroyed, but should be attached to the respective counterfoils and signed by a responsible officer.

Keeping in mind the above precautions, the auditor may commence the vouching of debit side of cash book. The method of vouching in respect of various items of receipts side of cash book is discussed below.

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1. Cash Sales

Since the sales are handled by different salesmen and carried out continuously every day, there is a greater scope for fraud. The salesmen may sell goods and may not make an entry in the cash book. Therefore, the salesmen should not be allowed to deliver the goods. This forms part of the internal check system in the firm. The auditor should verify this internal check system.

As a part of vouching cash sales, the auditor should thoroughly check the carbon duplicates of cash memos. The salesman, who sells goods to a customer, should prepare three copies of cash memo and hand over two copies to the customer. Meanwhile goods are sent to the cashier. On presentation of these two copies by the customer the cashier stamps them as 'cash paid' and returns the original receipt back to the customer along with the goods. Thus there are at least two persons involved in the carrying on of cash sale transaction. Depending upon the number of transactions, even more persons can be involved. At the end of the day, the salesman, the cashier and the gate keeper (if any) will prepare the summaries and send them to the Sales Manager /General Manager. Thus, the quantity, value of goods and the cash collections are tallied every day.

In small business firms, where internal check system is not in operation, the auditor will have to check each and every transaction.

2. Receipts from Debtors

Selling goods on credit basis is very common in most of the manufacturing and trading concerns. The cash received from debtors should be vouched by the auditor and the only evidence available for vouching is the counterfoils of the receipts issued to them. The auditor should not totally rely upon this evidence in view of the following types of frauds.

a) Less amount may be written on counterfoil than the actual amount received.

b) Less amount may be entered in the cash book than the amount actually received.

c) A receipt from an unused book may be issued and the amount is not entered in the cash book.

d) The process of teeming and lading may be adopted by the clerks and thus cash may be misappropriated for short period. "Teeming and Lading" is a process wherein the cash received from a debtor is not entered in cash book and when cash is received from another customer later, it is entered against the former customer i.e., to the former debtor's account. This is also called 'Lapping' which means concealment of shortage of money by delaying the recording of cash receipts.

The auditor can check the teeming and lading practices by verifying the Rough Cash Book and the counterfoils of the pay-in-slips. Where corrections in rough cash book are found, the auditor should check them with double care.

The auditor should also pay his attention to the discount allowed to customers and the amount of bad debts written off. He should check the transactions and verify if they are in conformity with the credit terms of the firm in force. Cash received may be misappropriated by writing off the whole or a part of the debtor's balance as bad.

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The best course of action would be to contact the debtors, he can do so after obtaining permission from the client, for confirming the balances or to detect any frauds committed in this regard.

3. Bills Receivable

Bills Receivable Book should be compared with cash book and the pass book to see that amounts have been received on the due dates. In case of the bills discounted the postings in discount account and the entries in Pass Book should be verified. Where the bills are matured but the amounts are not received, necessary entries should be checked. Where the drawees of the bills honour their bills by paying cash, there is a possibility of misappropriation. Similarly where the bills are retired by the drawees in advance, the clerks may not record the cash received till the maturity date of such bills. The auditor should examine the bills and contact the drawees incase of any doubt.

4. Commission Received

The auditor should check the commission account, confirm the rates of commission from the original documents of agreement and should also check whether the amounts are accurately calculated. Counterfoils of receipts should be checked with reference to amounts, dates and other terms of agreement.

5. Rents Received

The auditor should examine the lease deeds to ascertain the amounts of rent payable, the due dates, provision regarding the repairs etc. If rents are collected by agents, their accounts should be verified. 'Rent-outstanding' if recorded in books should also be checked to avoid the misappropriation by not recording the rent received. If outstanding amounts are heavy, the tenants may be contacted for confirmation. If the properties are shown as 'unlet' or 'vacant', it should be confirmed with the responsible officials.

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6. Income from Interest, Dividends, etc.

Interest may be received from various types of securities. Each amount of interest received should be checked with reference to the agreement. The period, rate of interest, due dates for payments, penal interests, if any, should be verified. In case of fixed deposits with banks, interest received should be vouched with the help of the pass book.

If dividends are received, their counter foils along with covering letters must be verified. If securities are sold or bought, the 'ex-dividend' and 'cum-dividend' aspects must be carefully verified. Allocation between capital and revenue should also be verified.

7. Sale of Investments

Investments are normally sold through brokers. The broker's 'Sold Note' may be examined to vouch the amount received from the sale of investments. The sold note contains the details of the amount received and the commission. Cum-dividend and ex-dividend transactions and the allocation between capital and revenue should be verified carefully.

8. Sale of Fixed Assets

The fixed assets like land, buildings, machinery, furniture etc., are usually sold through a broker or an auctioneer. The Auctioneer's Note, Directors' Resolution, Sale Contract and other correspondence should be examined by the auditor. Profit or loss on such asset should be considered as a capital item. Any prepaid expenses like insurance should be properly accounted for.

9. Receipts from Hire Purchases

Goods sold on Hire Purchase and the receipts thereon should be thoroughly examined with reference to the terms of agreement. Since the installments include interest, proper allocation between sales and interest should be made.

10. Insurance Claims

The correspondence between the client and the insurance company should be examined in connection with any claim. The calculation of loss should also be verified.

11. Miscellaneous Receipts

Other receipts like share capital, loans from financial institutions, subscriptions, bad debts recovered etc., the auditor should examine the documents, minutes of the directors, agreement copies, terms and conditions, etc. and verify whether they are properly calculated and posted in relevant accounts or not.

6.9 VOUCHING OF CASH PAYMENTS

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Normally auditors would undertake to vouch the debit side of the cash book, i.e., cash receipts and then proceed to vouching of credit side of cash book, i.e., cash payments. Vouching of cash payments is done to ensure that :

(i) the payments are made to right persons or parties, and properly recorded.
(ii) the payments are made for the business purposes.
(iii) the payments are made within the limits sanctioned by higher authorities.
(iv) the payments are supported by proper documentary evidence.

The vouching procedure for some of the items of payments is discussed below :

1. Payments to Creditors

The auditor should enquire whether periodical statements are sent by the creditors, i.e., suppliers of goods. All the payments made to them should have a prior sanction of the authorities concerned and for each payment original and permanent receipt should be obtained. The total payment to a creditor should be compared with the amount of invoice. If any goods are returned a debit note should be sent to the creditor, and the auditor has to verify whether the amount of the debit note is entered in the account of the creditor. The discounts, rebates, penalties for delay in supplies, etc. should be verified with the agreements, terms and conditions, contracts, minutes and other evidences.

2. Cash Purchases

While vouching the cash payments for cash purchases made, the auditor should compare cash memos, goods inward book with the entries in cash book. He should examine whether the trade discounts are deducted from the total amount of purchases and net purchases only should be carried to the purchases account.

3. Wages

Vouching of payment of wages requires utmost attention of the auditor as it involves more chances of misappropriation. Inclusion of fictitious names or 'dummy workers' in the wage-book, over-stating of wage rates and hours of work, under-statement of deductions etc. may be committed. The auditor should verify the internal check system with regard to the preparation of wage sheet and payment of wages to workers.

The auditor should take note of the following aspects with regard to vouching of wages.

1. He should thoroughly examine the internal check system and wherever the loopholes are found, he should probe into them.

2. He should verify the calculations and totals of the wage sheets and check the items of deductions.

3. He should check the amounts drawn from bank for payment of wages and actual wages paid. Both must agree.

4. He should check the names of the workers in the wage sheet and those appearing in the foreman's register.

5. He should check whether the wage sheets are signed by the responsible officials.

6. Wages of previous month should be compared with the current month and increase in the number of workers should be checked with the appointment / recruitment orders.

7. He should examine the leave register

8. He should examine the casual workers registers.

4. Purchase of Fixed Assets

With regard to purchase of fixed assets like land and building, machinery, furniture, etc. the auditor should verify the sanction from the board of directors and also the estimates/ quotations from suppliers. In case of land & buildings the contract papers, architect's / surveyor's certificate, broker's commission, registration charges, etc. should be verified. In case of plant and machinery and furniture, receipts, terms of payment, expenses for erection etc. should be examined. He should also verify whether all the payments are capitalized or not.

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5. Patents

Sanction for purchase of patents by the Board of Directors and recommendation of the specified patents by the engineers / scientists should be examined. The correspondence, agents' notes, commission payable to agents etc., should be examined. While all the payments at the time of purchase are capitalised, the renewal fees paid in subsequent years should be charged to revenue expenditure.

6. Investments

Sanction for purchase of investments by the Board of Directors or other responsible officers should be verified. Where the investments are bought through agents/ brokers, the payments should be vouched with the Broker's Bought Note. The auditor should also physically verify the share/ debenture certificates. The bank payments, discounts or premiums on the securities, ex-dividend or cum-dividend transactions should be verified. Proper allocation must be made between capital and revenue, in case of ex-dividend and cum-dividend transactions. If the investments consist inscribed stocks, the certificate from the bank should be verified.

7. Loans

In vouching the loans advanced, the sanction of the responsible officials, loan agreement, pro-note or bills of exchange should be verified by the auditors. He should read carefully the terms of loan regarding rates of interest, schedule of payment of interest, repayment of loan, installments allowed, if any. The securities received against loans, the mortgage deeds, title deeds, value of the securities should be examined. In case of loans to directors, managing agents and officers of a company, compliance with the provisions of the Companies Act should be verified.

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8. Salaries

Salaries Book and the cash book entries should be compared month-wise. The salary-bill may have variations from month to month because of increments, revisions in pay-scales, promotions, etc. These variations must be thoroughly verified by the auditor with their sanctions. Similarly provident fund, income tax and other deductions should be checked. If any loans are advanced to employees, their recovery should be verified. The Form-16 to be issued by employer under Income Tax Act should contain the actual salary and allowances paid to the employees.

9. Insurance Premiums

When a new insurance policy is taken, the necessary sanction and the term of the policy, value of the policy and premium payable shall be verified by the auditor. The insurance premium receipts should be vouched with the entries in cash book. If any policy lapses, the reasons therefore shall be enquired into. In case of life insurance policies, the auditor should verify whether the claims are made and amounts received promptly on maturity of the policies.

10. Bank Charges

Bank charges, bank commission, interest on loans and overdrafts should be verified with the entries in the pass book. The auditor should check the calculation of interest.

11. Postage

No voucher would be available for the postal stamps purchased. Hence, the amount shown for purchase of postal stamps and the use of postal stamps should be checked with the postage book. If franking machine is in use, the receipts issued by post office should be verified.

12. Travellers Allowances

Rules and regulations regarding allowances to travellers should be seen by the auditor and he should verify whether the payments are within the limits. If the allowances are fixed, there is no need for payments. Where payments have to be made on the basis of actual travelling expenses incurred, the auditor should be cautious. He should make calculations and verify the programme sheets of the travellers and vouchers and he should also see whether a responsible officer has certified the expenditure.

Opening and Closing Balances

Opening balance in the cash book and pass book should be compared with the audited balance sheet of the previous year. After completion of the vouching of cash receipts and cash payments, the closing balances in cash book and pass book should be verified. As far as bank transactions are concerned, the auditor should ask the client's staff to prepare the bank reconciliation statement and should verify it to confirm the accurate balances of cash in hand and cash at bank.

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Check Your Progress

1. List out the objects of vouching a cash book.

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6.10 SUMMING UP

Vouching is considered to be the essence of auditing. It is concerned with testing of genuinity of the receipts and payments with the original evidence, i.e., receipts, agreements, sanctions, etc. Auditors, while carrying out vouching, should observe whether the vouchers are consecutively numbered, and whether all the relevant vouchers are filed at a place. Checking the vouchers in respect of the date, amount, signature of a responsible officer is the primary duty of the auditor. The auditor should cancel the vouchers immediately after verification. Regarding the cash transactions, the auditor should ensure that all the cash receipts are properly recorded and all the cash payments are made to genuine parties for genuine purposes with proper sanction from the authorities.

6.11 ANSWERS TO CHECK YOUR PROGRESS

Vouching of cash book has the following objects.

(i) All the receipts and payments are properly and duly accounted for, i.e., recorded in their respective accounts.

(ii) All the receipts and payments have proper and authentic documentary evidences.

(iii) The opening and closing balances are correctly arrived at.

6.12 MODEL EXAMINATION QUESTIONS

A. Answer the following questions in about 15 lines.

1. What do you mean by vouching ? What are its objectives ?
2. What is meant by documentary evidence ?
3. How do you vouch the 'purchase of investments' ? As an auditor what special points would you keep in mind in this regard ?
4. What aspects are to be considered while vouching the wage-payments ?

B. Answer the following questions in about 30 lines.

5. 'Vouching is the essence of auditing'. Explain the statement and also discuss the objectives of vouching.
6. How do you vouch different cash receipts ?
7. Describe the method of vouching for different cash payments.
8. What do you mean by vouching ? How do you vouch the cash book.

6.13 GLOSSARY

1. Counterfoil : A detachable portion of a cheque, dividend warrant, or postal order which can be retained as a record of a payment or receipt.

2. Cum-Dividend : The sale price of securities includes the dividend accrued thereon.

3. Ex-Dividend : The sale price of the securities does not include the dividend accrued thereon.

4. Pay-In-Slip : It is a form used to deposit money in the bank.

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UNIT – 7 : VOUCHING OF CREDIT TRANSACTIONS

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7.0 AIMS AND OBJECTIVES

The aim of this unit is to discuss the procedure to be followed by auditor for vouching of credit transactions. After going through this unit, you will be able to:

- explain the importance of vouching the credit transactions
- summarise the points to be considered in and procedure for vouching credit purchases
- explain the procedure for vouching the credit sales

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7.1 INTRODUCTION

After vouching the cash transactions, the auditor proceeds for vouching of the credit transactions, i.e., credit purchases and credit sales. Before the auditor begins this work, he should examine the internal check system regarding the credit purchases, credit sales, returns outward. The vouching of credit transactions is important to know and detect the misappropriation of goods, the auditor has to ensure that the payments made are for the goods which have been actually ordered for and received. Similarly, all the goods which are sold are properly accounted for and the amounts are received or shown as due form customers. In this Unit, the vouching procedure for different credit transactions is explained.

7.2 VOUCHING OF CREDIT TRANSACTIONS

7.2.1 Vouching of Purchases Book

The auditor before commencement of the vouching of purchases book, he should examine the internal check system adopted by the client. If the system is found to be perfect he can resort to test checking otherwise, he should thoroughly and exhaustively conduct the vouching. The basis for any purchase shall be the purchase requisition sent by the department requiring the goods, which should contain the quantity, quality of the goods and the time by which they have to be supplied. The purchasing Department shall invite tenders or quotations from the suppliers. The procedure for opening and accepting the tenders should be examined. The goods received should be opened in the presence of the store keeper and a responsible officer.

Auditor's Duty Regarding Credit Purchases

Auditor should pay attention to the following aspects while vouching the credit transactions.

1. The invoice is in the name of the client, i.e., the firm, the invoices in the name of the officers or partners should not be accepted. Sometimes, the purchases for personal requirements of the officers and partners may be included in the firm's purchases.

2. The goods mentioned in the invoice relate to the client's business. The goods received must be checked with the order placed.

3. The invoice must be signed by a responsible officer after verifying the goods received.

4. The date of the invoice should relate to the period under review. This prevents the production of old invoices for which payments are already made.

5. The goods mentioned in the invoice are not capital goods. capital goods should not be recorded in the purchases book.

6. The contents of invoice should be compared with the stores ledger and the gate-keeper's inward book to ensure that the goods have been actually received. This helps him to ensure that fictitious invoices are not included.

7. The auditor should also ensure that the invoice is entered in the name of the purchases book.

8. The trade discounts should be deducted from the total amount of the invoice. Trade discounts should be calculated according to the terms of supply.

9. The auditor should verify the casts and cross - casts of the purchases book.

10. If the goods are received but the invoice is not received, such goods should not be included in the stock register. If the goods are immediately required, they should be

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passed through the purchases book. However, when the invoice is received later, it should not be entered again.

11. The auditor should affix his initial on the invoice after it is compared with the entries in the purchases book

12. All the invoices should be compared with the purchase orders.

13. The directors and other officers may purchase goods through the firm to take advantage of the larger trade discounts. In such case, the personal accounts of the officials concerned should be debited.

14. The original invoices must be obtained from the client for verification. Invoices marked as 'duplicate' or 'copy' should not be accepted.

15. The officials, in order to show more profits, may not record certain invoices in the purchases book. This kind of manipulations are particularly made in the last month of the accounting year. The auditor should be doubly cautious while checking the transactions of the last month.

16. Sometimes, the purchases made in the last month of this year may be recorded in the first month of next year. This practice should not be accepted as this would tamper the fairness of the final accounts and the profits.

7.2.2 Vouching of Purchase Returns

If the goods received are not in conformity with the quality and price mentioned in the quotation, such goods are returned back to the supplier. If the amount is already paid, a credit note should be obtained from the supplier. If the payment is not made, the value of the goods returned may be deducted from the amount of the invoice. After a thorough examination of the internal check system in operation in the client's firm, the auditor should start vouching of purchase returns. In this regard he should keep the following points in mind.

1. The auditor should compare the credit notes obtained from the suppliers with the purchase returns book and goods outward book. The debit notes sent by the client should also be verified.

2. The castings of the purchased returns book should be checked, after verifying all the postings in the ledger.

3. The auditor should verify whether quantity and price of the purchases returns correspond with the goods outward book.

4. Manipulation of accounts may be made by showing the fictitious purchases before closing of the books and showing the same goods as being returned in the beginning of the following accounting year. Therefore all the heavy returns should be thoroughly checked.

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7.2.3 Internal Check Regarding Credit Sales

Most of the sales made by big organisations are on credit basis. Separate invoice books should be maintained for credit sales and cash sales. The firm receives orders from the customers, prepares invoice and then despatches goods. The auditor, before commencing the vouching of sales, should examine the internal check system regarding sales. The internal check system should comprise of the following steps.

a) Orders received from customers should be entered in the Orders Received Book.

b) The order or a copy of it is sent to the despatch department.

c) The despatch department prepares an invoice in duplicate or triplicate. The goods mentioned in the invoice are packed in the packaging section and the officer responsible for packing shall affix his signature on the invoice.

d) The head of the Despatch department or any other responsible officer shall verify the goods packed and the prices charged in the invoice.

e) The goods despatched shall be recorded by the gate keeper in his Goods Outward Book.

f) The accounts department records the transaction in the 'Sales Book', and thereby it is posted to the customer's account.

The auditor shall make a note of the following points while vouching the sales book.

7.2.4 Auditor's Duties Regarding Credit Sales

1. The auditor should, first of all, compare the name, the date, the amount and other details of the invoice with those given in the Sales Book.

2. The sale of assets, i.e., capital items should not be entered in the Sales Book.

3. Sales invoices, trade discounts offered should be checked by him.

4. Invoice book should contain serially numbered invoices. No invoice should be omitted from being recorded. Clerk may deliberately avoid recording and whenever cash/ cheque is received from the customers, they misappropriate it by not entering in cash book. This is not disclosed by the books of account.

5. With the permission of the client, the auditor should send Statements of Account to customers, to confirm the accuracy of the balance.

6. The auditor should particularly check all the transactions during first and last months of the accounting year. This not only reveals the fictitious sales recorded to inflate the profits but also the goods manipulated throughout the year and recorded as sales at the end of the year.

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7. Sales tax, insurance charges etc., should be debited to the customers' accounts and credited to appropriate accounts.

8. The auditor should check the castings and postings of the sales book.

9. If a significant difference in trade discount is observed with different customers, the auditor should enquire into the reasons for the same.

10. If goods are supplied on 'Sale or Return basis', it should be seen that such goods are not taken as sales till the letters of approval are received.

7.2.5 Vouching of Sales Returns

If goods are returned by customers on account of defective or inferior quality, they should be recorded in goods inward book and also in the Sales Returns Book. The following points should be noted by the auditors in connection with the vouching of sales returns.

1. The entries in the sales returns book should be verified with the help of the copies of the credit notes. The credit notes must be serially numbered.

2. The sales returns during the first and last months of the accounting year should be thoroughly examined as scope for frauds would be more during those periods.

3. Goods returned back by the customers to whom they are supplied on 'sale or return basis' should not be recorded in Sales Returns Book.

4. Castings of the Sales Return Book and the posting in the ledger should be checked by the auditor.

7.2.6 Vouching of Goods Sent on Consignment

If goods are sent out to agents on consignment basis, a separate book called 'Consignment Outward Journal' should be maintained. This book should be vouched with the copies of the proforma invoice, correspondence, account sales received and agreements with the consignees. When goods are sent at invoice price, necessary adjustments should be made. Valuation of unsold goods must be carefully verified. Not all the goods sent on consignment, but the goods sold by consignee only should be included in sales.

7.3 VOUCHING OF JOURNAL PROPER

In journal proper we record all those entries which can not be passed through other books of prime entry. The entries pertaining to purchase of assets, taking over of liabilities, issue and allotment of shares, forfeiture of share, provision for doubtful debts, outstanding expenses, prepaid expenses, depreciation, opening and closing entries etc., are recorded in the journal proper.

For most of the entries, supporting vouchers may not be available. Therefore, the auditor should verify whether the entries are properly authorised and relate to business. The basic vouchers should be verified in respect of certain adjustments. For e.g. Insurance premium receipts should be verified while verifying the prepaid insurance. Other vouchers include the

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last years balance sheet, minutes of directors, allotment letters, correspondence, wage bills etc.

7.4 VOUCHING OF CREDITORS LEDGER OR BOUGHT LEDGER

After verification of the Purchases Book, Sales Book, Purchases Returns Book and Sales Returns Books, the auditor should proceed to check the ledgers. Bought Ledger contains the creditors or suppliers accounts. The vouching of the bought ledger is carried out as below.

1. The opening balances of different accounts are checked with the last years audited balance sheet / schedule of creditors,

2. All the entries in the Purchases Book and Purchase returns book are compared with the postings in the bought ledger,

3. The postings pertaining to cash and bills are compared from cash book and bills payable book.

4. The totals, balances carried forward and brought forward are checked to ascertain their correctness.

5. If the firm has the practice of maintaining the self-balancing ledgers, the aggregate figures of these ledgers should be compared with the total of the schedule of creditors.

6. The discounts and allowances offered by them, and debit notes received for the goods returned should be properly checked. No account should have any amount pending for a long period. Special attention should be paid to verify such balances.

7. If any advances are sent against the orders placed, the supplier's account shows a debit balance. The auditor should also verify the dates of payment of advance, Invoice and actual receipt of goods. The longer gaps among these dates may involve manipulations or unfair understandings / collusions between the suppliers and client's officers.

8. Sometimes cash may be shown as paid to the creditor but it may be misappropriated by the cashier. The date of payment, the date of receipt from the suppliers, should be compared. Further the auditor, with the consent of the client, may invite the statements from the creditor for comparison.

9. The auditor should see that the debit balances, if any, in the accounts of certain creditors should be separately shown on assets side of the Balance Sheet . They should not be set off against the credit balances in the ledger.

10. Normally, it is not desirable to maintain the 'Reserve for discount' on creditors. If it is maintained, the auditor should see that it is reasonable.

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7.5 VOUCHING OF SALES LEDGER OR DEBTORS LEDGER

Sales ledger contains the accounts of the debtors or customers. The auditor should follow the procedure given under while vouching this ledger.

1. The opening balances must be checked from the previous year's audited balance sheet / schedule of debtors.

2. The credit entries in the sales ledger should be carefully checked as there is a possibility of committing fraud by passing fictitious entries in respect of credit notes, cash discounts, allowances and bad debts.

3. Advances received from customers against their orders will appear on credit side of their accounts. These should be separately shown as 'Advances against Goods on order' and should not be included in the sundry creditors.

4. The accounts of debtors may also show credit balance due to omission of invoice amounts in respect of goods supplied. Necessary adjustments should be made by the auditor in this regard.

5. The auditor in consultation with the client, should send the statements of account to the customers, for their confirmation. The responses from the customers should be directly received by auditor, so that the client's staff do not make any alterations.

6. The discounts, allowances, bad debts etc. credited to the customers account shall be verified with the invoices, terms and conditions, minutes, and the orders of the appropriate officers.

7. Classification of debtors as good, doubtful and bad shall be made carefully. The auditor should not totally depend upon the client for such clarification. He shall scrutinize each case to his satisfaction.

8. Provision for doubtful debts should be appropriate. Recovery of bad debts shall be properly checked.

9. If cheques are received from the debtors, the posting in their accounts should be made only after collection of such cheques.

10. The auditor should verify whether the provision for doubtful debts is adequate. He should persuade directors to raise the amount of reserve, if it is not felt to be adequate.

The auditor, thus, should vouch the credit transactions with utmost care and any negligence there upon may make him responsible for the consequences.

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Check Your Progress

1. What are the points to be kept in mind by an auditor while vouching credit purchases?

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2. What is the procedure for vouching credit sales?

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7.6 SUMMINIG UP

Credit is inevitable in the business world. Every firm purchases and sells on credit. Credit transactions involve many sub sequential transactions and thereby accounting procedures. In vouching the credit transactions, the auditor has to satisfy himself with the internal check system in operation in the firm with regard to the credit purchases and sales and purchase returns and sales returns. Terms and conditions, invoices, debit notes, credit notes and correspondence with debtors and creditors form the basis for vouching of credit transactions. Goods on 'sale or return' basis, consignment transactions also form part of these transactions. Auditors should verify all the vouchers, ledger postings and castings with utmost care.

7.7 ANSWERS TO CHECK YOUR PROGRESS

1. (i) The invoice is in the name of the client.
   (ii) The date of invoice relates to the current period.
   (iii) The invoice relates to the business and its merchandise.
   (iv) The invoice is signed by a responsible person indicating the receipt of the goods mentioned therein.
   (v) The amount of invoice is properly posted in the account of the supplier.
   (vi) The trade discount is properly calculated and deducted from the amount of the invoice and the accounting is made for the net amount.
   (vii) Advances given are properly recorded
   (viii) Payments by cheques, bills and otherwise are properly recorded.
   (ix) Casting and balances are correct

2 (i) The invoice prepared is in the name of the customer and goods mentioned there in are despatched. Despatching officer's signature should be verified.
   (ii) All the sales are entered in sales book and there from posted in the ledger accounts properly.
   (iii) Trade discount offered is within the norms of the client
   (iv) Sale of assets should not be recorded in sales book
   (v) Opening and closing balances are properly recorded
   (vi) Castings and balances are correct

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3. The totals of the subsidiary books should be checked and their postings in the general ledger should be verified.

4. The adjustments which are done before preparation of final accounts such as outstanding expenses, prepaid expenses, outstanding and accrued incomes, depreciation etc., should be verified carefully with their entries in the journal proper.

5. The ledger balances in the real accounts and outstanding accounts should be checked and verified with the Balance Sheet of last year. Current year ledger balances should be verified with the Trial Balance as on the closing date of the year.

8.2 VOUCHING OF OUTSTANDING ASSETS AND LIABILITIES

Even though the balances in the impersonal ledger are correct, the profit or loss arrived thereby will not be correct unless the expenditure incurred but not paid and incomes that are earned or accrued but not received are also taken into account. These items are accounted for through passing adjusting entries. Normally a Memorandum book is maintained to record these outstanding transactions. Auditor should exercise reasonable skill and diligence while examining these items. The outstanding amounts of the previous year are compared with those of the current year. These balances are ultimately shown in the Balance Sheet.

8.2.1 Outstanding Assets

The outstanding assets or intangible assets comprise of the following three items.

a) Income receivable
b) Prepaid expenses and
c) Deferred revenue expenses

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a) Income Receivable

There may be two types of income receivable. Firstly the income earned and due but not received (outstanding income). Secondly, income earned but not due (accrued income) at the end of the current year. For e.g., Dividend declared by a company but not received, interest due from the borrower not yet received, commission, shipping rebates, taxation claims etc. may also be outstanding since these incomes belong to the current year, it is desirable that they have to be included in current year's incomes, though not received, with a view to arrive at correct profits.

Auditor has to check these items from two points of view. Firstly, they belong to current year and are correctly calculated. Secondly, they are really recoverable. Amounts which are doubtful of recovery should not be considered as receivable.

b) Prepaid Expenses

Prepaid expenses are unconsumed services or inventories. These prepaid expenses arise where contractual payments are made in advance for services to be availed of in future. For e.g., insurance premium is paid in advance for a period of one year of insurance cover. The premium portion pertaining to the period falling in the next accounting year is regarded as prepaid. The prepaid portion of expenditure should be deducted in the current year's payment in order to arrive at correct profits. When the amount of prepaid expenses are negligible and are not going to affect the accounts significantly, they can be ignored. The auditor should examine all the vouchers relating to the [illegible] and verify the calculation of

prepaid amounts. The necessary entries and postings in accounts should also be checked by him.

c) Deferred Revenue Expenditure

Deferred revenue expenditure is a non-recurring expenditure paid in this year and expected to yield its benefits in future years. Though it is paid in this year, it should be charged to those years when its benefits are received. The auditor should see that the expenditure is spread over a reasonable period. Preliminary expenditure, heavy repairs to machinery etc., which cannot be treated as capital expenditure are considered as deferred revenue expenditure.

Exceptional losses such as loss by fire when the property is not insured can be recovered out of future profits. Such losses must not be confused with Deferred Revenue Expenditure.

8.2.2 Outstanding Liabilities

Any amount which is remaining unpaid against an expenditure is known as an 'outstanding liability'. Such liabilities must be brought into account to arrive at correct profits. It is the duty of the auditor to see that all such liabilities are brought into account before the current year's profit is arrived at. If these amounts are not considered, the profit arrived at will be over-stated and the auditor shall be held responsible for the dividends declared out of capital.

It is difficult for the auditor to verify the outstanding liabilities, since some of the expenses might be suppressed or concealed. Therefore, auditor should obtain a certificate from a responsible official stating that there are no expenses omitted form the books of account. The outstanding liabilities include unpaid expenses like rent, rates and taxes, electricity charges, wages and salaries, freight and carriage, travellers and agents' commission, and unearned income received. Some of these items are discussed below:

Unpaid Expenses: Expenses incurred during the year but the payment in respect of which is due either fully or partly, are known as unpaid or outstanding expenses. The total amount of such expenses must be charged to profit and loss account irrespective of payment. The auditor should examine all the vouchers, receipts, invoices etc.

Some of the common items of unpaid expenses are discussed below:

a) Purchases: Sometimes, it may so happen that the goods received in respect of the purchases made at the close of the year are entered in the stores ledger but are omitted to be entered in the purchases book. The auditor should compare the goods Inward Book with the Purchases Book and also the creditors statements.

b) Rent, Rates, Taxes, Electricity Charges etc.: Some of the expenses like rent are contractual payments, while the others like rates, taxes etc., are periodical. Such expenses which are incurred may have their due dates falling in the next accounting year, and hence their payment may be postponed. Though these payments are not made, they are supposed to be charged to current accounting year, so that current year's financial statements show correct results. The auditor should verify the contracts, agreements, receipts, etc. Further, he should also take into consideration the last year's financial statements and the items and amount showed there in.

c) Wages and Salaries: Most of the business firms will have the practice of paying the wages and salaries of the current month, in the first week of the next month. Thus the cash

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book will bear an entry for this in the next month and thereby the wages and salaries account will also have the same effect. Payment of such wages and salaries falling in the next accounting year should be shown as outstanding in the current year.

d) Freight and Carriage: The clearing and forwarding agents, sometimes, may not send the account for the freight and carriage for the goods imported, or purchased at the close of the year. Such amount, though remaining unpaid should be included in the current year's expenditure. The auditor should also verify that last year's freight and carriage expenditure paid in this year is not included in current year's expenditure.

e) Interest on Loans: If interest on loans and debentures is due and not paid, such amount should be included in current year's expenditure. The auditor should carefully verify that the interest is calculated upto the date of balance sheet.

f) Audit Fees: Some people argue that since the audit work is being taken up after the close of the accounting year, the audit expenses can't be included in the expenditure of the current year. But, it is fair to treat as the current year's expenditure, as it is concerned to that year. However, since no payment is made in current year, it is to be shown as outstanding expenditure.

8.2.3 Unearned Income

There may be certain incomes which are received but are not applicable to current year partly or fully. Such amount which is not applicable to current year should not be credited to Profit and Loss Account. Income items like rent, apprenticeship fees etc., may be received in the middle of the accounting year for a period of one year from the date of receipt. That portion of income falling in the next accounting year must be treated as unearned income or income received in advance. This amount should not be considered as current year's income, and hence it is deducted from the income received in Profit and Loss Account and shown as a liability in the balance sheet. The auditor should verify these items carefully.

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8.2.4 Contingent Liabilities

According to W.G. Meigs 'a contingent liability is a potential obligation which may, in future, develop into actual liability or may dissolve without necessitating any outlay.' It is a possible liability. It may be presently of a determinable or indeterminable amount. It arises from past circumstances or actions or from the happening of event in future. If it arises, it may result into a loss or an expense or an asset of doubtful value. The following are some of the contingent liabilities.

(i) Bills of Exchange discounted: The bills receivable received from the customers may be discounted with the bankers before their dates of maturity. In these cases, there are two possibilities: (a) the bill may be honoured by the drawee on the due date or (b) it may be dishonored. If it is honoured, no liability arises in future, but, if it is dishonoured, there arises a liability for the client to repay the bill amount to the banker. However, the amount of liability is determinable in this case.

(ii) In respect of income tax, sales tax etc. the tax levied may be disputed by the client: Any additional liability of tax in case the client loses in the dispute is a contingent liability. The amount of liability in this case may be determinable or indeterminable.

(iii) Suits pending for damages : Suits may be pending against the client, under which damages may be claimed for breach of contract. The amount of liability may be indeterminable.

Where the amount of liability is interminable the auditor, in consultation with the legal advisor or solicitor of the client, should assess the value and genuineness of such liabilities. The auditor, while going through the books of account, correspondence, minute books, bank statements etc., can find out such liabilities.

8.2.5 Contingent Assets

Certain assets may arise on the happening of an event in future, for e.g., claim from the drawee of a bill which has been dishonoured after discounting, claim for refund of tax, claim for breach of contract by suppliers of goods etc. While the contingent liabilities are shown in the balance sheet, it is felt appropriate that the contingent assets shall also be shown. But according to the conservative concept of accounting, they are treated as assets only on their happening. The Companies Act also does not require their disclosure.

Check Your Progress

1. What do you mean by income received in advance and state the duties of an auditor in regard thereto.

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2. What do you mean by deferred revenue expenditure? Also state the duties of the auditor regarding it.

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8.3 SUMMING UP

Impersonal or general ledger consists of two kinds of accounts, viz., real accounts and nominal accounts. The ledger is verified with the cash book entries primarily. The auditor shall ensure the correctness of the postings at the first instance and shall verify the postings, castings, direct entries from the journal proper and shall also verify the amounts of outstanding liabilities. The auditor should calculate the amounts of Income receivable, deferred revenue expenditure, outstanding expenses, etc., and should see that the final accounts represent fair and true position of the affairs. Similarly the auditor has to assess the amounts of contingent liability and a clear explanation in respect of their arrival should be prepared by him.

8.4 ANSWERS TO CHECK YOUR PROGRESS

1. Income received in advance refers to the income received during the current accounting year pertaining to the next year. In other words it is the income received for the unexpired period. The auditor should verify the correspondence, contracts/ agreements, etc., for

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ascertainment of the amount of the income received in advance. He should also make necessary calculations and should see that proper journal entries are made for it.

2. Deferred revenue expenditure is that amount which represents un-written off expenditure. The expenditure, if huge in amount, is not written off in one year but is spread over a few years in future. It is also done in cases where the benefits of the expenditure are expected to be received over a few years in future. The auditor should verify the entries, correspondence, office notes, minutes of the directors etc. He should also assess the genuineness in the period of spread.

8.5 MODEL EXAMINATION QUESTIONS

A. Answer the following questions in about 15 lines

1. What do you understand by 'impersonal or general ledger'? Explain its vouching procedure.
2. Write short notes on (a) income received in advance, (b) deferred revenue expenditure (c) outstanding expenses.
3. What do you understand by 'outstanding liabilities' and 'outstanding assets'

B. Answer the following in about 30 lines.

4. What is an 'outstanding liability' ? Explain the duties of an auditor with regard to various outstanding liabilities.
5. What are contingent liabilities? How would you vouch contingent liabilities?
6. What is an 'outstanding asset'? How is it accounted for ? What is its vouching procedure?

8.6 RECOMMENDED BOOKS

1. Kamal Gupta : Contemporary Auditing (Tata Mc.Graw-hill Publishing Co.Ltd., New Delhi)
2. B.N. Tandon : Practical Auditing (S.Chand and Co., Ltd., Ram Nagar, New Delhi)
3. Spicer & Pegler : Practical Auditing (Allied Publishers Pvt. Ltd. New Delhi)
4. Dinkar Pagare : Principles and practice of Auditing (Sultan Chand & Sons, 23, Darya Ganj, New Delhi)
5. T.R. Sharma : Auditing (Sahitya Bhavan, Hospital Road, Agra)

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BLOCK – III

VERIFICATION AND VALUATION OF ASSETS AND LIABILITIES

Unit – 9 : Depreciation

Unit – 10 : Reserves and Funds

Unit – 11 : Verification and Valuation of Assets

Unit – 12 : Verification of Liabilities

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UNIT - 9 : DEPRECIATION

Contents

9.0 Aims and Objectives
9.1 Introduction
9.2 Meaning and Definitions of Depreciation
9.3 Objects of Providing Depreciation
9.4 Effects of not Providing for Depreciation
9.5 Factors in the Measurement of Depreciation
9.6 Depreciation is an Estimate
9.7 Methods of Depreciation
9.8 Auditor's Duty Regarding Depreciation
9.9 Summing up
9.10 Answers to Check Your Progress
9.11 Model Examination Questions
9.12 Glossary

9.0 AIMS AND OBJECTIVES

The present chapter is aimed at explaining the various aspects related to depreciation such as the meaning and definitions of depreciation, the factors influencing it, the methods for its calculation etc. After going through this unit, you will be able to :

- explain the meaning of depreciation
- explain the objects of providing depreciation
- explain the factors influencing the measurement of depreciation
- explain the methods of depreciation
- understand the auditor's duty regarding depreciation

9.1 INTRODUCTION

Depreciation is an accounting term. It means a gradual decrease in the value of an asset due to wear and tear or effluxion of time. Depreciation is permanent and continuing. Fluctuations in the market value of an asset have no relationship with the depreciation. Depreciation is a gradual shrinkage in the intrinsic value of an asset. It is a capital loss and is charged to profit and loss account. If depreciation is not provided, the profits and loss account does not exhibit true profit position. It is, therefore,, necessary to know the different aspects pertaining to depreciation in detail.

9.2 MEANING AND DEFINITION

Depreciation has been defined by different authorities as follows:

Spicer and Pegler defined the term depreciation as 'a measure of the exhaustion of the effective life of an asset from any cause during a given period'.

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R.G. Williams defines depreciation as a 'gradual deterioration in value due to constant use'.

According to B.G. Vickery 'Depreciation is permanent decrease in the value of an asset through wear and tear in use with passage of time.'

De Paula says 'In practice, the term depreciation is commonly used in a very wide sense covering diminution in the value of assets caused by outside fluctuation in realisable and replacement value and also the amortisation in the cost of an asset over the period of its use'.

9.3 OBJECTS OF PROVIDING DEPRECIATION

The following are the objects of providing depreciation on any asset other than land. Land is considered to have unlimited life and hence it is not depreciated. Any other asset requires to be depreciated for the following purposes.

1. To find out net profit or loss for an accounting period. While compiling all expenses that are incurred for generation of revenues, depreciation should also be considered which represents the cost of the fixed asset that has expired during the period.

2. To present a true and fair value of the state of affairs of the business. If depreciation is not charged, the fixed assets may be over-stated in the balance sheet.

3. A continuous decline in the value of the asset over several years may lead to a decision to replace the asset. If depreciation is not charged, profits are over-stated and are distributed to the owners resulting in deficiency of funds for replacement of old assets.

9.4 EFFECTS OF NOT PROVIDING FOR DEPRECIATION

Depreciation is an accounting requirement and if it is not provided for, the income statement (Profit and Loss account) and the Balance Sheet will not exhibit a true and fair view of the business. The effects of not providing for depreciation can be stated as follows:

a) Periodic expenses will be understated.
b) Profits are overstated.
c) The values of assets will be overstated.
d) Capital depletion will take place.
e) Cost of production will be understated.
f) Price determination will be inappropriate.
g) Net worth will be overstated, and
h) Dividend distributed include unearned income.

9.5 FACTORS CONSIDERED IN THE MEASUREMENT OF DEPRECIATION

Following are the factors that influence the amount of depreciation, from an accounting point of view.

1. **Cost of the Asset :** The cost of the asset is the basis for all the subsequent accounting for the asset. It is also essential for calculating the amount of depreciation. Any addition or disposal of assets are also considered in calculating depreciation. The cost of an asset includes

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the purchase price, freight, installation costs, etc. A fixed percentage or any proportion of the cost of the asset may be charged as depreciation.

2. The Residual or Scrap Value of the Asset: It is the estimated value of a fixed asset at the end of its economic life. It is the amount expected to be received on sale of the asset. This scrap value, since it is realisable, is not considered as an expense. Thus, the life-time depreciation of the asset shall be equal to cost less scrap value. A spread of this life-time depreciation over the total life period gives the annual depreciation.

3. Working Life of the Asset: The basic objective of estimating the working life of an asset is to allocate the net cost of the asset over its useful life by means of depreciation. Working / useful life is the asset's service life expressed in terms of

(i) number of accounting periods or years or
(ii) units of output (i.e., pre-determined quantity of output) or
(iii) operating periods (eg. certain number of working hours)

4. Obsolescence: If the existing machine becomes outdated and if it becomes necessary to replace it by a new machine, the old machine is called obsolete. Depreciation is charged on the basis of estimated period after which the asset becomes obsolete.

5. Other Factors : The interest that may be earned if the amount is invested elsewhere instead of in the asset, the speed and the efficiency of the machine, repairs and renewals that are required, provisions under the Companies Act and the Income Tax Act are the other factors that influence the amount of depreciation chargeable on an asset.

9.6 DEPRECIATION IS AN ESTIMATE

It is very difficult to estimate in advance how long an asset will be useful to the business and what its salvage value will be. There is no scientific or strict logical way of ascertaining these factors. Since the residual value and the useful life of an asset are mere estimates, the amount to be charged as depreciation resulting from all these judgements is also an estimate.

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9.7 METHODS OF DEPRECIATION

There are many methods for calculation of depreciation. However, no single method can be applied for all the assets. The method of depreciation to be used for a particular asset depends upon : (i) the policy of the management (ii) the nature of business and (iii) the Laws applicable to the asset or business. Some of the important methods are briefly discussed hereunder :

1) Fixed Instalment Method

It is also called as straight line method. It is the principal method of determining the depreciation. Under this method the amount of depreciation is uniform in all the years of the assets life. The depreciation is determined by dividing the value of the asset minus its scrap value by the number of years it is expected to last.

This method is simple to understand and it is easy to calculate the amount of depreciation. This method is recommended by the Income Tax Act in India.

2) Diminishing Balance Method

It is also known as Reducing Instalment Method, or Written Down Value method. Under this method, a fixed percentage is adopted to calculate depreciation. This percentage is applied on the opening balance of the asset's value. Since the value of an asset goes on decreasing year after year (due to depreciation) the amount of depreciation also reduces year after year. This method does not consider the scrap value of the asset and the value of the asset never becomes zero under this method. This method is also recognized by the Companies Act and the Income Tax Act in India.

3) Annuity Method

Under this method, the cost of the asset is taken as an investment. So, interest is charged on the opening balance of the asset each year and a fixed amount of depreciation is written off every year, in such a manner that the assets' value shall become zero at the end of its life. This method is more suitable for leasehold assets. Annuity tables can be used for determining the amount of depreciation avoiding complex calculations.

4) Depreciation Fund Method

This is a specially designed method to make a provision for replacement of the asset. Under this method, the asset stands at cost in books and the depreciation provided is accumulated year after year as a fund. Simultaneously investments are made outside the firm year after year to accumulate funds for replacement of the asset. The annual amount to be charged as depreciation is determined with the help of sinking fund tables.

5) Insurance Policy Method

This is also a method meant for providing funds for replacement of the asset. Under this method, an insurance policy is taken for the asset for the whole of its life period and the annual amount of depreciation is used for payment of insurance premium. The proceeds of the policy are used for replacement of the asset.

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6) Revaluation or Inventory Method

This method can be successfully used in case of assets of small value such as loose tools, live stock, patents, and copyrights. Under this method, independent valuation of the asset is made at the end of every financial year and the difference between its value at the beginning and at the end of the accounting year is known as depreciation.

7) Machine Hour Rate Method

Under this method, the life of the asset is estimated in terms of hours the machine is expected to work. The Depreciation in a year is calculated based on the number of hours the machine has worked in that year. The depreciation per hour is calculated by dividing the 'cost of the asset minus scrap value' 'the number of hours the machine is expected work'. The total depreciation is calculated by multiplying the depreciation per hour with the number of hours the machine has worked in that year.

8) Depletion or Output Method

This method is specially suitable for wasting assets such as mines, quarries and oil wells. The mines and quarries reach a stage of depletion after extracting the deposits or available resources. Under this method, the cost of the wasting asset is divided by the estimated output to arrive at the rate of depreciation per unit of minerals extracted. The depreciation for an accounting period is calculated on the basis of output extracted during the period.

9) Production Unit Method

It is same as machine hour rate method. But, instead of considering the number of hours, the total number of units that can be manufactured by a machine during its life period is estimated and depreciation is calculated based on the actual number of units produced. This method helps in arriving at true cost of production.

10) Sum of the Years Digits Method

If the life of an asset is three years, each year is given a digit as 3 for first year, 2 for second year and 1 for third year. The proportion of each year's digit to the total of digits shall be applied for calculating the depreciation. Depreciation amount, under this method, goes on decreasing year after year.

11) Global Method

Under this method, all assets are pooled together and a flat rate is applied for calculation of depreciation. The individual assets lose their identity and no discrimination would take place among the different assets.

9.8 AUDITOR'S DUTY REGARDING DEPRECIATION

The auditor is expected to have a fair knowledge of various provisions of the relevant laws, like Companies Act, Income Tax Act etc., and also various methods of depreciation. He should note the following points while vouching the depreciation.

1. The auditor should see whether an appropriate depreciation policy is adopted from the view point of the nature of asset and the law applicable.
2. He should verify whether sufficient amount of depreciation is charged to P&L A/c or not. Under-charged depreciation results in over - estimation of profits and asset's value, and vice-versa.
3. He should see whether proper adjustment for repairs and renewals has been made.
4. If he feels that the amount of depreciation charged in previous years is not appropriate, necessary adjustments should be made for it in the books of account.
5. He should verify the calculations of depreciation and their postings in the books of account.

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6. He should also verify the register of assets and the method of depreciation for each asset.

7. If there is a change in the method of depreciation necessary adjustments should be carried out and the same should be incorporated in the financial statements with a specific note therefor.

Check Your Progress

1. Define depreciation and explain the causes of depreciation.

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2. List out the factors influencing depreciation

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3. Explain the straight line and the diminishing balances methods of depreciation.

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9.9 SUMMING UP

Depreciation is a permanent and continuous decrease in the value of an asset caused by various factors, such as wear and tear, effluxion of time, obsolescence, exhaustion, etc.,

The other factors which determine the amount of depreciation chargeable each year are cost of asset, working life of asset, scrap value, passage of time etc.

The are various methods for arriving at the amount of depreciation. Principal methods are : straight line method, diminishing balance method, annuity method, depreciation fund method etc. The method to be adopted for calculating the amount of depreciation for a particular asset should be based upon the nature of the asset, nature of the business, related laws and so on.

9.10 ANSWERS TO CHECK YOUR PROGRESS

1. Depreciation is an accounting concept. It can be defined as a permanent loss in the value of an asset. It is accounted for fair and true disclosure of profits and the values of assets. The causes of depreciation are (i) wear and tear (ii) effluxion of time (iii) obsolescence, (iv) exhaustion and (v) the other factors like market value, weather conditions etc.

2. The factors influencing the amount of depreciation are (i) cost of the asset, (ii) working life of asset, (iii) scrap value (iv) passage of time or obsolescence and (v) related provisions of income tax act, companies act and other enactments.

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3. The straight line method or fixed installment method is a widely used method of depreciation. Under this method, the amount of depreciation chargeable to each year would be fixed and equal. It is calculated by dividing the original cost of the asset less scrap value by the expected life of the asset in years.

The diminishing balances method or reducing installments method is another important method under which the amount of depreciation would be decreasing year after year. It is calculated by applying a fixed rate on the opening balances of the assets' value every year.

9.11 MODEL EXAMINATION QUESTIONS

A. Answer the following in about 15 lines

1. What do you mean by depreciation? Explain briefly the causes of depreciation
2. What are the objects of depreciation?
3. What is the purpose of annuity method of depreciation and to what type of asset it is suitable?
4. Describe the straight line method of depreciation.
5. What is the purpose of depreciation fund method. How is depreciation calculated under this method?

B. Answer the following question in about 30 lines.

6. Explain the factors influencing the amount of depreciation.
7. List out the methods of depreciation and explain briefly about each of them.
8. What are the duties of an auditor with regard to depreciation?
9. Explain the following
   (i) Fixed Instalment Method
   (ii) Reducing Instalment Method
   (iii) Depreciation Fund Method.

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9.12 GLOSSARY

Annuity Method : Under this method of charging depreciation the asset is treated just like an interest bearing investment.

Depreciation : It is a gradual decrease of any asset value from any cause.

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UNIT – 10 : RESERVES AND FUNDS

Contents

1.0 Aims and Objectives
1.1 Introduction
1.2 Meaning of Reserves, Provisions and Funds
1.3 Classification of Reserves
1.4 Duties of the Auditor
1.5 Summing up
1.6 Answers to Check Your Progress
1.7 Model Examination Questions
1.8 Glossary

10.0 AIMS AND OBJECTIVES

The aim of this unit is to explain the meaning and purpose of various reserves created and maintained by a business undertaking and to discuss the duties of the auditor with regard to them.

After going through this unit, you will be able to:

- classify the reserves
- differentiate among reserves, provisions and funds.

10.1 INTRODUCTION

Any business unit, generally, will not distribute all the profits among the owners. Some of the profits are retained or appropriated for various purposes. There may be certain expenses relating to current year but not yet specifically determined. Without necessary arrangement for such expenses, the current year's profits do not represent true and fair profits. Similarly, there may be some contingencies which are indeterminable currently. Such contingencies have to be faced or met by the firm as and when they occur. Such situations are the basic reasons for creation of provisions, reserves or reserve funds in the business units.

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10.2 MEANING OF THE TERMS PROVISIONS, RESERVES AND RESERVE FUNDS

Provisions

Provisions are the amounts set aside, before ascertaining the net profits, as reasonably necessary for the purpose of providing for any liability of an expense or loss, which is likely or certain to be incurred, but the amount or date on which they will arise may or may not be ascertained with reasonable accuracy. E.g., provision for taxation, provision for sales tax, provision for bad debts, provision for depreciation etc.

A provision is a term generally used to indicate known expenses and losses like depreciation or income tax but which can't be estimated with substantial accuracy.

A provision can be 'specific' like depreciation on a particular asset or 'general' like provision for bad and doubtful debts expressed as a percentage on all debtors.

Reserves

Reserves are the items of owners' equity which arise from retention of profits (appropriation of profit or a sum of profit set aside). Such reserves are called Revenue Reserves and would be available for distribution in future.

If reserves are created out of capital profits, such as profit on sale of a fixed asset or profit arising out of revaluation of a fixed asset, such reserves are known as Capital Reserves. These are not available for distribution among owners in future.

Reserve Funds

If any reserve is represented by a specific investment, it is known as a 'Reserve Fund'. For example, if some profits are set aside for construction of a building, such reserve is known as 'Building Fund'. The term 'Reserve Fund' indicates that an equivalent amount is invested outside the business in specific securities.

10.3 CLASSIFICATION OF RESERVES

Various classes of Reserves can be distinguished as follows :

1. General Reserve
2. Specific Reserve
3. Reserve Fund
4. Sinking Fund
5. Capital Reserve
6. Secret Reserve

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1. General Reserve

General Reserve is the amount of the profits or surpluses set aside in the business. It is an appropriation of profit. That is, it can be created only when there is a profit. It is created for general purposes and not against any known liability. It is also called as 'Free Reserve'. The amount of appropriation is the discretion of the management. There is no minimum or maximum limits for it. The management can use it for distribution among owners, if necessary.

2. Specific Reserves or Provisions

'Specific Reserve' is a reserve created for a definite purpose. It is created to provide for loss in the value of an asset (i.e. depreciation) or a liability which is certain to occur but the amount is not accurately known (eg. Income tax). These specific reserves or provisions are created irrespective of availability of profits. These reserves will not exist in books for a long time. They are closed by reducing the value of the asset (in case of depreciation) or on payment of

the known liability (eg. Income tax). The balance of specific reserves can't be used to distribute among owners.

3. Reserve Fund

This is same as General Reserve, but where an amount equal to General Reserve is invested, outside the business, in securities, it is called Reserve Fund. This Reserve Fund is arranged where the business is highly risk-prone and requires funds to meet contingencies.

4. Sinking Fund

A sinking Fund is always represented by investments outside the business. These funds are created for specific purposes like acquisition, and replacement of fixed assets or redemption of long term liabilities. For eg., Building fund is arranged for purchase or construction of a building, Depreciation Fund is created for replacement of an asset Debenture Redemption Fund is created for arrangement of funds for redemption of debentures at a future date.

5. Capital Reserve

The capital reserve is created out of capital profits. The profit on sale of fixed assets, premium on issue of shares etc., are capital profits and since these profits are not operational profits, they are not included in the profit and loss account and they are not distributed to owners.

6. Secret Reserves

Secret reserve or internal reserve or inner reserve or hidden reserve can be defined as 'a reserve which is not apparent on the face of the Balance Sheet'. It is surplus of assets over liabilities and capital. Secret reserves are undisclosed understatement of financial position of a business unit resulting from the following:

(i) Excessive depreciation written off the assets.
(ii) Overstatement of provisions and liabilities.
(iii) Writing off additions to fixed assets as expenses.

Banking, Insurance and other financial concerns create secret reserves to secure a stronger financial base for the firm.

10.4 DUTIES OF THE AUDITOR REGARDING RESERVES

In all cases, it is not a legal obligation to create reserves. It is for the internal convenience of the management, these reserves are created. However, certain reserves are created to arrive at a true and fair financial position of the firm. Therefore, the auditor should take into consideration, the views of the management necessary resolution taken by the partners or directors. In case of provisions, the estimated amount should be checked by the auditor. On the whole, the auditor should see that the reserves do not mislead the viewers of the financial statements and they do not cause any distortion to the purpose of accounting. The auditor should not approve the unnecessary reserves. Regarding the secret reserves, the auditor should see whether the company is legally permitted to have secret reserves.

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The auditor has to find out the facts pertaining to various reserves. The auditor has to disclose these facts in the report to be submitted by him.

Check Your Progress

1. What is a provision? What is the purpose of creating the provision for bad debts ?

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2. Give any three instances of capital profit.

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3. What is a secret reserve? Give any three ways of creating secret reserve ?

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10.5 SUMMING UP

A provision is an amount set aside towards an expenditure before ascertaining net profit. Reserves are the amounts set aside from profits to meet a known or unknown contingency or liability. A fund is an amount of reserve against which an investment of equal value is purchased.

Reserves can be divided into several types. They are (1) General Reserve (2) Specific reserve (3) Reserve Fund (4) Sinking Fund (5) Capital Reserve and (6) Secret Reserve.

A reserve created for a known or specific purpose is called 'Specific Reserve' and that created for a general purpose or not any known liability is called a 'General Reserve'.

A reserve fund is always represented by an asset or investment. Sinking funds are meant for replacement of an existing asset or redemption of a liability. Capital Reserves are created out of capital profits. Secret Reserves are undisclosed reserves which are created by over depreciation of assets or excess valuation of liabilities.

The auditor has to verify the purpose of reserves and the amount of reserves in case of specific reserves. Though there is no legal restriction on the creation and maintenance of reserves, they should not hamper the interests of the owners (shareholder's) and should not cause any distortion in the true and fair presentation of the accounts.

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10.6 ANSWERS TO CHECK YOUR PROGRESS

1. A provision is an amount set aside towards an expenditure the amount of which is still indeterminable before ascertaining the net profits of a business unit. The provision for bad debts is created to meet any future loss if the debtors fail to pay the whole or a part of the debt owning by them.

2. Capital profits may arise due to
   a) appreciation in the value of fixed assets
   b) sale of an asset at a higher value than the cost of the asset
   c) premium received on issue of shares or profit available after reissue of forfeited shares.

3. A secret reserve is not disclosed by the books of account. It can be created by
   a) over stating the liabilities
   b) under stating the assets
   c) excessive depreciation written off on assets

10.7 MODEL EXAMINATION QUESTIONS

A. Answer the following questions in about 15 lines.

1. What is a provision ? How and why it is made ?
2. Distinguish between a provision and reserve.
3. Distinguish between a reserve and a reserve fund.
4. Distinguish between a general reserve and a specific reserve.
5. What is a secret reserve ? Why is it created ?
6. What is a capital reserve ? How do they arise ?

B. Answer the following questions in about 30 lines.

7. Explain the auditors' duty with regard to the reserves arranged by a firm.
8. What is a secret reserve ? What precautions an auditor should take in respect of this reserve.
9. What is a sinking fund ? How is it created what is the difference between a Reserve Fund and a Sinking Fund ?
10. Distinguish between
    a) a reserve which is a charge on profits and
    b) a reserve which is an appropriation of profit.

10. 8 GLOSSARY

1. Free Reserves : General Reserve.

2. Provision : An amount written off or retained to provide for depreciation or any known liability, the amount of which is not accurately known.

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3. Reserve : Profit set aside for a specific purpose or general purpose.

4. Reserve Fund : Reserve represented by securities.

5. Revenue Profits : Profits earned in the regular course of business.

6. Secret Reserve : Reserve which is not apparent on the face of the Balance Sheet.

7. Sinking Fund : A kind of specific reserve created to repay a liability or to replace an asset.

8. Specific Reserve : Reserve created for a specific purpose.

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UNIT - 11: VERIFICATION AND VALUATION OF ASSETS

Contents

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11.0 AIMS AND OBJECTIVES

In this unit, verification and valuation of various types of assets has been dealt with. After going through this unit, you will be able to:

- explain and distinguish between verification and valuation
- explain verification process and valuation methods of various assets
- explain the points to be noted by the auditor with regard to verification and valuation of assets.

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11.1 INTRODUCTION

The auditor of a business is required to report in concrete terms that the balance sheet exhibits a true and fair view of the state of its affairs. The auditor has the obligation to verify the physical existence of the assets and documentary evidence proving its acquisition and ownership. The auditor should also ascertain that the balance sheet should represent correct values of all the assets which are existing in the business.

11.2 MEANING AND DEFINITION OF VERIFICATION

Verification means proving truth or confirmation. Verification of an asset means the ascertainment of actual position of an asset. It indicates the procedure carried out at the end of the year by an auditor to confirm the ownership, existence and valuation of an asset that is shown on Balance Sheet. It can be described as an enquiry into the ownership and title, existence and possession and the presence of any charge on the asset. It also involves that the classification and presentation of the asset is in accordance with the principles and rules of accounting and the legislations applicable.

The term verification has been defined by Spicer and Pegler as follows. "The verification of assets implies an enquiry into the value, ownership and title, existence and possession, and the presence of any charge on the assets."

In the words of Lancaster 'the verification of assets is a process by which the auditor substantiates the accuracy of the right hand side of the balance sheet and must be considered as having three distinct objects : (i) verification of the existence of assets, (ii) the valuation of assets and (iii) the authority of their acquisition.

The Institute of Chartered Accountants of India, laid down that the verification of assets should be aimed at establishing their (a) existence (b) ownership (c) possession (d) freedom from encumbrances (e) proper recording and (f) proper valuation

11.3 OBJECTS OF VERIFICATION

The objectives of verification of assets may be said to form an opinion in respect of

(i) Evidence of the existence of the assets as at the date of balance sheet which is done by physical examination.
(ii) Evidence of ownership of the assets which is done by examination of legal and official documents.
(iii) Evidence as possession of the assets and to see whether they are free from any charge.
(iv) Evidence with regard to proper valuation of assets.
(v) Evidence for.proper accounting of the assets.

The Verification Provides

a) a clear idea on accounts and financial statements.
b) for saving the business from unscrupulous motives
c) authenticity of records

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11.4 DISTINCTION BETWEEN VERIFICATION AND VOUCHING

The vouching and verification are not one and the same. They differ in the following aspects.

1. **Nature of work :** Vouching examines the entries relating to transactions recorded in the account books while verification examines the assets and liabilities appearing in the balance sheet.

2. **Time :** Vouching is done through out the year while verification is done at the end of the year when the balance sheet is prepared.

3. **Basis :** Vouching is based only on documentary examination while verification is based on personal as well as documentary examination.

4. **Valuation:** Vouching does not include valuation while verification includes valuation.

5. **Personnel :** Vouching is done by juniors and assistants like clerks, articles etc. where as verification is done by the auditor himself.

For example, if a building is purchased by the client, vouching of purchase refers to the payment made for it, while verification includes the examination of genuinity of documents, measurements of the dimensions, mortgages and other charges and disputes and claims etc., on such building.

11.5 DISTINCTION BETWEEN VERIFICATION AND CONFIRMATION

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In the course of an audit pertaining to assets, certain assets require confirmation, while certain other assets require physical verification. The written statements or certificates obtained from bankers, creditors, sister concerns, subsidiaries, financial institutions and from the officers of the client, etc., stand for confirmation. Thus, the confirmation is for intangible asset. On the other hand, physical verification means inspection of tangible assets by the auditor. It includes counting, weighing, identification as also quality evaluation of the assets like cash in hand, bills receivable, securities, plant and machinery, land and buildings, etc.

11.6 VALUATION OF ASSETS – MEANING

According to J.R. Batliboi 'a balance sheet is not drawn for the purposes of showing what the capital would be worth if the assets were realized and liabilities paid off, but to show how the capital stands invested.' Thus, valuation forms an important part of audit. The accuracy of balance sheet depends upon how correctly the estimation of assets and liabilities has been made. Both over-valuation and under-valuation of assets and liabilities would exhibit a wrong picture of the financial results and the financial position.

11.7 AUDITOR AND THE VALUATION

In the words of Lancaster 'an auditor is not a valuer and can't be expected to act as such. All that he can do is to verify the original cost price and to ascertain as far as possible that the current values are fair and responsible and are in accordance with the accepted commercial principles'. Thus the valuation of assets should be done by a responsible officer of the concern and the auditor has to see whether they have been properly valued or not.

11.8 METHODS OF VALUATION

'Financial accounts are largely a matter of convention, judgment and opinion and not a matter of certainty. The balance sheet can never show the real financial position, but only fairest possible estimates of the financial conditions'. It is because of the multiplicity of methods available for valuation of assets. They are as follows :

1. Cost Price: The price paid for acquisition of an asset is known as its cost price. The purchase costs, installation costs are also included in it.

2. Market Value: The market value is the amount which the asset can fetch if it is sold in the market.

3. Replacement Value: It is the price at which a particular existing asset can be replaced at the end of its life.

4. Book Value: This is the value at which the asset appears in the books of account. It is usually the cost minus depreciation.

5. Historical value: It is also known as 'going concern value' or 'conventional value' or 'token value'. This is also same as book value. No fluctuation in the price of the asset is taken into consideration for the reason that the assets are bought for constant use and not for resale.

6. Realisable Value: This is same as the market value. This represents the value that the asset can fetch when sold in the market.

7. Scrap Value: If the asset is sold as scrap after expiry of its life, the value it is estimated to fetch is called scrap value. This also influences the service value of the asset.

11.9 BASES OF VALUATION

In the process of valuation of assets, the auditor has to ensure that the bases of valuation are correct and reliable, and that necessary provision has been made for all contingencies. Fixed assets should be valued at cost less depreciation to date, while current assets should be valued at cost or the market value whichever is less. In the process of valuation, the auditor must keep in mind the following aspects.

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i) Original cost of the asset
ii) Expected working life of the asset
iii) Wear and tear of the assets
iv) Scrap value of the asset
v) The chances of the asset becoming obsolete
vi) Accounting method adopted for the asset

11.10 DISTINCTION BETWEEN VERIFICATION AND VALUATION

Following are the points of distinction between verification and valuation.

	Verification	Valuation
1. Meaning	- It proves the existence, ownership and title to the asset	It certifies the correct value of the asset
2. Extent	- It is complete process of examination	It is the concluding part of the examination process
3. By whom	- It is done by the auditor and his associates	It is done by the experts
4. When	- At the end of the accounting year.	As on the date of Balance Sheet
5. Evidence	- Title deeds, receipts for payment, etc.	Valuer's certificate
6. Responsibility	- Auditor is held responsible for improper verification	Auditor is not responsible as the valuation is done by expert valuers

11.11 VERIFICATION AND VALUATION OF FIXED ASSETS

The Institute of Chartered Accountants of India states that 'a convenient working rule is to regard the fixed assets as those acquired for the purpose of use in the business with the object of earning revenue and which are not intended for resale at a profit and conversion into cash in the ordinary course of business'. No asset will have a constant value throughout its life. Hence valuation should follow the verification of a fixed asset. The verification involves the following:

(i) Comparison of the ledger account balances with the balance sheet values
(ii) Verification of the physical existence of the assets
(iii) Whether the asset is in the possession and control of the client
(iv) Whether the asset is mortgaged
(v) Whether the title deed is in the name of the client
(vi) Whether the assets are used for the business.

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1. Land and Buildings

The auditor should verify the title deeds to ensure that they are in the name of the client. Any addition or sale should be carefully examined. If the property is mortgaged, he should obtain a certificate from the mortgage stating that the title deeds of the property are in their hands. The auditor cannot be held responsible for defects in the title deed, if any. In case of lease-hold property, the auditor should examine the conditions of lease. Free hold land is not a depreciable asset. It should be shown at cost. Buildings are valued at cost less a reasonable depreciation. Depreciation should be provided even if the buildings are not used during the year. The appreciations in the market value should not be considered.

2. Plant and Machinery

Generally, Plant Registers are maintained to keep a detailed record of plant and machinery. The auditor should verify the asset comparing the schedule with the plant register. If some machinery is sold out, its value as on the date of sale, depreciation and profit or loss thereon should be carefully examined. If any part of the machinery is installed outside the country, necessary certificate should be obtained from the competent authority.

In case of machinery bought on hire-purchase system, the interest included in the hire purchase price should not be included in the cost.

For valuing the plant and machinery, cost less depreciation should be considered. However, the determination of the depreciation rate is not the duty of the auditor. The auditor, any how, shall have to examine the adequacy of the amount of depreciation.

3. Furniture, Fittings, Fixtures and Office Equipment

These items are verified with the help of the invoices and Furniture Stock Register. Freight and carriage paid at the time of purchase should be charged to the Asset. Any additions or sales during the year should be carefully scrutinized.

A single rate of depreciation can not be applied to all the items of assets , because, for instance, the life of a machine can't be compared with a desk. The auditor should examine that adequate depreciation is provided on each item.

4. Motor Vehicles

The auditor should call for a schedule of motor vehicles and compare it with the Motor Vehicles Register. The registration certificate of each vehicle should be examined. If the registration is not in the name of the client, the auditor should verify the arrangement charges, if any, on vehicles should also be examined. The auditor has to verify if the insurance premium is paid for the vehicles. The valuation shall be on the basis of cost less depreciation. The depreciation rates need not be same for all the vehicles. Any expenditure on repairs should not be added to the cost. The auditor should also verify that all the vehicles are used for business purposes only.

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11.12 VERIFICATION AND VALUATION OF CURRENT ASSETS

The assets which are not held on a permanent basis are called current assets. They include cash in hand, cash at bank, Bills Receivable, Stock-in-Trade, sundry debtors, short term investments etc.

1. Cash-in-Hand

Cash in hand should be personally counted and verified by the auditor on the date of balance sheet. If unusually heavy balance of cash is found, the auditor should take it to the notice of the management. He should also verify the system and the frequency of bank remittances to form an idea which helps in identifying the cash manipulations and frauds. If he finds that the cash in hand is not in agreement with the cash book balance, he should include this fact in his report.

The auditor should also verify the I Owe You (IOUs), temporary advances made to employees etc. cheques received but not yet sent for collection should be accounted for cash in transit, if any, should be supported by documentary evidence.

2. Cash at Bank

The auditor should take the following steps in verifying the cash at bank.

i) He should compare the balances as per cash book and the Pass Book.
ii) He should get the Bank Reconciliation statement prepared by the client.
iii) He should obtain a letter of confirmation from the bank.
iv) He should obtain separate certificates for different accounts.

3. Bills Receivable

Verification of Bills Receivable is to (i) establish the accuracy of amounts, (ii) ascertain the validity of the bills as claims, (iii) check the collectibility of bills and (iv) for a fair disclosure of financial statements.

The Bills Receivable Book and the bills on hand should be verified. If the bills are discounted, the discount amount should be checked and if a portion of the discount falls in the next financial year, it should be properly accounted for.

4. Sundry Debtors

The sundry debtors form an important asset for a firm. The auditor should take the following steps while verifying the sundry debtors.

1. He should verify the individual balances of debtors with the schedule of debtors.

2. Confirmation letters should be directly obtained by the auditor from debtor either on complete basis or sample basis.

3. Where there are discrepancies, the auditor should ask the client to investigate, and the same fact be included in his report.

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4. Where confirmation letters are not received from any customer even after sending reminders, such accounts must be carefully and thoroughly examined. Bad Debts written off should be thoroughly examined into. He should satisfy himself that the debts are declared bad by a competent authority. The book debts should not contain the balances from customers to whom goods are sent on sale or return basis or on consignment basis.

5. Loans and advances

Loans and advances given by the client should be carefully examined by the auditor. In case of mortgage loans the documentary evidences should be verified. In case of loans to directors, employees etc., the firm's policy or practice should be examined. Rates of interest charged, securities obtained and recovery procedure (by way deduction from salaries etc.) should be examined.

6. Investments

The auditor should call for the schedule of investments. He should pay attention to nominal value, book value, paid up value and market value of investments. He should satisfy himself that the investments are in the name of the client and they are safe and secure. The mode of operation of the 'Investment Fluctuation Fund' should be verified, if it is maintained by the client. It is always better to show the investments in the Balance Sheet at cost. The auditor should verify the documentary evidences. Investments should not be written off except in special circumstances.

7. Stock-in trade / Inventory

Inventory or stock-in-trade includes raw material, work-in-progress and finished goods, stores and spare parts, loose tools and scrap or by-products. Correct recording of inventory is of paramount importance. According to Walter B. Meigs, inventories require special attention for the following reasons.

(i) The inventories constitute a largest current asset
(ii) Multiplicity of valuation methods in practice
(iii) Valuation method directly affects cost of production and thereby profits
(iv) More susceptible to errors and manipulations
(v) Rapid and higher fluctuations in price levels result in inconsistencies in the conventional valuation methods.
(vi) Verification of the quality, condition and value of inventory is more complex and difficult.

The objectives of verification of inventory are to ascertain

(i) that the stock mentioned is physically existing and
(ii) that the value of the stock is correctly taken.

It is practically impossible of an auditor to physically verify every item of the stock because of the lack of technical knowledge and limited time. Therefore, the auditor has to rely upon test checks.

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Over-valuation of stock shall inflate the profit and under-valuation results in deflation of profit. Therefore, the auditor has to take enough care in verification of inventories / stock and he has to pay his attention towards the following:

(i) He should examine the method of stock-taking
(ii) He should conduct test checks both for highly valued inventory and low-cost inventory
(iii) He should compare the prices on the stock sheet with the invoices on a test-check basis.
(iv) He should examine the basis of valuation.
(v) He should ensure that no over valuation takes place.
(vi) He should compare the figures of the previous and those of current year and observe the glaring differences, if any.
(vii) He should examine and find out that no goods which do not belong to the client are included in the stock.

Valuation of Stock

Stock-in-Trade being a current asset, should be valued at 'cost price or market price whichever is lower'. Increase in the market price should not be taken into consideration, even though such increase seems to be of permanent nature. Some of the important methods of ascertaining 'cost price' of the stocks are given below:

a) **Unit Cost Method:** Actual cost at which each unit of stock is purchased or manufactured is called unit cost. Incase of manufactured goods, the total cost incurred for a batch of production is divided by the number of units produced in the batch.

b) **Average Cost Method:** Where goods are purchased at different intervals of time, the total cost is divided by the total number of units to arrive at average cost per unit. Under this method, actual cost per unit cannot be ascertained, but it is a better method for valuing the goods sent on consignment.

c) **First-in-First-out Method:** Under this method, the stock is valued under the assumption that goods first purchased are first sold and recently purchased goods are held in stock. This method gives good results if the prices of the goods do not fluctuate largely. But, during the inflationary conditions, closing stock value shall be very high and it may result in payment of dividend at higher rates.

d) **Last-in-First-out Method:** Under this method, it is assumed that latest purchased goods are first sold and the earliest purchases are held in stock. This is suitable for pricing of the goods manufactured/ sold which represents the latest market prices which do not represent present market prices. Hence, this method is not suitable for valuation of closing stocks.

e) **Base Stock Method:** A specified quantity of stock is always carried at the original cost and it is not supposed to be issued unless there is an emergency. This stock is treated as fixed asset. The stock in excess of basic quantity is valued at cost or market price whichever is lower. This is almost like LIFO method.

f) **Adjusted Selling Price Method:** Under this method, stock is valued at current selling price. Selling and distribution costs are deducted form it and a reasonable

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profit margin is also deducted. The balance is considered at the value of the closing stock. This may not provide a true value of the stocks.

g) **Standard Cost Method:** Under this method, the stock is valued at some pre-determined cost per unit, called standard cost. Original cost is totally ignored and any variations between original cost and standard cost are considered later

Which Method to Choose?

In view of the multiplicity of methods, it is pertinent to ask as to which method be chosen. The objective of any method is to depict the actual cost of the inventory. Depending upon the nature of the stocks, frequency of purchases and fluctuations in their market prices, the firms may choose an appropriate method. Auditor has to see that the chosen method represents a fair value of stocks and does not result in over-valuation.

Valuation of Different Classes of Inventory

a) **Raw-Material:** Raw-Material is normally valued at cost or market price, whichever is lower. This practice is adopted to avoid future losses. It is a cautious approach. If any other method is adopted, the auditor should ensure that stock is not over-valued.

b) **Work-in-Progress:** Work-in-progress is valued to include the cost of the raw-material used and the proportionate wages and overheads. The auditor should verify the valuation method of work-in-progress and should ensure that it is not over-valued.

c) **Finished Goods:** The finished goods are valued to include total raw-material, wages and overheads. The cost must always be less than the market price. Auditor should examine the method of valuation adopted.

d) **Stores:** Lubricants, grease, waste cotton, certain implements are known as stores. They are valued at cost or market price, which ever is less.

e) **Spare Parts:** Spare parts are kept for maintenance of plant and machinery. They are always valued at cost. Auditor should see that the spares are maintained at a reasonable level, and their cost must be lower than the market value.

Auditor's Duty: Besides examining the valuation methods for the inventory, the auditor should particularly ensure that necessary provision is made for damaged and out dated stock. He should also ensure that the goods remaining in stock with branches, with consignees, and with customers on sale or return basis are all included in the closing stock.

11.13 VALUATION OF INTANGIBLE ASSETS

Intangible assts include goodwill, patents, trade marks and copyrights. Since they are intangible, physical verification is not possible.

a) **Goodwill:** Goodwill is the monetary value of the reputation of the firm. It has no physical existence. It does not diminish in value with use. The goodwill should be shown in the balance sheet only when (1) it is purchased by payment of a price, (2) where the assets of another running business is purchased by payment of an excessive price, such amount is treated

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as the goodwill value (3) where the whole of assets of a firm are revalued and goodwill is raised in the books (4) where a new partner is admitted or an old partner retires or dies, in a partnership firm, the goodwill may be shown in the books,

In all the above situations, the auditor should verify the necessary documents. When the goodwill is purchased, the terms of agreement should be verified. When the assets are revalued, their valuations should be checked. In case of partnership, the deed should be verified.

If the auditor feels that the benefits of the goodwill are not existing, he may advise the client to write off the goodwill. Though the benefits are available, it is always desirable to write off the goodwill gradually over a period of time.

b) Patents: A patent is a right transferred by an inventor of a design or formula to another person for the use of such design or formula for a fixed period at an agreed price. These rights are registered with the concerned authority. The auditor should clearly verify the registered documents and should ensure that such rights have not lapsed. The patents may be depreciated for three reasons. Viz. lapse of time, obsolescence and the patented commodity becoming out of fashion. The auditor should see that the patents are depreciated reasonably. If the patents are acquired out of research and development by the client, it may not appear at a high value in the books.

c) Copyrights: Copyrights are connected to literary works. It is the legal protection provided to an author by which the publication of his work by other is prohibited. If the copyright is purchased by a publisher, the price paid for it shall be the value of such copyright. The auditor should verify the documents. The copyright may lose their value over a period of time which is reflected by low or no sale of the books published. In such case, the copyrights should be written off reasonably on the basis of popularity of the literary work.

d) Trade Marks: 'Trade marks the distinctive marks attached to goods offered for sale in the market so as to distinguish the same from similar goods and to identify them with a particular trader or manufacturer.' These trade marks may also be transferred from one trader to another and are registered. The auditor should examine the relevant documents and ascertain their value.

Any renewal fees paid for patents, trade marks or copyrights should be treated as revenue expenditure.

11.14 VERIFICATION OF FICTITIOUS ASSETS

Fictitious assets are not real assets. They are artificial in nature. They cannot be sold and cannot be converted into cash. The preliminary expenses and discount on issue of shares and debentures are the best examples.

a) Preliminary Expenses: There are the expenses incurred in connection with the location and incorporation of a company. This is a capital expenditure and is shown on assets side of the balance sheet. However, the auditor after verifying the expenses, should advise the client to write off them as early as possible, either through the profit and loss account or through the capital profits existing in the company, if any.

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b) Discount on Issue of Shares/ Debentures: Where the shares / debentures are issued at a value less than the face value, the difference is the discount allowed and represents a capital loss for the company. It is shown in a separate account and is written off over a period of time. The auditor should see that, such discount amount is written off at the earliest. It may be written off through capital profits, if any, or through profit and loss account over a period of time.

Check Your Progress

1) Distinguish between vouching and verification

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2) Distinguish between verification and valuation.

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11.15 SUMMING UP

Verification of an asset means the ascertainment of actual position of an asset, with regard to ownership, possession, existence and valuation of an asset. Verification is different from Vouching. While Vouching refers to examination of the entries recorded relating to all transactions, Verification refers to examination of the assets with respect to their physical existence, charges thereon and their valuation. Verification and Valuation are carried out with an objective of showing the true and fair values of the assets.

For the purpose of verification and valuation, the assets are divided into four types: (i) fixed assets, (ii) current assets, (iii) intangible assts and (iv) fictitious assets. The auditor is not a valuer but should ascertain the current values of the assets so as to show the financial statements is accordance with the accepted principles.

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11.16 ANSWERS TO CHECK YOUR PROGRESS

1. Vouching examines the entries relating to transactions recorded in the books of account while verifications is to examine the physical existence, documentary evidence and the confirmation of the values of the assets.

2. While Verification refers to confirmation and attestation of accuracy and truth regarding the existence of assets, valuation refers to ascertaining the value of assets critically and correctly. The object of both the Verification and Valuation is to show the right assets at their right values. Between the Verification and Valuation, the Verification is a broader term and includes the Valuation also.

11.17 MODEL EXAMINATION QUESTIONS

A. Answer the following in about 15 lines.

1) What do you mean by verification of assets.
2) Distinguish between Verification and Vouching.
3) Distinguish between Verification and Confirmation.
4) Distinguish between FIFO and LIFO methods of inventory valuation.
5) How do you verify the fictitious assets?
6) What is the verification process for Freehold Property?
7) How do you verify the book debts?
8) Explain the procedure for verification of stock-in-trade.

B. Answer the following questions in about 30 lines.

9) Discuss the procedure and the auditor's duty regarding verification and valuation of fixed assets.
10) Discuss the procedure for verification of stock in trade and also the methods available for its valuation.
11) How do you carryout the verification and valuation of intangible assets?
12) 'An auditor is not a valuer but he is intimately connected with values.' Explain.
13) How do you verify the current assets? Explain the auditor's duty regarding it.

11.18 GLOSSARY

1. **Verification** : It is referred to the verification of assets and liabilities to ensure their physical existence and proper value.

2. **Fictitious Assets** : An asset which is not physically visible and not represented by actual value.

3. **Intangible Assets** : It is an asset which is not visible but serviceable and valuable like any other asset.

4. **Valuation** : It means testing the exact value of an asset on the basis of utility.

5. **Goodwill** : It is an intangible asset. It depends upon the earning capacity of the business concern.

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UNIT – 12 : VERIFICATION OF LIABILITIES

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12.0 AIMS AND OBJECTIVES

This unit intends to explain the verification procedure of the liabilities. After going through this unit, you will be able to:

- explain the meaning of verification of liabilities
- discuss verification of various liabilities
- explain the auditor's duty regarding verification of liabilities.

12.1 INTRODUCTION

Verification of liabilities is also as important as the verification of assets. All the liabilities of long-term and short-term nature should be verified by the auditor. Any commission, over-statement or under-statement of liabilities will lead to presentation of unfair financial position in the balance sheet.

Since the liabilities are contractual amounts payable to third parties, and are ascertained as per the documents, they need no valuation. However, the interests and other charges must be clearly and correctly calculated to arrive at actual amount of liabilities. Unrecorded liabilities for purchases, outstanding expenses etc., must be carefully accounted for, contingent liabilities, if any, have to be disclosed by way of foot-notes or additional information. Wherever necessary the auditor has to ascertain certificates from the competent officers.

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12.2 VERIFICATION OF LIABILITIES – MEANING

Verification of liabilities means (i) ascertaining that all the liabilities are identified, (ii) that all the liabilities are taken at actual and correct values and (iii) that all the liabilities are disclosed in the financial statement. The auditor should carryout the verification process carefully so that the Balance Sheet shows a correct and true financial position. The verification of liabilities include verification of capital, verification of long-term liabilities like debentures, bank loans and short-term liabilities like trade creditors, bills payable etc. Besides, the contingent liabilities are also disclosed in the financial statements.

12.3 VERIFICATION OF CAPITAL

Capital is not a third party liability. However, it is known as internal liability. Incase of a firm, the auditor should verify the capital with the help of partnership deed, cash book and pass book. Interest on capital, partners salaries, drawings etc., must be carefully accounted for, keeping in view the legal aspects and the partnership deed. In case of a company, the auditor should examine the Memorandum of Association, Articles of Association, Prospectus, etc. The discount offered or premium collected should not be included in the share capital account.

If the shares are allotted to promoters, vendors, the documents and the minutes of the board of directors should be examined. Different clauses of shares, their values, the number of calls made, amount of each call should be kept in mind. The amounts received on each call should be verified on the basis of bank statements.

The guidelines issued in this respect by the Institute of Chartered Accountants of India state that the Authorised, Issued, Subscribed and called up capital should be presented separately in the balance sheet comprising all the classes of shares. Where the consideration for shares is not received in cash, this must be disclosed in the balance sheet. If the shares are issued as bonus shares, their number, and paid up value should be maintained. Regarding the source of funds from which bonus shares are issued, i.e., capitalization of profits should be thoroughly examined. The compliance of the provisions of the Companies Act should be ensured. The qualifying shares held by the directors should also be observed.

If the shares are forfeited, the resolutions, the treatment of the forfeited money, and the reissue transactions must be verified. The forfeited money should be added to paid up share capital, if the forfeited shares are yet to be reissued. Surplus of forfeited money after reissue of forfeited shares should be transferred to capital reserve.

In case of first audit after incorporation, the auditor should ensure that all legal formalities are followed in regard to issued and allotment of shares. He should examine the share application account, share call money account and share capital account. Share Application Register, Share Allotment Register, Share Calls Register and the shareholders / Members register should be examined.

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12.4 VERIFICATION OF DEBENTURES

The auditor should refer to the Memorandum of Association and Articles of Association to assess the powers of the company to issue the debentures. The debentures may be issued and redeemed at par, at a discount or at a premium. The auditor should note the conditions of issue and redemption. If the mortgages are offered to debenture holders the mortgages register should be verified. 'Debenture Trust Deed' should be inspected and thereby the debentures account and the register of debenture holders should be examined. In case of redeemable debentures, the arrangements for redemption should be examined. Any profit on redemption of debentures should be treated as capital profit.

12.5 VERIFICATION OF TRADE CREDITORS

Vouching of purchases book, purchases returns book, bills payable book and cash book will almost give a final figure of the liability towards trade creditors. However, the auditor should take a 'schedule of creditors' from the competent officer and check the balances of ledger amounts. Wherever necessary the auditor can get the balances confirmed from the creditors, with prior permission from the client.

If the client is maintaining any provision in respect of discount on creditors, he should check this with reference to the total of creditors' balances.

12.6 VERIFICATION OF BILLS PAYABLE

The auditor should obtain a list of bills payable outstanding and check it with the bills payable book and bills payable account. Any variation between the two should be reconciled. The auditor can obtain confirmation letters form the drawers, with prior permission from the client. Disowning of bills, renewal of bills, retirement of bills before due date should be carefully verified. The auditor should ensure that this item shows a true liability. He should see that bills which are paid are not shown as a liability again.

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12.7 VERIFICATION OF LOANS

The client may be having loans taken from banks, financial institution or public. As a part of the verification of loans, the auditor should verify the agreements and correspondence between the client and the parties. In case of bank overdraft or cash credit, the auditor should obtain a statement from the bankers.

If the interest on loans is due and remain unpaid till the date of balance sheet, it should be carefully calculated and should be included in liabilities. The auditor should also examine the borrowing powers, register of charges.

12.8 VERIFICATION OF LIABILITIES FOR EXPENSES

The outstanding expenses like salaries payable, legal expenses, rent, wages, audit fees outstanding are ascertained by examining the relevant registers like wages register, salaries register, rent agreement, etc.

The auditor should obtain a certificate from a responsible officer stating that all the liabilities for outstanding expenses have been included in the books. These items ensure disclosure of correct profits as well as true and fair financial position of the company.

12.9 VERIFICATION OF CONTINGENT LIABILITIES

A contingent liability is a possible liability, which may be, presently, of determinable or indeterminable amount, which arises from past circumstances or action which may or may not become a legal obligation in the future. A liability in a disputed case where damages may have to be paid, guarantees given by company or a speculative transaction are some of the examples of contingent liabilities. These contingent liabilities do not form part of the total of the balance sheet.

Unless a contingent liability is of quite a negligible amount, it should be disclosed by way of a foot note under the balance sheet. The auditor should inspect various contracts entered into by the client and bills receivable discounted by the client and thereby assess the likelihood of contingent liabilities. He should obtain a certificate from the client stating that all the possible estimated contingent liabilities have been disclosed to the auditor.

Check Your Progress

1. What is meant by verification of liabilities?

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2. How do you verify the share capital of a company?

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12.10 SUMMING UP

Liabilities are mostly contractual amounts. A thorough verification will ensure proper and fair presentation of the financial position of the firm. The verification of liabilities include verification of internal and external liabilities. Internal liabilities include capital, reserves, etc. While external liabilities include loans, debentures trade creditors, bills payable, outstanding expenses etc. Contingent liabilities are also verified by the auditor for presentation along with the balance sheet though they are not included in the balance sheet.

12.11 ANSWERS TO CHECK YOUR PROGRESS

1. Verification of liabilities means ascertaining that all the business liabilities are properly disclosed, classified for presentation in the financial statements. The auditor should see that the liabilities are not omitted, over-stated or under-stated to ensure true and fair view of financial position. Verification includes the vouching of various documents, registers agreements, ledgers, statements, etc. for confirmation of the balances.

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2. Share capital verification can be divided into two stages : (i) first audit and (ii) subsequent audit. In the first audit Memorandum of Association, Articles of Association, Terms of Prospectus, Allotment Register, Minutes of Directors, Bank Statements, etc. are verified to ascertain the amount of capital actually received. If the shares are allotted for consideration other than cash, it should be stated separately. All classes of capital should be dealt with separately.

In subsequent audits, further issue of shares, forfeiture and reissue of shares, issue of bonus shares etc. are verified. In case of forfeiture, the forfeited amount should be treated separately. In case of bonus issue, the profits, which have been capitalized, should be stated specifically.

12.12 MODEL EXAMINATION QUESTIONS

A. Answer the following in about 15 lines.

1.) What do you mean by verification of liabilities?
2.) What are contingent liabilities? How are they verified?
3.) State the procedure for verification of share capital.
4.) How would you verify the outstanding liabilities for expenses?

B. Answer the following questions in about 30 lines each.

5.) What are the duties regarding the verification of share capital and debentures?
6.) Narrate the procedure for verification of various liabilities and state the auditor's duty in this respect.

12.14 RECOMMENDED BOOKS

1. Kamal Gupta : Contemporary Auditing (Tata Mc. Graw-Hill Publishing Co. Ltd., New Delhi)
2. B.N. Tandon : Practical Auditing (S.Chand and Co., Ltd., Ram Nagar, New Delhi)
3. Spicer & Pegler : Practical Auditing (Allied Publishers Pvt. Ltd., New Delhi)
4. Dinkar Pagare : Principles and Practice of Auditing (Sultan Chand & Sons, 23, Darya Ganj, New Delhi)
5. T.R. Sharma : Auditing (Sahitya Bhavan, Hospital Road, Agra)

12.13 GLOSSARY

1. Intangible Liability : It is a liability, which may or may not arise in future for payment.

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BLOCK – IV

COMPANY AUDIT

Unit – 13 : Company Auditor

Unit – 14 : Books, Records and Final Accounts of a Company

Unit – 15 : Audit of Share Capital

Unit – 16 : Audit of Other Aspects

Unit – 17 : Loans and Remunerations to Directors and Managerial Personnel

Unit – 18 : Dividends

Unit – 19 : Divisible Profits

Unit – 20 : Audit Report

Unit – 21 : Rights, Duties and Liabilities of Auditor

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UNIT –13 : COMPANY AUDITOR

Contents

13.0 Aims and Objectives
13.1 Introduction
13.2 Appointment of Company Auditor
13.3 Limit on the number of Audits which can be accepted
13.4 Removal of Company Auditor
13.5 Qualifications and Disqualifications of a Company Auditor
13.6 Remuneration of Auditor
13.7 Auditor's Lien
13.8 Summing up
13.9 Answers to Check Your Progress
13.10 Model Examinations Questions
13.11 Glossary

13.0 AIMS AND OBJECTIVES

This unit aims at discussing the provisions of the Companies Act with regard to the appointment and other aspects of a company auditor. After going through this unit, you will be able to :

- understand the provisions relating to appointment, qualifications, remuneration and removal of company auditor.
- recognize auditor's lien.

13.1 INTRODUCTION

As has been discussed in an earlier unit, Companies Act makes audit of all companies registered under the Companies Act mandatory. Every company has to get its books of account audited every year. The Companies Act lays down the rules regarding appointment of auditors, qualification of auditors, how their remuneration has to be fixed and the procedure for removing them. The Act also contains provisions on what should be the audit format, who should sign the audit report.

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13.2 APPOINTMENTOF COMPANY AUDITOR

Section 224 of The Companies Act contains provisions regarding appointment of a company auditor. How the appointment is made under various circumstances is discussed as under:

First Auditors

Section 224 (5) contains provisions regarding appointment of first auditors. The Board of Directors has to make appointment of the first auditors within one month of the date of incorporation of the company. The auditor so appointed holds office till the conclusion of the First Annual General Meeting of the company. If the Board of Directors does not appoint the first auditors in the stipulated one month time, the company in general meeting may appoint the first auditors.

Subsequent Appointments

As has been stated earlier, the first auditors hold office till the conclusion of the first annual general meeting of the company. At this annual general meeting the shareholders have the power to appoint the next auditors who hold office till the conclusion of the next annual general meeting. Thus two things become clear. The first thing is that auditors hold office from the conclusion of one annual general meeting till the conclusion of the next annual general meeting. The second thing is that auditors have to be appointed at every annual general meeting.

The company is required to inform the auditor about his appointment within 7 days of the appointment. Thereafter the auditor has to communicate his acceptance or refusal to the concerned Registrar of Companies within 30 days of the receipt of intimation from the company.

In case the auditor so appointed at the annual general meeting does not accept the appointment it is not treated as a casual vacancy and hence the Board of Directors don't have the power to appoint another person as auditor. In such a case the only course of action is to hold another general meeting of the shareholders for fresh appointment.

Appointment of Auditors by Central Government

At an annual general meeting if no auditor is appointed or re-appointed, the Central Government may appoint a person to fill the vacancy. If no auditor is appointed at an annual general meeting, within 7 days of the meeting, the company shall inform the central Government that no auditor has been appointed and thereafter the central Government shall proceed to make such appointment.

Filling up of Casual Vacancy

If a casual vacancy is caused because of the death, insanity or insolvency of an auditor, this casual vacancy can be filled up by the Board of Directors by appointing a new person. The Board has to exercise this power by passing a resolution at a meeting of the Board of Directors. An auditor thus appointed holds office till the conclusion of the next annual general meeting.

Appointment by Special Resolution

In the case of a company in which not less than 25 % of the subscribed share capital is held, whether singly or in combination by a public financial institution, or a Government company or central or state Government, or a nationalised bank or an insurance company etc the appointment of auditors has to be done at an annual general meeting by passing a special resolution (instead of an ordinary resolution which is sufficient in all other cases).

Compulsory Re-appointment

The Companies Act lays down that except in the following circumstances a retiring auditor shall be reappointed at an annual general meeting. The circumstances where a retiring auditor is not reappointed are as under:

a. Where he is not qualified for reappointment
b. Where the auditor has sent a communication that he is not willing to accept the reappointment.
c. Where a resolution has been passed at the meeting providing expressly that he shall not be re-appointed.

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d. Where notice has been given of an intended resolution to appoint some other person in the place of the retiring auditor.

Appointment by Comptroller Auditor General (C & AG)
None of the provisions regarding appointment of auditors as discussed above are applicable to Government companies. The auditor of a Government company is appointed or re-appointed only by the Comptroller and Auditor General of India.

13.3 LIMIT ON THE NUMBER OF AUDITS WHICH CAN BE ACCEPTED

The Companies Act puts a restriction on the number of audits which an auditor can accept. After the Companies Amendment Act of 2000 the limits are as under:

The total number of company audits, which can be accepted by an auditor, is 20 out of which not more than 10 companies should be having paid-up share capital of Rs 25 Lakhs or more. This limit is applicable per person. Thus in the case of a firm of Chartered Accountants, each of the partners shall have a limit of 20 audits. If there are 2 partners, the firm can do 40 audits. It is also important to know that the above limits are not applicable to audits of private limited companies. Thus an auditor can audit any number of private limited companies plus 20 other companies with the above restrictions.

13.4 REMOVAL OF COMPANY AUDITOR

The shareholders in a general meeting may remove the first auditor of a company appointed by the Board of Directors of the company even if his tenure of office has not come to an end.

For removal of subsequent auditors, before the expiry of his term, prior permission of the Central Government has to be obtained and then an ordinary resolution has to be passed at a general meeting.

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13.5 QUALIFICATIONS AND DISQUALIFICATIONS OF A COMPANY AUDITOR

Who is Qualified to be Appointed
Section 226 of The Companies Act prescribes the qualifications and disqualifications of a company auditor. As per the provisions of the above section ' a person shall not be qualified as auditor of a company unless he is a chartered accountant and he holds a certificate of practice.

In addition to the above, the Companies Act also permits a holder of a certificate in an erstwhile Part-B State which entitled him to act as an auditor of companies in the jurisdiction of that state, to be appointed as an auditor of companies.

Who is Disqualified from being Appointed?
In the following cases an auditor is disqualified from being appointed as auditor of a company.

a. a body corporate
b. an officer or employee of the company
c. a person who is a partner, or who is in the employment, of an officer or employee of the company

d. a person who is indebted to the company for an amount exceeding Rs 1000
e. a person holding equity shares of a company.

The Companies Act also states that if an auditor becomes subject, after his appointment, to any of the above disqualifications he shall be deemed to have vacated his office.

13.6 REMUNERATION OF AUDITOR

Remuneration of an auditor is fixed by the Board if the Board has made the appointment. In all other cases the remuneration has to be fixed either by the Shareholders in the general meeting or the shareholders should approve the way in which the remuneration has to be fixed. To give an example, the shareholders will approve appointment of an auditor and the resolution will also say that their remuneration shall be fixed by the Board of Directors. In this case the Board can fix the remuneration.

When an auditor is re-appointed and if no remuneration is mentioned in the resolution appointing him, then the remuneration paid for the earlier year shall continue.

13.7 AUDITOR'S LIEN

We shall examine whether the auditor has got a lien over the books of account of the client and over any other documents in the following paragraphs.

Lien on Books of Account
Any person having the lawful possession of somebody else's property, on which he has worked, may retain such property if his fee for the work done has not been paid. An auditor can exercise lien on books and documents of his client for non-payment of his fee provided the following conditions are satisfied.

a. Documents retained by the auditor must belong to the client who has not paid the fee.
b. Documents must have come into possession of the auditor in the regular course. In other words, the documents should not have been obtained in an illegal way.
c. The auditor has a lien over the books provided he has done some work on the books and records.
d. Only those books and documents, which are connected with the work, can be retained.

Lien over Working Papers, Correspondence with Client etc.
Working papers are the property of the auditor and hence the question of lien does not arise. The auditor can retain all such papers with him. The auditor may at his discretion provide the client with copies of the working papers or copies of any portions of the working papers. Correspondence with the client is the property of the auditor and hence the question of lien does not arise.

If the auditor has done any correspondence with third parties in the capacity of an auditor and as part of his audit work, then the correspondence also becomes the property of the auditor and hence he can retain all such papers. However, if the auditor has acted as an agent of the client - for eg. if he has prepared a project report and for this purpose, on behalf of the company, he has corresponded with third parties - in such a case the correspondence will be the property of the client. And the auditor can still exercise his lien over these papers if his fee has not been paid.

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Check Your Progress

1. What are the disqualifications of Company Auditor?

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2. What is Auditor's Lien?

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13.8 SUMMING UP

The first auditors of a company are appointed by the Board of Directors and if they fail to do so, the shareholders will have to appoint them in a general meeting. Subsequent auditors are appointed by the shareholders in an annual general meeting. In case where the Govt. or a Govt. company holds more than 25 % of the paid up capital a special resolution is required for appointment of auditors. In the case of Government companies auditors are appointed by the C & AG.

Removal of an auditor before his term expires needs permission of the Central Government.

A practicing Chartered Accountant or a firm of Chartered Accountants can be appointed as auditors. Section 226 (3) of the Companies Act give a list of disqualifications of an auditor.

Remuneration of an auditor is fixed by the Board if the appointment is made by the Board. In other cases the remuneration is fixed by the shareholders or the shareholders approve the manner in which remuneration has to be fixed.

Auditor has a lien over the books and records if he has worked on such books and the books have come in his possession in a legal way. The question of lien does not arise for working papers and correspondence with the client as this is the property of the auditor.

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13.9 ANSWERS TO CHECK YOUR PROGRESS

1. The following are disqualifications to be appointed as auditor of a company.

   a. a body corporate
   b. an officer or employee of the company
   c. a person who is a partner, or who is in the employment, of an officer or employee of the company
   d. a person who is indebted to the company for an amount exceeding Rs 1000
   e. a person holding equity shares of a company.

2. Auditor can exercise lien on books and documents of his client for non-payment of his fee provided the following conditions are satisfied.

a. Documents retained by the auditor must belong to the client who has not paid the fee.
b. Documents must have come into possession of the auditor in the regular course. In other words, the documents should not have been obtained in an illegal way.
c. The auditor has a lien over the books provided he has done some work on the books and records.
d. Only those books and documents, which are connected with the work, can be retained.

13.10 MODEL EXAMINATION QUESTIONS

A. Answer the following questions in about 15 lines.

1 Explain the following in brief:
   a. What is meant by Auditor's Lien.
   b. What are the limits on the number of audits which can be accepted by an auditor.
2 Can a company auditor be removed and under what circumstances.
3 How is the remuneration of an auditor fixed.

B. Answer the following question in about 30 lines.

4. Explain how a company auditor is appointed under various circumstances.
5. What are the qualifications and disqualifications of an auditor..

13.11 GLOSSARY

Auditor's Lien : A legal right of the auditor whereby he can retain books and records of a client.

Casual Vacancy : Vacancy caused because of the death or disqualification of an auditor.

Working Papers : Papers which are generated by the auditor during the course of his audit for making notes and jotting down important points.

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UNIT - 14 : BOOKS, RECORDS AND FINAL ACCOUNTS OF A COMPANY

Contents

14.0 Aims and Objectives
14.1 Introduction
14.2 Provisions in the matter of Books of Account
14.3 Statutory Registers to be Maintained
14.4 Provisions Relating to Final Accounts
14.5 Report of the Board of Directors
14.6 Summing Up
14.7 Answers to Check Your Progress
14.8 Model Examination Questions
14.9 Glossary

14.0 AIMS AND OBJECTIVES

This unit is designed to give the student an idea about the statutory requirements under the Companies Act for maintenance of books of account and various registers. The unit also deals with the provisions relating to final accounts as well as the contents of the report of the Board of Directors. On going through the unit you will be able to:

- explain the requirement about books of account to be maintained by every company.
- statutory registers to be maintained by a company
- provisions relating to final accounts and
- contents of the report of the Board of Directors

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14.1 INTRODUCTION

It is very essential to know the exact provisions of the Company's Act in relation to the books of account to be maintained by a company. It becomes easy to understand the audit requirements once you know what are the legal requirements about maintenance of books of account by/a company and also the provisions regarding final accounts of a company. Similarly all companies are also required to comply with maintenance of statutory registers like the fixed assets register, minutes books, charge register etc.

14.2 PROVISIONS IN THE MATTER OF BOOKS OF ACCOUNT

As per the provisions of section 209 of the Companies Act every company is required to maintain at its registered office proper books of account with regard to :

(a) all sums of money received and expended by the company and the matters in respect of which the receipts and expenditure take place;
(b) all sales and purchases of goods by the company;
(c) the assets and liabilities of the company; and
(d) in case it is a company engaged in production, processing, manufacturing or mining activities, particulars relating to utilisation of material or labour or other items of cost, provided there is such a requirement by the Central Government in respect of the class of companies which it belongs to.

The Act lays down that proper books of accounts shall not be deemed to be kept with respect to the matters referred to above.

(a) If there 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
(b) If such books are not kept on accrual basis and according to the double entry system of accounting.

The books of account should be open for inspection by any director of the company, by the Registrar of Companies or any such officer authorised by the Central Government or the SEBI during the business hours.

Every company is required to preserve books of account and other relevant records for a period of not less than eight years immediately preceding the current year.

As has been stated earlier books of account should be kept at the registered office of the company. However, the Board of Directors can decide to keep them at any other place and in such a case the Registrar of Companies should be informed about the address at which books are kept.

The following important features emerge out of the above discussion.

1. All companies are required to maintain proper books of account
2. All companies should follow the mercantile system of accounting.
3. Books should be open for inspection during the business hours by any director, registrar or other Government / SEBI authorised officer.
4. Books should be maintained on a double entry system of accounting.
5. Books of account and other records should be preserved for at least 8 years preceding the current financial year.
6. Books of account should be kept at the registered office of the company unless the Board has taken a decision to keep them at any other place and the same has been informed to the Registrar.

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14.3 STATUTORY REGISTERS TO BE MAINTAINED

Apart from the regular books of account every company has to maintain certain registers as per the requirements of The Companies Act. These registers are as under:

Register of Investments which are not held in Company's name - Section 49 (7)

If a company has made investments not in its own name but in the names of its nominees, such investment details have to be recorded in this register.

Register of Charges - Section 143

When a charge is created over the assets of the company as per the provision of section 125 of the Companies Act, this charge has to be registered with the Registrar of Companies and in addition to this the company is required to maintain a register giving details of the charge created. The particulars required to be given are :

1. a short description of the property charged;
2. the amount of the charge; and
3. the names of the persons entitled to the charge

Register of members - Section 150

Every company is required to maintain a register of shareholders giving the following details.

1. name, address and occupation of the member
2. shares held by each member with distinctive numbers. (This will not be necessary in case shares are held in demat form)
3. date on which the person has become the member
4. date on which a person ceased to be a member

In addition to the above every company should also maintain an index of members.

Register and Index of Debenture Holders - Section 152

If a company has issued debentures, it's required to maintain an index and register of debenture holders on the same lines as a register and index of members.

Foreign Register - Section 157

Any company, if authorised by its articles, can keep in any country outside India a branch register of shareholders and debenture holders resident in that country.

Minutes Book - Section 193

Every company is required to maintain a minutes book containing minutes of the proceedings at the Board meetings as well as at the general body meeting of the shareholders.

Minutes book for the Board meetings would contain the following details:

a. date, time and place of the Board meeting
b. names of the directors present
c. chairman at the meeting
d. brief particulars of discussions which took place
e. text of the resolutions passed at the meeting

Minutes book for the Meetings of the Shareholders would contain the following details:

a. date, time and place of the meeting

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b. chairman at the meeting
c. notes regarding quorum for the meeting
d. brief particulars of discussions at the meeting
e. text of resolutions passed at the meeting and whether they were ordinary resolutions or special resolutions.

Register of Contracts with related parties - Sections 297, 299 and 301

Companies are required to maintain a register giving particulars of contracts entered into by the company either with the directors or in firms and companies in which directors are interested.

Register of Directors - Section 303

Every company is required to maintain a register containing names and residential addresses of all directors including the Managing Director. The register will also contain the dates on which these persons became directors and the date of cessation of directorship, if any.

Register of Directors' Shareholding - Section 307

This register will contain details about the shares held by the directors.

Register of Loans to Companies under the same Management - Section 370

If any loans have been given to companies under the same management details of such loans are to be recorded in this register.

Register of Investments in Shares and Debentures of other Companies - Section 372

If the company has made investments in shares and debentures of other companies particulars of the same are to be given in this register.

Other Non-statutory Registers

Companies, even though not required to maintain these registers statutorily, maintain the following registers so as to achieve better controls and administration.

1 Register of sealed documents
2 Register of share warrants
3 Register of lost share certificates
4 Dividend and interest payments register
5 Directors' attendance register
6 Application and allotment book.

14.4 PROVISIONS RELATING TO FINAL ACCOUNTS

As per the provisions of Section 211 of the Companies Act every company should prepare a Balance Sheet and a Profit & Loss at the end of every financial year. The financial year could be less or more than a calendar year, but it shall not exceed fifteen months. It may be extended to eighteen months with the permission of the Registrar of Companies.

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The Balance Sheet of a company has to be set out in the format given in Part I of Schedule VI of The Companies Act and it should reflect a true and fair view of the state of affairs of the company as at the Balance Sheet date.

The Profit and Loss account of company has to comply with requirements of Part II of Schedule VI of the Companies Act and it should reflect a true and fair view of the profit or loss of the company for the financial year.

Insurance companies, Banking companies and Power generation and supply companies are exempted from presenting their final accounts in Schedule VI format as separate formats have been prescribed for them under the specific laws applicable to them.

It is also mandatory on the part of all companies to comply with accounting standards as prescribed by The Institute of Chartered Accountants of India (ICAI). At present there are 27 Accounting Standards prescribed by the ICAI. Where the profit and loss account and the balance sheet of the company do not comply with the accounting standards, such companies shall disclose in its Profit & Loss Account and Balance Sheet the following namely :

a. the deviation from the accounting standards
b. the reasons for such deviation and
c. the financial effect, if any, arising due to such deviation.

A Balance Sheet in Part I of Schedule VI format in a horizontal form would appear like this:

Format of Balance Sheet
As per Schedule VI of Companies Act

Liabilities	Amount (in Rs)	Assets	Amount (in Rs)
Share Capital (Divided into shares of Rs each)		Fixed Assets	
Reserves & Surplus		Investments	
Secured Loans		Current Assets, Loans & Advances	
Unsecured Loans		Miscellaneous Expenditure	
Current Liabilities & Provisions		Profit & Loss Account	

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Notes to Accounts and Significant Accounting Policies

Under this the company is required to disclose all the significant accounting policies followed by the company as well as any other matters, which should be brought to the notice of the shareholders and other readers of the financial statements.

14.5 REPORT OF THE BOARD OF DIRECTORS

Section 217 of The Companies Act requires that with every Balance Sheet and Profit and Loss Account of a Company there shall be attached a report by its Board of Directors giving the following information

a. information explaining the state of company's affairs. In other words the Board has to explain how the company has fared during the financial year. Has it achieved its sales or turnover targets, has it achieved the expected profits and other results or not. What are the future plans and prospects for the company
b. the amounts it proposes to carry to any reserves
c. the amount of dividend recommended by it
d. material changes and commitments affecting the financial position of the company which have occurred between the end of the financial year and the date of the report
e. the conservation of energy, technology absorption, foreign exchange earnings and outgo in the manner prescribed
f. names of all employees who are drawing remuneration of Rs 1 lakh or above per month
g. whether the applicable accounting standards have been applied or not while preparing the final accounts and whether the accounts have been prepared on a going concern concept or not
h. the Board's comments and clarifications on every qualification or adverse remark made by the auditors in their audit report.

An illustrative report of the Board of Directors covering the above points would be as under:

Report of the Board of Directors of Motor Axle Manufacturing Company Limited

Your directors are happy to present the 4th Annual Report of your company. Matters relating to the performance of the company and other matters, which are required to be reported, are as under.

a. Your company has done exceedingly well during the financial year ended 31.03.2002 with the turnover going up by 40 % and the net profit of the company seeing a growth of 55 %. The prospects for the company in the current year are very bright and the company would easily achieve a growth of more than 50 % in its sales during the year.
b. Out of the total profits in the current year the Board has proposed to carry an amount of Rs 1.40 crores to the general reserves.
c. The Board recommends a dividend of 60 % on the Equity Share Capital of the Company.
d. After the date of the Balance Sheet there was a fire in one of the godowns of the company and stocks worth Rs 6 crores have been destroyed. The company is likely to get an insurance claim of Rs 4.80 crores.
e. During the year the company has taken a number of steps to conserve energy by installing more latest machinery and because of this there was a power saving of Rs 60 lakhs. New technology developed by the company's own Research and Development department has been tested and it would be put to commercial use in

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the current year. The company earned a foreign exchange of Rs 8 crores during the year and the net outflow of foreign exchange was to the tune of Rs 2.50 crores.

f. The company had no employees during the year drawing remuneration of Rs 1 lakh or more.

g. Accounting Standards as are applicable have been complied with while preparing the final accounts of the company.

h. The auditor's have not made any adverse comments in their audit report.

Check Your Progress

1. State the names of any four statutory books.

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2. What are the particulars to be mentioned in the Minutes of Board of Directors.

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14.6 SUMMING UP

The important provisions in relation to the books of account of a company are:

1 All companies are required to maintain proper books of account.
2 All companies should follow the mercantile system of accounting.
3 Books should be open for inspection during the business hours by any director, registrar or other Government / SEBI authorised officer.
4 Books should be maintained on a double entry system of accounting.
5 Books of account and other records should be preserved for atleast 8 years preceding the current financial year.
6 Books of account should be kept at the registered office of the company unless the Board has taken a decision to keep them at any other place and the same has been informed to the Registrar.

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The statutory registers to be maintained by a company are as under:

Register of Investments which are not held in company's name - Section 49 (7)
Register of Charges - Section 143
Register of members - Section 150

Register and index of debenture holders - Section 152

Foreign Register - Section 157
Minutes Book - Section 193
Register of contracts with related parties - Sections 297, 299 and 301
Register of Directors - Section 303
Register of Directors' shareholding - Section 307

Register of loans to companies under the same management - Section 370
Register of investments in shares and debentures of other companies - Section 372

Provisions relating to final accounts

As per the provisions of Section 211 of the Companies Act every company should prepare a Balance Sheet and a Profit & Loss at the end of every financial year. The financial year could be less or more than a calendar year, but it shall not exceed fifteen months. It may be extended to eighteen months with the permission of the Registrar of Companies.

The Balance Sheet of a company has to be set out in the format given in Part I of Schedule VI of The Companies Act and it should reflect a true and fair view of the state of affairs of the company as at the Balance Sheet date.

The Profit and Loss account of company has to comply with requirements of Part II of Schedule VI of the Companies Act and it should reflect a true and fair view of the profit or loss of the company for the financial year.

Report of the Board of Directors

As per the provisions of Section 217 of the Companies Act every company is required to attach a report of the Board of Directors containing the details as required by the above section.

14.7 ANSWERS TO CHECK YOUR PROGRESS

1. The following four are the statutory books
   a) Register of charges
   b) Register of members
   c) Register of Debenture Holders
   d) Minutes Book

2. The information to be shown in the Minutes book of Board of Directors is as follows:
   a) the date, time and place of the board meeting
   b) names of directors who were present at the meeting
   c) name of the chairman of the meeting
   d) information relating to the discussion taken place in the meeting
   e) resolutions taken in the meeting

14.8 MODEL EXAMINATION QUESTIONS

A Answer the following questions in about 15 lines

1. What are the important provisions under the Companies Act in relation to the books of account of a company.
2. Discuss in brief the important provisions of The Companies Act in relation to the final accounts of a company.
3. Explain in brief the following:
   a) Register of charges
   b) Minutes book
   c) Fixed Assets register

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B. Answer the following questions in about 30 lines

4. Discuss the important statutory registers to be maintained by a company.
5. What is meant by Report of the Board of Directors and discuss the contents of it.

14.9 GLOSSARY

Directors Report : This report is to be prepared by the Board of Directors and has to be attached to every Balance Sheet and Profit & Loss Account of a company.

Statutory Registers : All those registers which a company is compulsorily required to maintain.

Minutes Books : This book contains a summary of the proceedings at the meeting of the Board of Directors as well as at the meeting of the shareholders. It also contains text of the resolutions passed at the meetings.

Register of charges : Every charge created on the assets of the company has to be registered with the Registrar of Companies and details of such charge are to be recorded in the Register of charges.

B R A O U

UNIT - 15 : AUDIT OF SHARE CAPITAL

Contents

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15.2 Verification of Share Capital
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15.0 AIMS AND OBJECTIVES

This unit aims at explaining in detail as to how share capital of a company has to be verified. It also explains various terms like alteration of capital, reduction of capital, forfeiture of shares, buy back of shares etc. After going through the unit you will be able to:

- explain how audit of share capital is done
- what is meant by alteration of capital, reduction of capital, forfeiture of capital, buy back of shares etc
- explain how shares transfer audit is to be done
- explain how preference shares are issued and redeemed.

B R A O U

15.1 INTRODUCTION

A company is a separate legal entity and has existence of its own. The funds of the shareholders, which are introduced as their capital contribution, are termed as 'share capital of the company'. There are various terms associated with share capital and you should not only understand all these terms in detail but you should be able to know how share capital audit is undertaken under various circumstances.

Two basic documents on the basis of which a company is registered are the Memorandum of Association and the Articles of Association. All the companies registered under The Companies Act of 1956 have to necessarily file these two documents with the Registrar of Companies. An auditor, before starting the audit of a company must go through both the above documents to find out what is the Authorised Capital of the company and how it is divided into Preference Shares and Equity Shares. The articles of association will also give

an idea as to the restrictions placed on the transfer of shares, what procedure is to be followed in case of forfeiture of shares etc.

15.2 VERIFICATION OF SHARE CAPITAL

You should understand the meaning and difference between the following terms before we go into explaining how share capital has to be verified.

Authorised Capital : This is the capital which is authorised by the Memorandum of Association of a company. In other words, a company can raise share capital upto the maximum extent of authorised capital. If a company wants to raise its capital beyond this it has to increase its authorised capital by passing requisite resolution, filing the necessary forms with the Registrar of Companies and paying the required fee. For instance a company's Memorandum of Association contains the following clause :

The Authorised Capital of the Company shall be Rs 5 crores divided into 1 Lakh 8 % Redeemable Preference Shares of Rs 100 each and 4 Lakh Equity Shares of Rs 100 each. Thus the authorised capital of the company in this example is Rs 1 crore of Preference Capital and Rs 4 crores of Equity Capital.

Issued Capital : Issued Capital is that part of the authorised capital which the company has decided to raise. Thus in our above example the company may decide to issue 2 lakh equity shares of Rs 100 each amounting to Rs 2 crores. Which means the company would like to have funds to the extent of Rs 2 crores of equity shares.

Subscribed Capital : Subscribed Capital is that part of the issued capital which people are willing to subscribe to. In our above example even though the company has issued 2 lakh equity shares of Rs 100 each amounting to Rs 2 crores people may send in applications subscribing to 1.50 lakh equity shares in which case the subscribed capital would be 1.50 crores.

Paid up Capital : Paid up capital is that part of the subscribed capital which is actually paid by the shareholders to the company. Thus in our above example eventhough the company had received applications from public giving a commitment for subscription of Rs 1.50 crore of capital the actual funds flow could be to the tune of Rs 1.40 crores. This Rs 1.40 crores becomes the paid up capital and the balance Rs 10 lakhs which has not been received will be termed as calls in arrears.

To summarise the above example the position of capital would be as under :

Authorised Capital :	1 lakh 8 % Preference Shares of Rs 100 each	- Rs 1 crore
	4 lakh Equity Shares of Rs 100 each	- Rs 4 crores
Issued Capital :	2 lakh Equity Shares of Rs 100 each	- Rs 2 crores
Subscribed Capital:	1.50 lakh Equity Shares of Rs 100 each	- Rs 1.50 crore
Paid up Capital :	1.50 lakh Equity Shares of Rs 100 each Amount paid up	- Rs 1.40 crore

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Having understood the above terms let us now try to understand how share capital is to be audited. We will first discuss the general programme for verification of share capital.

1 Authorised Capital can be verified from the Memorandum of Association of a company.
2 Issued capital can be verified with reference to the following:

a. Go through the Memorandum to find out any conditions attached to issue of share capital and whether they have been fulfilled or not.
b. Verify that the company has issued a prospectus inviting the public for subscribing to its shares and all legal formalities as per law have been complied with.
c. Verify that all the guidelines and regulations of the SEBI (Securities and Exchange Board of India) have been complied with before issuing shares to the public
d. Verify that no allotments were made before receipt of the minimum subscription as prescribed under law.
e. Verify that a separate account has been opened for receipt of the share application money and the same is utilised strictly as per the rules framed for the same.
f. Companies going in for public issues appoint registrars and merchant bankers to the issue and these registrars and merchant bankers are also required to certify various aspects of the public issue. The auditor should ascertain whether all such certificates have been obtained or not and copies of the same have been filed with the SEBI and other authorities or not.

15.2.1 Shares issued for cash

1 Verify the receipt of cash along with the share applications.
2 Check entries in the Application and Allotment Book
3 Verify that money is refunded to those who have not been allotted shares.
4 Verify amounts collected on allotments as well as amounts collected on calls made.
5 Verify that the allotments have been made as per resolutions passed by the Board and are in conformity with the rules laid down by the SEBI and stock exchanges
6 Verify that calls have been made as per the Board resolutions.
7 Verify that a record is maintained for calls in arrears and it is properly reflected in the Schedule to the Balance Sheet enclosed.
8 Verify that the paid up capital does not exceed the issued and authorised capital.
9 Verify that commission and brokerage have been paid as per the terms of the prospectus and are within the limits laid down by law.
10 Verify that share certificates have been delivered to shareholders within 3 months after allotment.
11 Verify that return of allotments has been filed with the registrar of companies.

15.2.2 Shares issued for Consideration other than Cash

The Companies Act permits issue of shares for consideration other than cash. In such a case the auditor is required to verify whether such allotment has been made after passing of a Board resolution or not. A copy of the contract for such allotment as required under section 75(1)(b) of The Companies Act needs to be filed within one month of the date of allotment with the Registrar of Companies.

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15.2.3 Shares issued at a Premium

When shares are issued at a premium the auditor should verify whether this is in accordance with the SEBI rules or not. He should also verify whether the premium received on shares is being shown under 'Share premium account' in the Balance Sheet. It should be remembered that when shares on which premium has been received are forfeited the amount of share premium cannot be forfeited.

15.2.4 Shares issued at a Discount

As per the provisions of Section 79 of The Companies Act a company can issue shares at a discount on the following conditions :

i. a resolution is passed by the company in a general meeting and the same is sanctioned by the Company Law Board
ii. the resolution specifies the maximum rate of discount. Discounts of more than 10 % are approved only in special circumstances
iii. issue can be made one year after the entitlement to commence business
iv. shares should be issued within 2 months after it is sanctioned by the Company Law Board.

The auditor should verify all the above aspects in case of an issue made at discount.

Issue of Sweat Equity Shares

Sweat equity shares means shares issued by the company to its employees or directors either at a discount or for consideration other than cash for providing know-how, or intellectual property rights etc. For example if a company decides to issue equity shares worth Rs 5 Lakhs to a director who has permitted the company to copy and sell the computer software developed by him this would amount to an issue of sweat equity shares. As per the provisions of section 79A of the Companies Act four conditions are to be fulfilled to make a sweat equity issue.

a. the sweat equity issue is authorised by a special resolution of the company in a general meeting
b. the resolution should specify the number of shares to be offered and to whom they are being offered
c. issue can be made one year after the entitlement to commence business
d. if the shares are listed on any stock exchange then the issue must be in accordance with the SEBI guidelines.

The auditor while verifying the issue of sweat equity shares should proceed to examine all the above aspects.

15.3 ALTERATION OF CAPITAL

A company can alter its share capital as per the provisions of section 94 of The Companies Act. If share capital has been altered the auditor should look at the following :

a. verify whether the alteration is authorised by the Articles of Association or not
b. verify the resolution passed by the shareholders in this regard

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c. verify whether the procedure as laid down in the articles as well as that contained in section 94 of the Companies Act has been complied with or not
d. verify whether necessary forms have been filed with the Registrar of Companies or not.

15.4 REDUCTION OF CAPITAL

Capital can be reduced by a company as per the provisions of Section 100 of the Companies Act.
The auditor's duties in verifying reduction of share capital would be as under:

a. verify whether the reduction is authorised by the Articles of Association or not
b. verify the resolution passed by the shareholders in this regard
c. verify whether the procedure as laid down in the articles as well as that contained in section 100 of the Companies Act has been complied with or not
d. verify whether the same has been approved by the jurisdictional High Court or not
e. verify whether necessary forms have been filed with the Registrar of Companies and a certificate has been obtained or not
f. verify that share capital after reduction is properly shown in the Balance Sheet

15.5 FORFEITURE OF SHARES AND RE-ISSUE OF FORFEITED SHARES

Forfeiture of shares should be done in accordance with the terms laid down in the articles of association and re-issue of shares should also be as per the procedure laid down in the articles. The Board should have an authority under the articles to re-issue such shares.

15.6 SHARES TRANSFER

In the last decade the number of companies going for public issues has seen a tremendous growth and with this the transactions involving share transfers have also grown rapidly. The audit of transactions involving share transfers would involve the following steps.

1 Scrutinise transfer forms and satisfy yourself that it is complete in all respects including the data of the transfer deed, signatures of transferors, transferees, consideration for transfer, stamp duty paid, signatures of witnesses etc
2 The transfer deed should have been delivered to the company, in the case of quoted shares, before the Register of members was closed for the first time subsequent to the transfer within 12 months from the date of presentation to the Registrar of Companies whichever is later and in any other case within two months from the date of presentation of the instrument to the Registrar of Companies.
3 Signatures of the transferors have been compared with the specimen signatures available with the company.
4 Verify that none of the transferees is disqualified from holding shares.
5 Verify with reference to the minutes book whether the transfers have been approved by the Board of Directors or not.
6 Verify that the Share transfer register as well as the members register has been updated incorporating all the changes.
7 Verify that proper notings have been made in the counterfoils of the share certificates
8 Verify that duplicate share certificates issued are in accordance with the procedure laid down by the company for this purpose.
9 Verify that transfer notings are made by an official who is authorised to do so.

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Students should also note that with the introduction of shares in the dematerialised form there are no share certificates or transfer deeds to be delivered to the company for transfer of shares. Each shareholder who is holding shares in dematerialised form (demat form) has an account with a depository participant (DP). This is like our SB account in a Bank. The DP will maintain an account of the shares held by each account holder and will send a statement periodically showing company wise details of shares held. When shares are to be transferred, the account holder will fill up a form called the 'delivery instruction' and will send it to the DP. The DP will effect the transfer and inform the company. Thus a lot of paper work which is done by the company is reduced. The company will receive statements periodically for the shares for which transfers have been effected. The auditors job also is made simpler in the above system as he does not have to go through the entire process mentioned above and he can rely on the statements received by the company from the DPs.

Currently most of the big listed companies have opted for the above demat form of shares. The detailed work of the auditor for verification of share transfer is thus limited to private limited companies and those public limited companies who have not issued shares to the public.

15.7 ALLOTMENT OF BONUS SHARES

Bonus shares can be allotted by companies in accordance with the guidelines issued in this regard by the SEBI. The job of the auditor is to verify whether these guidelines have been complied with or not and in addition to this he also has to verify whether the documentation for the issue of such shares has been properly followed or not.

15.8 BUY BACK OF SHARES BY COMPANY

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The Companies Act now permits companies to buy its own shares which is termed as buy-back of shares. Section 77A lays down the conditions under which such a buy-back is possible. Some of the important conditions are as under:

1. The buy-back should be authorised by the Articles of Association
2. A special resolution has to be passed by the shareholders authorising such a buy-back.
3. The buy-back cannot exceed 25 % of the total paidup capital plus the free reserves of the company.
4. The buy-back should be out of its free reserves or out of share premium account or out of proceeds of an earlier issue which was not specifically made for buying back shares.
5. If the shares are listed it should be in accordance with the other applicable SEBI rules.
6. The buy-back should be completed within 12 months of the passing of the resolution
7. The shares to be bought back should be fully paid up shares

An auditor verifying the buy-back of shares should see that all the above conditions have been fulfilled by the company and proper documents have been filed with the SEBI and Registrar of Companies.

15.9 ISSUE AND REDEMPTION OF PREFERENCE SHARES

In the beginning of this unit we discussed that the company can have preference capital as well as equity capital. For issue of preference capital generally a rate of dividend is fixed. In

the example which we discussed we said 8 % preference shares. This means that preference share capital will get dividend at 8 % p.a. and they will get priority in getting dividend first and only if any profit remains equity shareholders can be given dividend. Another feature of preference capital is that it can be redeemable. Which means after a certain period of time the capital can be paid back. This is not possible with equity share capital unless the company goes in for reduction of capital.

The auditor has to keep the following points in mind while verifying issue and redemption of preference shares.

1 Whether the issue has been made as per the provisions contained in the Memorandum of Association.
2 Whether dividend has been paid on all these shares in preference to the equity shareholders.
3 Whether redemption is as per the conditions laid down in the Memorandum and Articles of Association.
4 Whether proper entries have been made in the books of account for redemption.
5 Whether the redemption is properly reflected in the Balance Sheet or not.
6 The shares have to be redeemed out of profit available for distribution as dividend or out of proceeds of a fresh issue made for this purpose.
7 The shares redeemed are fully paid up shares.
8 If the shares are redeemed out of profits available for dividend, an equal amount has been transferred to the capital redemption reserve account.

Check Your Progress

1. What do you understand by Sweat Equality Shares

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15.10 SUMMING UP

Verification of Share Capital involves various steps beginning with verification of the provisions in the Memorandum and Articles of Association of the company. The steps in verification would differ if the shares are issued for consideration other than cash, or if they have been issued at a premium or at a discount.

If the company has altered its capital then the auditor has to verify whether it is in accordance with section 94 of the Companies Act or not.

Reduction in share capital has to be in accordance with the provisions of Section 100 of The Companies Act. Similarly forfeiture of shares, re-issue of shares and verification of transfer of shares has to be in accordance with the provisions contained in the articles of association of the company.

Allotment of Bonus Shares has to be verified keeping in view the guidelines applicable to issue of bonus shares.

Section 77A of the Companies Act permits a company to buy-back its own shares provided conditions laid down in the section are fulfilled. The auditor's duty is to see whether the company has complied with all such conditions or not.

The Companies Act also authorises companies to issue redeemable preference shares and the issue of such shares and redemption thereof should be as per the provisions of section 80 of The Companies Act as well as the regulations contained in the Articles of association of the company.

15.11 ANSWERS TO CHECK YOUR PROGRESS

1. If the shares issued by the company to its employees or directors either at a discount or for consideration other than cash for providing know-how, or intellectual property rights etc., it is called sweat equity shares.

15.12 MODEL EXAMINATION QUESTIONS

A. Answer the following questions in about 15 lines

1 What is meant by shares transfer and what are the steps involved in verification of share transfers.

2 How will an auditor verify the following :
   a) Issue of Bonus Shares
   b) Buy-back of shares

B. Answer the following questions in about 30 lines.

3. Explain in general the procedure involved in verification of share capital and the points to be seen by an auditor in the following cases.
   a) When shares are issued for consideration other than cash
   b) When shares are issued for a premium
   c) When shares are issued at a discount

4. Explain the meaning of the following and how and auditor would go about to verify the same.
   a) Reduction of Capital
   b) Forfeiture of shares and re-issue of shares
   c) Preference shares and issue and redemption of the same.

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15.12 GLOSSARY

Buy-back of shares : Buying back of its own shares by the company is termed as buy-back of shares. This is permitted as per the provisions of Section 77A of the Companies Act.

Authorised Capital : This is the capital which is authorised by the Memorandum of Association of a company. In other words, a company can raise share capital

upto the maximum extent of authorised capital.

Issued Capital	:	Issued Capital is that part of the authorised capital which the company has decided to raise.
Subscribed Capital	:	Subscribed Capital is that part of the issued capital which people are willing to subscribe to.
Paid up Capital	:	Paid up capital is that part of the subscribed capital which is actually paid by the people to the company.
Equity Capital	:	Equity Capital is that capital which has voting rights.
Preference Capital	:	Preference capital is that capital which doesnot have voting rights. It gets preference in declaration of dividend over the equity shares.

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UNIT - 16 : AUDIT OF OTHER ASPECTS

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16.0 Aims and Objectives
16.1 Introduction
16.2 Borrowing Powers
16.3 Debentures
16.4 Preliminary Expenses
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16.7 Summing up
16.8 Answers to Check Your Progress
16.9 Model Examination Questions
16.10 Glossary

16.0 AIMS AND OBJECTIVES

This unit aims at explaining the audit of some main items in company audit. Having gone through this unit, you would be able to :

- recognize the borrowing powers of a company
- understand the audit procedure of debentures
- identify the preliminary expenses
- explain the audit in relation to purchase of a business
- explain the profits or losses prior to incorporation

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16.1 INTRODUCTION

In the earlier units we have discussed the rules regarding the appointment and removal of an auditor, various books that are required to be maintained an.. audit of share capital. This unit discusses the other aspects of a company audit like the borrowing powers, debentures, preliminary expenses, purchase of a business and profits and losses prior to incorporation.

16.2 BORROWING POWERS

The power of a company to borrow is exercised by the Board of Directors of the company. The borrowing powers of a company are subject to two limitations.

a. The statutory limitation as laid down in Section 293(1)(d) of the Companies Act.
b. The limitation prescribed in the Memorandum of Association and Articles of Association of a company.

Section 293(1)(d) of The Companies Act prohibits the directors from borrowing money beyond the aggregate of the paid-up capital and free reserves (i.e. reserves created for no specific purpose) of the company, unless they have prior sanction of the share holders at a general body meeting.

Borrowing ultra vires the company

When a company borrows money exceeding the powers given to it by the Act and the Memorandum of Association and Articles, the borrowing becomes **ultra vires** the company. That is, it is beyond the powers of the company and hence the same is void.

Borrowing intra vires the company but ultra vires the directors

If the borrowing exceeds merely the powers of the directors but not of the company, it is intravires (within the powers) of the company, although it is ultra vires the powers of the directors. Such borrowing can be approved and made valid by the company. This situation arises when the company has limited authority of the directors to borrow upto a certain amount and not to the full amount to which the company is entitled.

A company borrows usually in the form of debentures, bonds and long term loans. The auditor, while auditing the borrowings of the company should find out whether its total borrowings are within the borrowing powers and ensure that there are no ultra vires borrowings.

16.3 DEBENTURES

A debenture is a document that acknowledges a debt. It is a form of borrowing by a company. A company may issue debentures if it has an implied or express power to borrow. Debentures are issued by a company in the same way as shares through prospectus. They are usually in the denomination of Rs 100 or Rs 1000. The amount is payable in either on lump sum or in fixed installments. Interest is payable every 6 months or on an annual basis.

Debenture may be issued at a discount subject to the provisions of section 76(2) of The Companies Act. Such a discount must be shown in the annual returns. The discount is written off over a number of years and the unwritten off discount should be shown on the asset side of the Balance Sheet.

Debentures may be issued at par but repayable at a premium. Such a premium is a loss and it should be spread over the number of years for which the debentures are issued. The loss is debited to 'loss on issue of debentures account' and the premium payable is credited to 'premium on redemption of debentures account'.

Debenture may also be issued at a discount but repayable at a premium. In such a case the discount and the premium payable should both be treated as a loss and spread over the number of years for which the debentures are to run.

Charge for Debentures

The company may give security for the debentures by creating a charge or mortgage on its property. When any specific and definite property is offered as security it is known as a fixed charge. On the other hand when the security is offered in some class of property which is constantly changing, the charge is called floating charge. Debentures are usually secured by a floating charge on the assets of the company.

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Debenture Trust Deed

A company may convey its property as security to the trustees for debenture holders by means of a debenture trust deed. The trustees look after the interests of the debenture holders.

Redemption of debentures

According to the terms of issue debentures may be redeemed periodically by drawings or on a fixed date or at the opinion of the company.

In the case of repayment on a fixed date the terms usually provide for the creation of a sinking fund by the company. The fund is built up annually by debiting the profit and loss account with a sum calculated to accumulate to the amount of debentures over the years for which the debentures run. Annually an amount equal to the annual provision is invested in securities outside the company. They will be realized in cash on the date of repayment of debentures for the purpose of redemption of debentures. The sinking fund is then transferred to the general reserve.

Audit of Debentures

The auditor should first examine the borrowing powers of the company. The Memorandum of Association and Articles of Association should be seen with regard to the borrowing powers and the terms of issue of debentures.

He should vouch the receipt of cost in connection with the issue of debentures. He should check the register of charges to find out whether any charge is created on the property and if so he should inspect the certificate of registration issued by the registrar of companies to ensure the charge is properly registered.

He should examine the terms of the issue of debentures. The debenture trust deed should be seen. If the terms provide for the creation of a sinking fund for repayment of debentures, the auditor should check whether the fund is created and maintained.

He should check whether the list of debenture holders agrees with the total amount of debentures shown in the Balance Sheet. He should also see whether the security against the debentures is properly disclosed in the Balance Sheet. In case of redemption of debentures he should examine the cancelled debenture bonds or registered certificates and the directors minute book authorizing the repayment of debentures.

16.4 PRELIMINARY EXPENSES

Preliminary expenses are expenses incurred in the formation of the company. These are also known as flotation, promotion or formation expenses.

Generally the following are debited to the preliminary expenses account.

a. Legal expenses for drafting the Memorandum of Association, Articles of Association and the prospectus and the contracts entered into with the vendors etc.
b. Fees of the valuers, surveyors, engineers, accountants etc

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c. Stamp duty and registration fees.
d. Cost of the books of the company.
e. Cost of printing of Memorandum and Articles of Association and the prospectus, debenture bonds, share certificates etc.
f. Cost of advertising the prospectus.

The auditor should see that only formation or incorporation expenses are debited to the preliminary expenses account and not the ordinary revenue expenses. If the company has issued a prospectus and stated therein the amount of preliminary expenses, the auditor should see that this amount is not exceeded. The amount of preliminary expense should be stated in the statutory report.

Preliminary expenses are written off over a period of years. According to section 78 premium received on issue of shares may be utilized in writing off preliminary expenses. The unwritten off amount should be shown in the Balance Sheet on the assets side under Miscellaneous Expenditure as required under Schedule VI to the Companies Act.

Banking companies are prohibited from payment of dividends until the preliminary expenses are written off completely.

16.5 PURCHASE OF BUSINESS

A company may be formed to take over a running business. In such a case the prospectus of the company should contain the following information under section 56 of the Companies Act.

a. The names, addresses, description and occupation of the vendors, the amount paid or payable in cash, shares or debentures and the amount paid or payable for goodwill.
b. If the business has been carried on for less than 3 years the length of time during which the business has been carried on.

Further a report by the accountant is also required to be included in the prospectus, if the business is to be purchased directly or indirectly out of the proceeds of the issue of shares or debentures of the company. Such accountants must be named in the prospectus as experts within the meaning of Section 58. They need not be the actual auditors of the company. The report must be made on the following matters.

a. The profits or losses of the business for each of the 5 financial years immediately preceding the issue of prospectus.
b. The assets and liabilities of the business on a day which must not be more than 120 days before the date of the issue of the prospectus.

When a running business is purchased the auditor should examine the contract with the vendors and ensure that the relevant information is given in the prospectus. If the value of the net assets taken over is less than the purchase price the difference shows the amount paid for the goodwill of the business acquired. This additional amount is debited to the goodwill account. The auditor should examine the agreement with the vendors and find out the values at which the goodwill and the other assets and liabilities have been taken over.

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If the purchase price is paid in the form of shares the information should be disclosed in the Balance Sheet.

16.6 PROFITS AND LOSSES PRIOR TO INCORPORATION

The promoters of a company might have entered into a contract with the vendors for the purchase of a business to come into effect from a date before the incorporation of the company. The business might have earned a profit since then. Such profit is not available for distribution of dividend by the company as a company cannot earn anything before it comes into existence legally. Therefore, profits before incorporation are in the nature of capital profits. They can be utilized in the following ways.

a. In the payment of interest to the vendors on purchase price only upto the date of incorporation.
b. In wiping of goodwill
c. In writing down the value of fixed assets
d. The balance should be carried to capital reserve

There are difficulties in calculating profits prior to incorporation especially because there might have been no stock taking on the date immediately preceding the date of incorporation. In such a case profits are to be apportioned between the two periods – 1 – Pre incorporation period and 2- post incorporation period. The dividing line is the date of incorporation and not the date of certificate of commencement of business. The apportionment may be made on the following basis.

1 Gross profit : on the basis of turnover of each period

2 Direct expenses such as commission: on the turnover basis

3 Indirect expenses such as salaries, rent etc : on the basis of time of each period.

4 Expenses incurred solely for the company such as preliminary expenses : These should be charged only to post incorporation period.

Any loss prior to incorporation may be treated in the following ways:

1. It may be debited to the goodwill account.
2. It may be written of out of capital profit.

The auditor should check the apportionment of the profits on the above basis. He should see that such profits are not distributed to the shareholders as dividends but utilized only in the ways permitted. Profits prior incorporation until they are utilized should be shown on the liabilities side of the Balance Sheet.

B P A O U

Check Your Progress

1. What is the difference between utra vires and intra vires?

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16.7 SUMMING UP

The power to borrow is exercised by the Board of Directors of the company. When the company borrows money beyond its limits, the borrowing is ultra vires of the company. Hence it is void.

A debenture is a document that acknowledges a debt. It is a form of borrowing by a company. A company may secure a loan by mortgaging a specific asset or all its assets.

Preliminary expenses are expenses incurred in the formation of the company. These expenses are written of over a period of years.

A company may be formed to takeover a running business. Sometimes a company might have entered into a contract with the vendors for the purchase of a business to come into effect from a date before the incorporation of the company. Profit earned before the incorporation are called profits prior to incorporation. In all the above cases the auditor finds out the facts and reports the same in his audit report.

16.8 ANSWERS TO CHECK YOUR PROGRESS

1. When a company borrows money beyond the powers given to it by the Act and the Memorandum of Association and Articles, the borrowing becomes ultra vires the company. Where as the borrowing is with in the powers of the company it is intravires.

16.9 MODEL EXAMINATION QUESTIONS

A. Answer the following questions in about 15 lines.

1. What are the limitations to the borrowing powers of a company.
2. Give the difference between fixed charge and a floating charge with examples.
3. What do you mean by preliminary expenses. Give few examples.
4. Explain borrowings ultra vires of the company and ultra vires of the directors.
5. What are preliminary expenses. What is the auditor's duty with regard to them.
6. Can profits prior to incorporation be distributed as dividends.

B. Answer the following questions in about 30 lines.

1. What steps should be taken by an auditor in auditing the debentures of a company.
2. Explain the auditors duty in regard to purchase of a business by a company.
3. How are preliminary expenses dealt with in the accounts of a company. What is the auditors duty in this regard.

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16.10 GLOSSARY

Capital Profits	:	Profits of a capital nature.
Debenture	:	A document issued acknowledging a debt.
Debenture Trust Deed	:	An instrument by means of which a company conveys its property as security to the trustees for debenture holders.
Fixed Charge	:	Mortgage of a particular or definite property as security for a debt.
Floating Charge	:	Mortgage of some class of property which is constantly changing as security for a debt.
Preliminary Expenses	:	Expenses incurred for the formation of a company.
Profits Prior to Incorporation	:	Profits earned before the incorporation of a company as a result of taking over a running business effective from a date before incorporation.

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UNIT - 17 : LOANS AND REMUNERATION TO DIRECTORS AND MANAGERIAL PERSONNEL

Contents

17.0 Aims and Objectives
17.1 Introduction
17.2 Loans to Directors
17.3 Contracts entered into with Directors and related Parties
17.4 Managerial Personnel and their Remuneration
17.5 Summing up
17.6 Answers to Check Your Progress
17.6 Model Examination Questions
17.7 Glossary

17.0 AIMS AND OBJECTIVES

This unit is aimed at explaining you the meaning of managerial personnel and the limits fixed by The Companies Act on their remuneration. We shall also be discussing the legal provisions on loans to directors. After going through the unit you will be able to :

- explain the provisions applicable for loans to directors
- meaning of Managerial Personnel and the limits on their remuneration

17.1 INTRODUCTION

As a student of auditing you should know quite a few of the provisions under the companies Act which concern the auditor and the function of auditing. This is so because unless you know the basic legal provisions applicable to the work of auditing you will not be able to grasp the subject properly. In the other units we have discussed some of the provisions like appointment of auditors, limits on audits, requirements of audit report etc. In this Unit we will discuss a very important topic relating to directors, managers and other managerial personnel.

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17.2 LOANS TO DIRECTORS

Section 295 of the Companies Act puts restrictions on loans given to directors of a company. The section provides that no company shall, without obtaining prior permission of the Central Government, give any loans directly or indirectly to :

a. any director or any partner or relative of such director
b. any firm in which any such director or relative is a partner
c. any private company of which any such director is a director or member
d. any body corporate of which at least 25 % of voting power is held by such director

The above provisions are not applicable to a private company, a banking company or for any loans made by a holding company to its subsidiary company.

16.10 GLOSSARY

Capital Profits : Profits of a capital nature.

Debenture : A document issued acknowledging a debt.

Debenture Trust Deed : An instrument by means of which a company conveys its property as security to the trustees for debenture holders.

Fixed Charge : Mortgage of a particular or definite property as security for a debt.

Floating Charge : Mortgage of some class of property which is constantly changing as security for a debt.

Preliminary Expenses : Expenses incurred for the formation of a company.

Profits Prior to Incorporation : Profits earned before the incorporation of a company as a result of taking over a running business effective from a date before incorporation.

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c. any private company of which any such director is a director or member
d. any body corporate of which at least 25 % of voting power is held by such director

The above provisions are not applicable to a private company, a banking company or for any loans made by a holding company to its subsidiary company.

The auditor's duty in regard to the above provisions is that wherever loans have been given to directors or any of the parties mentioned above he should see that prior permission from the Central Government has been obtained and the terms and conditions of such permission are being complied with.

One more duty with regard to such loans is that the MAOCARO order has a specific clause on such loans and advances and the auditor is required to give his specific comments on such loans. The clause in the order reads as under:

" Whether the rate of interest and other terms and conditions on which loans have been granted to companies, firms or other parties listed in the registers maintained under section 301 and to the companies under the same management are not, prima facie, prejudicial to the interest of the company."

17.3 CONTRACTS ENTERED INTO WITH DIRECTORS OR RELATED PARTIES

The Companies Act also casts a duty on the auditor to verify all the contracts of a value of Rs 50,000 or more entered into by the company with the directors or any of the related parties and find out whether such contracts have been entered into at the prevailing market rates or not. The MAOCARO Order has a specific point on this subject which reads as under:

"Whether the transactions of purchases of goods and materials and sale of goods, materials and services, made in pursuance of contracts or arrangements entered in the registers maintained under section 301 and aggregating during the year to Rs 50,000 or more in respect of each party have been made at prices which are reasonable having regard to prevailing market prices for such goods, materials or services or the prices at which transactions for similar goods, materials or services have been made with other parties."

The auditor has to verify all such above transactions and has to make a specific comment on the same.

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17.4 MANAGERIAL PERSONNEL AND THEIR REMUNERATION

The term managerial personnel includes all directors of the company, Managing Director as well as Manager of the company. All the staff members who are designated as Managers are not included in the definition of a Manager. Thus if a person is working as purchase manager or a sales manager he would not fall within the definition of a manager as defined for the purpose of managerial remuneration. Manager is defined as a person who is responsible either for the whole management of the company or substantially the whole management of the company. This definition is very important as the company law puts restrictions on the total amount of remuneration, which can be given to a manager.

The provisions of the Companies Act regarding managerial remuneration are discussed as under:

Overall Managerial Remuneration
The total managerial remuneration payable by a company to its Managing Director, Whole-time director, other Directors and Manager all put together should not exceed 11% of the net profit of the company. The above amount does not include any sitting fee payable to directors for attending the directors' meetings.

If a company has no profits or profits are not sufficient to cover the remuneration fixed for any director, such remuneration can be given only with the approval of the Central Government. However section 269 read with Schedule XIII to the Companies Act provides for certain situations where Central Government permission is not required provided all the conditions set out in the above section and schedule are satisfied.

Remuneration payable to Managing Director etc
Provisions of section 309 of The Companies Act provide that a whole-time director or a managing director may be paid remuneration either on a monthly basis or as a percentage of net profits. However such remuneration shall not exceed 5 % of the net profits for one such director, and if there is more than one such director, 10 % of the net profit for all of them put together.

If a director is neither in whole-time employment or a managing director then he can be paid remuneration (or where there are more than one such director, then to all of them put together) subject to a maximum of:

1 % of net profit where there is a whole-time director or a managing director and in any other case

3 % of the net profit of the company

The company can enhance the above limits in a general meeting with the approval of the Central Government.

Remuneration payable to Manager
As per the provisions of section 387 of The Companies Act a Manager can be paid remuneration either on a monthly basis or as a percentage of the net profits and such remuneration cannot exceed 5 % of the net profits of the company. This amount can be increased only with the permission of the Central Government.

It is also pertinent to note that the above provisions do not apply to a private company unless it is a subsidiary of a public company.

The auditor while doing the audit has to keep in mind the above provisions and see that the remuneration debited does not exceed the limits as given above and also see that wherever required Central Government permission has been obtained by the company.

Check Your Progress
1. What are the restrictions on the remuneration payable to Managerial Personnel?
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The auditor's duty in regard to the above provisions is that wherever loans have been given to directors or any of the parties mentioned above he should see that prior permission from the Central Government has been obtained and the terms and conditions of such permission are being complied with.

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The Companies Act also casts a duty on the auditor to verify all the contracts of a value of Rs 50,000 or more entered into by the company with the directors or any of the related parties and find out whether such contracts have been entered into at the prevailing market rates or not. The MAOCARO Order has a specific point on this subject which reads as under:

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The term managerial personnel includes all directors of the company, Managing Director as well as Manager of the company. All the staff members who are designated as Managers are not included in the definition of a Manager. Thus if a person is working as purchase manager or a sales manager he would not fall within the definition of a manager as defined for the purpose of managerial remuneration. Manager is defined as a person who is responsible either for the whole management of the company or substantially the whole management of the company. This definition is very important as the company law puts restrictions on the total amount of remuneration, which can be given to a manager.

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If a company has no profits or profits are not sufficient to cover the remuneration fixed for any director, such remuneration can be given only with the approval of the Central Government. However section 269 read with Schedule XIII to the Companies Act provides for certain situations where Central Government permission is not required provided all the conditions set out in the above section and schedule are satisfied.

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If a director is neither in whole-time employment or a managing director then he can be paid remuneration (or where there are more than one such director, then to all of them put together) subject to a maximum of:

1 % of net profit where there is a whole-time director or a managing director and in any other case

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The company can enhance the above limits in a general meeting with the approval of the Central Government.

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As per the provisions of section 387 of The Companies Act a Manager can be paid remuneration either on a monthly basis or as a percentage of the net profits and such remuneration cannot exceed 5 % of the net profits of the company. This amount can be increased only with the permission of the Central Government.

It is also pertinent to note that the above provisions do not apply to a private company unless it is a subsidiary of a public company.

The auditor while doing the audit has to keep in mind the above provisions and see that the remuneration debited does not exceed the limits as given above and also see that wherever required Central Government permission has been obtained by the company.

Check Your Progress
1. What are the restrictions on the remuneration payable to Managerial Personnel?
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17.5 SUMMING UP

The Companies Act has placed restrictions on making loans to directors and parties related to the directors. Permission of the Central Government has to be obtained for giving such loans.

The Companies Act has also placed restrictions on the remuneration payable to the managerial personnel. The overall remuneration payable to managerial personnel should not exceed 11 % of the profit. The Managing Director and the whole-time directors can be given remuneration subject to a ceiling of 5 %. Other directors can be given remuneration subject to overall limit of 1 % where Managing Director or whole-time is there and in other cases the remuneration has to be restricted to 3 % of the net profit.

The auditors duty in this regard is to see that the company has obtained proper permissions from the Central Government and the remuneration paid to the managerial personnel does not exceed the limits set out under the Companies Act. For this purpose he will have to verify the minutes book of the company to see whether proper resolutions have been passed or not, verify copies of the approval letters from the Central Government and copies of any agreements entered into with the managerial personnel.

17.6 ANSWERS TO CHECK YOUR PROGRESS

1. The overall remuneration payable to managerial personnel should not exceed 11 % of the profit. The Managing Director and the whole-time directors can be given remuneration subject to a ceiling of 5 %. Other directors can be given remuneration subject to overall limit of 1 % where Managing Director or whole-time is there and in other cases the remuneration has to be restricted to 3 % of the net profit.

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17.7 MODEL EXAMINATION QUESTIONS

A. Answer the following question in about 15 lines.

1. What are the provisions under the Companies Act relating to loans to directors and what is the duty of the auditor in this regard.

B. Answer the following questions in about 30 lines.

2. Explain the provisions contained in the Companies Act relating to managerial remuneration and also briefly describe the duty of the auditor in this regard.

17.8 GLOSSARY

Manager : An individual who, subject to the superintendence, control and direction of the Board of directors, has the management of the whole, or substantially the whole, of the affairs of a company.

UNIT-18 : DIVISIBLE PROFITS

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18.3 Profits Vs. Divisible Profits
18.4 Provisions of the Companies Act
18.5 Factors affecting the Divisible Profits
18.6 Capital Profits
18.7 Distribution of Profits without providing for Depreciation on Wasting Assets
18.8 Distribution of Profits without making good the Loss of Fixed Assets
18.9 Profits prior to Incorporation
18.10 Auditor's Duty regarding Divisible Profits
18.11 Summing Up
18.12 Answers to Check Your Progress
18.13 Model Examination Questions
18.14 Glossary

18.0 AIMS AND OBJECTIVES

The aim of this unit is to explain 'Divisible' Profits, i.e., Profits available for dividends to the share-holders, and factors affecting the divisible profits.

Having gone through this unit, you will be able to:

- explain the meaning of terms – profit, divisible profit and capital profit;
- identify the factors affecting the divisible profits;
- understand the distribution of capital profits as dividends;
- explain the distribution of profits without providing for depreciation on wasting assets;
- recognise the distribution of profits without making good the loss of fixed assets;
- identify the duties of an Auditor.

18.1 INTRODUCTION

The purpose of running of any business is to earn profits. This is true of every kind of business be it one owned and run by an individual proprietor, partnership firm or a company. The profits earned during any given period have to be ascertained. The decisions about the future of the business (i.e. whether to expand or modify the business) largely depend upon the trend of the profits. Therefore, the profits are to be correctly ascertained. In the case of a business owned by a sole proprietor or even in the case of partnership firms the ascertainment of profits is not so important. But in the case of companies, proper ascertainment of profits is of great importance. There are various parties who may be involved in a deal with the company and who are interested in the determination of the profits of a company. The prospective shareholders, the creditors, the debenture holders, the management, the employees and tax authorities, and such others are all interested in the

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17.5 SUMMING UP

The Companies Act has placed restrictions on making loans to directors and parties related to the directors. Permission of the Central Government has to be obtained for giving such loans.

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The auditors duty in this regard is to see that the company has obtained proper permissions from the Central Government and the remuneration paid to the managerial personnel does not exceed the limits set out under the Companies Act. For this purpose he will have to verify the minutes book of the company to see whether proper resolutions have been passed or not, verify copies of the approval letters from the Central Government and copies of any agreements entered into with the managerial personnel.

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- explain the distribution of profits without providing for depreciation on wasting assets;
- recognise the distribution of profits without making good the loss of fixed assets;
- identify the duties of an Auditor.

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18.1 INTRODUCTION

The purpose of running of any business is to earn profits. This is true of every kind of business be it one owned and run by an individual proprietor, partnership firm or a company. The profits earned during any given period have to be ascertained. The decisions about the future of the business (i.e. whether to expand or modify the business) largely depend upon the trend of the profits. Therefore, the profits are to be correctly ascertained. In the case of a business owned by a sole proprietor or even in the case of partnership firms the ascertainment of profits is not so important. But in the case of companies, proper ascertainment of profits is of great importance. There are various parties who may be involved in a deal with the company and who are interested in the determination of the profits of a company. The prospective shareholders, the creditors, the debenture holders, the management, the employees and tax authorities, and such others are all interested in the

manner in which the profits are computed in companies. Therefore, it is necessary that profits should be correctly ascertained in the case of a company.

18.2 MEANING OF THE TERM "DIVISIBLE PROFITS"

Divisible profits are those profits which are available for distribution as dividends to the share-holders. The profits which are disclosed by the profit and loss account are not divisible profits but those profits which can legally be distributed among the share-holders are divisible profits. The amount of profit that can be distributed as dividend has to be determined in accordance with the provisions of the Companies Act, 1956 and the provisions of the Income Tax Act, 1961 and also keeping in view the circumstances of each and every case. The determination of profits available for distribution as dividends to the shareholders is important from the auditor's point of view for the following reasons:

(i) the shareholders appoint the auditor with specific purpose of reporting to them whether the accounts represent a true and fair view of the company state of affairs and whether the profits disclosed have been earned.

(ii) the auditor should ensure that the dividends are paid only out of such profits which are divisible and if any payment of dividend is made from what is beyond the divisible profits it would be construed as dividend paid out of capital for which the auditor may also be held liable.

18.3 PROFITS Vs. DIVISIBLE PROFITS

The terms 'Profit' and 'Divisible Profit', are not defined by the Companies Act 1956. Economists and Accountants differ as to the term, 'profit' means. Even the Accountants differ among themselves as to its correct meaning. While economists consider the increase in the value of total net assets of a business over a period of time after making due allowance for introduction and withdrawal of capital as profit, the accountants take the margin between operating income and the related outgoings over a given period of time as profit. In **Spanish Prospective Co. Ltd.**, case, the question of ascertainment of profit was considered in detail. The learned judge has given the ruling that if the total assets of the business at two points of time are compared, the increase which they show at the later date over and above those relating to the earlier date (due allowance of course, being made for any capital introduction into or taken out of the business in the meanwhile). Strictly represents the profits of the business during the period is in question. In other words, profits for a given period may be said to the excess of current incomes over current expenditures, after taking into account any loss suffered by fixed or current assets during that period in the process of earning such incomes. The term, "Divisible profits" mean & those profits which can legally be distributed among the shareholders by way of dividend. All the profits made by a Company during a particular period are not distributed to the share – holders. A part of the profits is set aside for reserves as decided by the directors and only the remaining profits are divisible among the shareholders. As stated in Fisher Vs. Black and White publishing Co., case, profits available for dividend means net profits after making any deductions which the directors can duly make. Therefore, divisible profits are those profits which can be distributed among the shareholders as dividend. Sec 205 of the Indian companies Act which deals with the question of dividends provides that no dividend shall be declared or paid except out of profits of the company arrived at after providing for depreciation or out of

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money provided by the Central or State Government for the payment of dividends in pursuance of the guarantee given by such Government.

The profits of a company may consist of profits arising from trading as well as from other sources like capital profits. These capital profits also may be distributed in the form of dividends on certain circumstances. In the absence of a clear definition of divisible profits, one has to depend upon legal decisions pronounced by various courts from time to time. The courts have given their verdicts on the merits of each case taking the circumstances into account and as such the rulings appear to be contradictory in some cases.

The following principles, however, should be kept in view in connection with the divisible profits:

(i) capital should not form part of divisible profits,
(ii) only bonafide surplus should be divisible among the shareholders; and
(iii) the provisions of the Memorandum and Articles of Association of the company and the provisions of the Companies Act must be complied with.

Check Your Progress - 1

(a) What do you mean by 'divisible profits'?

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(b) What principles should be followed in connection with divisible profits?

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18.4 THE PROVISIONS OF THE COMPANIES ACT, 1956

The divisible profits are briefly stated hereunder:

(a) A company must charge depreciation under Sec 205 before paying dividends.

(b) Dividends can be paid out of the following sources:

  (i) from current profits after providing for depreciation;
  (ii) from past profits or reserves only in accordance with the rules framed by the Central Government in this behalf under Sec.205-A(3) of the Act; and;
  (iii) out of moneys provided by the Central Government or the State government for payment of such dividends in pursuance of the guarantee given by that Government;

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manner in which the profits are computed in companies. Therefore, it is necessary that profits should be correctly ascertained in the case of a company.

18.2 MEANING OF THE TERM "DIVISIBLE PROFITS"

Divisible profits are those profits which are available for distribution as dividends to the share-holders. The profits which are disclosed by the profit and loss account are not divisible profits but those profits which can legally be distributed among the share-holders are divisible profits. The amount of profit that can be distributed as dividend has to be determined in accordance with the provisions of the Companies Act, 1956 and the provisions of the Income Tax Act, 1961 and also keeping in view the circumstances of each and every case. The determination of profits available for distribution as dividends to the shareholders is important from the auditor's point of view for the following reasons:

(i) the shareholders appoint the auditor with specific purpose of reporting to them whether the accounts represent a true and fair view of the company state of affairs and whether the profits disclosed have been earned.

(ii) the auditor should ensure that the dividends are paid only out of such profits which are divisible and if any payment of dividend is made from what is beyond the divisible profits it would be construed as dividend paid out of capital for which the auditor may also be held liable.

18.3 PROFITS Vs. DIVISIBLE PROFITS

The terms 'Profit' and 'Divisible Profit', are not defined by the Companies Act 1956. Economists and Accountants differ as to the term, 'profit' means. Even the Accountants differ among themselves as to its correct meaning. While economists consider the increase in the value of total net assets of a business over a period of time after making due allowance for introduction and withdrawal of capital as profit, the accountants take the margin between operating income and the related outgoings over a given period of time as profit. In **Spanish Prospective Co. Ltd.**, case, the question of ascertainment of profit was considered in detail. The learned judge has given the ruling that if the total assets of the business at two points of time are compared, the increase which they show at the later date over and above those relating to the earlier date (due allowance of course, being made for any capital introduction into or taken out of the business in the meanwhile). Strictly represents the profits of the business during the period is in question. In other words, profits for a given period may be said to the excess of current incomes over current expenditures, after taking into account any loss suffered by fixed or current assets during that period in the process of earning such incomes. The term, "Divisible profits" mean & those profits which can legally be distributed among the shareholders by way of dividend. All the profits made by a Company during a particular period are not distributed to the share – holders. A part of the profits is set aside for reserves as decided by the directors and only the remaining profits are divisible among the shareholders. As stated in Fisher Vs. Black and White publishing Co., case, profits available for dividend means net profits after making any deductions which the directors can duly make. Therefore, divisible profits are those profits which can be distributed among the shareholders as dividend. Sec 205 of the Indian companies Act which deals with the question of dividends provides that no dividend shall be declared or paid except out of profits of the company arrived at after providing for depreciation or out of

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money provided by the Central or State Government for the payment of dividends in pursuance of the guarantee given by such Government.

The profits of a company may consist of profits arising from trading as well as from other sources like capital profits. These capital profits also may be distributed in the form of dividends on certain circumstances. In the absence of a clear definition of divisible profits, one has to depend upon legal decisions pronounced by various courts from time to time. The courts have given their verdicts on the merits of each case taking the circumstances into account and as such the rulings appear to be contradictory in some cases.

The following principles, however, should be kept in view in connection with the divisible profits:

(i) capital should not form part of divisible profits,
(ii) only bonafide surplus should be divisible among the shareholders; and
(iii) the provisions of the Memorandum and Articles of Association of the company and the provisions of the Companies Act must be complied with.

Check Your Progress - 1

(a) What do you mean by 'divisible profits'?

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(b) What principles should be followed in connection with divisible profits?

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18.4 THE PROVISIONS OF THE COMPANIES ACT, 1956

The divisible profits are briefly stated hereunder:

(a) A company must charge depreciation under Sec 205 before paying dividends.

(b) Dividends can be paid out of the following sources:

   (i) from current profits after providing for depreciation;
   (ii) from past profits or reserves only in accordance with the rules framed by the Central Government in this behalf under Sec.205-A(3) of the Act; and;
   (iii) out of moneys provided by the Central Government or the State government for payment of such dividends in pursuance of the guarantee given by that Government;

(c) From February 1, 1975, when the companies (Amendment) Act (1974) has come into force, a Company is required to transfer a certain percentage of its profits (not exceeding 10%) to its reserves before declaring dividends.

18.5 FACTORS AFFECTING DIVISIBLE PROFITS

The following factors are to be considered before recommending the payment of dividend to the shareholders.

i) **Transfer to Reserves :** The provisions of the Articles of Association relating to creation of reserves should be complied with. It may require the transfer of a part of the profit to Dividend Equalization Reserve or General Reserve. Where certain laws require the creation or the setting aside of a part of profits to certain reserves, the directors should do so before distributing profits. In the case of Banking companies, statutory reserve is created by transferring 20% of the profits. Similarly, in the case of Electricity companies, contingency or tariff reserves are created. Some-times, the company may be under contractual obligation to transfer a part of its profit to Debenture Redemption Fund or Capital Redemption reserve in case the company has issued Redeemable preference shares.

ii) **Liquidity:** The dividend declared must be paid within 42 days of it to the shareholders, thus reducing the liquid funds of the company. The company must have sufficient cash resources in order to have an adequate working capital even after paying dividends. If the dividend is large, the effect of its payment is all the more on the working capital of the company. If the company has to borrow funds for payment of Dividend, the profitability of the company also will be reduced on account of payment of interest on borrowings therefore the liquidity of the finances of the company must be considered by the Board before they recommend the payment of dividend.

iii) **Past Policy:** The directors should follow a consistent policy while recommending the payment of dividends. A good management would not allow fluctuations in the rate of dividend, as the value of shares in the market will be affected by it.

iv) **Preference Shares:** If there are preference shares, dividends at fixed rate must be paid on them first before recommending dividends to equity shareholders. If there are any arrears of dividends on cumulative preference Shares, the company will have to clear the arrears of such dividend first. The balance left only will be considered for payment to equity shareholders.

v) **Other Factors :** The management should always remember that dividends should not be distributed at the cost of creditors, lenders, debenture-holders, third parties etc. The capital of the company should always be kept in tact. The distribution of dividends should not be ultravires the Articles of Association and also the Companies Act, 1956.

For ascertaining the profits available for dividends certain complications usually arise which may be discussed under the following heads:

(i) whether capital profits are available for dividends,

(ii) whether all the surplus made by a company engaged in working a wasting asset is available for dividends,

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(iii) whether profits can be distributed without making good the loss of fixed assets, and

(iv) whether profits made prior to incorporation are available for dividends.

We shall deal with each one of the above aspects.

Check Your Progress - 2

List any factors that affect divisible profits.

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18.6 CAPITAL PROFITS

Capital profits are those profits, which are earned, not in the usual or normal course of business. These profits are of unusual and exceptional nature. Profits earned on the sale of fixed assets, premium received on issues of shares and debentures, profits made on the re-issue of forfeited shares, profits made on the redemption of debentures in the open market, etc., are some of the examples of capital profits. Therefore, it is evident that unusual trading profits are capital profits. The question is whether such capital profits can be distributed among the shareholders by way of dividends. Ordinarily, such profits should not be made available to shareholders as they are not trading profits. When a fixed asset is sold at a profit and if such profits credited to the profit and loss account, the profits of that year will be more than those of the other years when fixed assets might not have been sold. If such profits are also distributed, the shareholders are likely to get smaller dividends in these years when only trading profits are distributed, thus leading to a fall in the market value of shares resulting in discontentment among the shareholders.

The courts have allowed the distribution of capital profits in certain circumstances. In **Foster Vs. The new Trinidad Asphate Company Ltd., (1901)** case, it was held that capital profits could not be distributed unless (i) all the other assets had been revalued, (ii) depreciation in the value of other assets was set off against the appreciated value of the asset, (iii) such profits had been actually realised and (iv) that the Articles of Association of the co., permitted such a step. A similar judgment was given in **Lubbock Vs. British Bank of South America (1892)** case, i.e., if the companies Articles of Association so provide a profit made on the sale of a part the undertaking is available for payment of dividend.

In **Wall Vs. The Landon and Provincial Trust Ltd., (1929)** case, it was held that the profit made by a company in redeeming debentures was a profit on capital account and an injunction was granted to restrain the company from transferring this profit to the revenue account and distributing it as dividend. In Stapley Vs. Read Brothers ltd. (1924) case, it was held that if a company had written down, excessively its assets out of profits made in the past, it might write up such assets again to the extent of such excess and use it for payment of dividends.

Thus, from the judgments cited above it is clear that the capital profits can be distributed if the following conditions are fulfilled:

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1. Articles of Association of a company must permit such distribution;
2. Such capital profits have been actually realised in cash;
3. Such capital profits, still exist after proper valuation of all the assets and liabilities of the business; and
4. The working capital should be sufficient to carry on the business.

Check Your Progress - 3

What do you mean by capital profits?

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18.7 DISTRIBUTION OF PROFITS WITHOUT PROVIDING FOR DEPRECIATION ON WASTING ASSETS

Wasting assets are properties of a fixed nature which are exhausted by depletion e.g., a mine, a quarry and an oil well, etc. The question is whether all the surplus made by a company engaged in the working of such assets is available for the payment of dividend. Different views have been expressed on this question. Accountants are of the opinion that this surplus is the capital and that the division of such a surplus, therefore, will amount to payment of dividend out of capital.

In **Lee Vs. The Newchatel Asphate Co., Ltd (1889)** case, it was held that if a company formed to work a mine, it might distribute the profits to the shareholders without making any provision for depreciation on the wasting assets where the Articles of the company did not compel it to do so. The judgment given in this case does not hold good in our country in view of Sec. 205 of the Companies Act, according to which depreciation must be provided on assets before dividend is declared and distributed among shareholders. Moreover, from the view pint of sound financial and commercial policy, provision for depreciation of assets, whether of fixed or working nature, must be made before declaring any dividend.

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18.8 DISTRINBUTION OF PROFITS WITHOUT MAKING GOOD THE LOSS OF THE FIXED ASSETS

Can a company declare dividend even though there may be a loss of fixed assets which is not taken into consideration while arriving at the profit of the year? In **Bolton Vs. Natal Land and Colonisation Co., Ltd. (1892).,** it was held that a company might pay a dividend out of the current profits without making good the previous loss of capital assets. In other words, the capital of the company need not be kept in tact. In **Verner Vs. Genearg and Commercial Investments Trust Ltd., (1894).,** case also, it was decided that a company could pay dividend out of the current profits without making good the loss of capital. In **Wilmer Vs. Mc. Namara & Co. Ltd., (1895)** case also the decision was that a company could not be restrained from declaring a dividend out of current profits all because no provision had been made for depreciation on fixed assets. In **Ammonia Soda Company Ltd., Vs Arthur Chamberlain and others (1918),** it was held that the directors of the company might distribute current profits without first making good the past losses.

But the judgements given in all the above mentioned cases do not hold good in India as Sec. 205 of the Companies Act, compels the companies to provide depreciation on fixed assets before a dividend is declared, and Sec. 205 (i) (b) of the Companies Act lays down that if a company has suffered any loss in the previous year or years, such a loss must be set off against profits of subsequent years.

18.9 PROFITS PRIOR TO INCORPORATION

Profits prior to incorporation of the Company cannot be distributed among the shareholders, as the company had not come in existence when such profits were made and consequently the shareholders have no claim to such profits. Sometimes the Articles of the company may provide for distribution of such profits. Even then the distribution of such profits would be illegal. The question is what should be done with such profits if they are not made available to shareholders. One method is to adjust the profit prior to incorporation against the value of net assets. The correct procedure would be to or adjust such a profit to the goodwill account or capital reserve.

There can be loss prior to incorporation also, such a loss may be dealt with in any of the following ways:

(i) it may be debited to the goodwill account and such a goodwill account should be written off as early as possible.

(ii) it may be debited to "Loss prior to Incorporation Account" which may be written off as early as possible.

(iii) it may also be debited to a suspense account which may be written of out of capital profits made in the subsequent years.

Points to be remembered in respect of Divisible profits.

(1) Dividends should be paid only out of trading profits.

(2) Shareholder's capital should not be used for payment of dividend.

(3) A company need not divide the entire profit among the shareholders.

(4) Depreciation on fixed assets should always be provided before the dividends are paid.

(5) The security of creditors should always be kept in view before declaring dividends.

(6) No dividend can be paid without providing depreciation on floating assets.

(7) Dividend cannot be paid if the Profit and Loss account of the company shows a debit balance.

(8) Dividend should be declared and paid only after transferring a certain percentage to reserve according to Companies (Transfer of Profits to Reserves) Rules, 1975.

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(9) Profit earned by a company prior to its incorporation are not available for distribution among the shareholders of the company.

(10) Capital profits can be distributed provided that certain conditions as mentioned earlier are satisfied.

Check Your Progress - 4

What is the accounting treatment of 'Loss Prior to Incorporation'?

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18.10 AUDITOR'S DUTY REGARDING DIVISIBLE PROFITS

The duty of an auditor in connection with divisible profits is very simple and not complicated. As far as the prudence of the conduct of business and the extent to which profits may be divisible concerned he has nothing to do. It is left to the discretion of the directors and auditor cannot question their authority. His duty is to see that the provisions of Articles and Memorandum as well as the provisions contained in the Companies Act have been duly complied with regarding the calculation of profits. He should ensure that the dividends are paid out of bonafide surpluses. He should also make sure that the distribution pf profits will not affect the interests of the shareholders as well as the creditors of the company.

In case he is not satisfied with the method of calculation of profits if he finds that the distribution of profits will adversely affect the interests of creditors and the shareholders of the company, he should point it out in his report.

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18.11 SUMMING UP

The very purpose of running of any business is to earn profit. Therefore, the profits earned during the year are to be correctly ascertained and distributed to shareholders as dividends. The profits which are disclosed by the profit and loss account are not divisible profits but those profits which can legally be distributed among the shareholders are divisible profits.

The profits of a company may consist of profits arising from trading as well as from other sources like capital profits. Capital profits are those profits which are earned not in the usual course of business but of unusual in nature. Ex.:- profit on sale of asset. Usually the capital profits are not available to distribute as dividends to shareholders, but capital profits can also be distributed as dividends under certain conditions as per the Companies Act, ex.:- to pay dividends out of capital, the working capital should be sufficient to carry on the business.

18.12 ANSWERS TO CHECK YOUR PROGRESS

I. (a) Divisible profits are those profits which can be legally distributed to the shareholders of a company in the form of dividend.

(b) The following principles to be followed in connection with the divisible profits:
   i) capital should not form part of divisible profits,
   ii) only bonafide surplus should be divisible among the shareholders; and
   iii) provisions of the Companies Act must be complied with.

2. The factors that affect divisible profits are :
   i) transfer to reserves
   ii) liquidity
   iii) past policy
   iv) preference shares
   v) other factors, such as dividends should not be paid out of capital, etc.

3. Capital profits are those profits, which are earned, not in the usual or normal course of business. These profits are unusual and exceptional in nature. Example: profit on sale of asset, profit prior to incorporation, etc.

4. The "Loss Prior to Incorporation" is a capital loss and may be debited to: a goodwill account, loss prior to incorporation account, or a suspense account and which may be written off as early as possible.

18.13 MODEL EXAMINATION QUESTIONS

A. Answer the following questions in about 15 lines.

1. What to you understand by 'divisible profits'? What are the principles to be kept in view in connection with the divisible profits?
2. Distinguish between profits and divisible profits.
3. What are the provisions of the Companies Act, 1956 regarding divisible profits?
4. State whether profits can be distributed without providing for depreciation on wasting assets.
5. State whether profits can be distributed without making good the loss of fixed assets.
6. State whether profits prior to incorporation can be distributed among the shareholders.

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B. Answer the following questions in about 30 lines.

7. What are the different factors, which affect the divisible profits?
8. Are capital profits available for dividends?
9. What are the points to be remembered in respect of divisible profits?
10. Discuss the duty of an auditor regarding divisible profits.

18.14 GLOSSARY

1. **Capital Profit** : Profit which is earned not in an usual course of business.

2. **Divisible Profits** : Profits which can legally be distributed among the Share-holders.

3. **Loss prior to incorporation** : Loss incurred by the company before it is incorporated.

4. **Profit prior to incorporation** : Profit made by the company before it is incorporated

5. **Wasting Asset** : Asset which is exhausted by depletion.

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UNIT-19 : DIVIDENDS

Contents

19.0 Aims and Objectives
19.1 Introduction
19.2 Meaning of the term, 'Dividend'
19.3 Sources of Dividends
19.4 Dividends and Capital
19.5 Payment of Interest to Shareholders
19.6 Powers of Directors and Shareholders Regarding Declaration of Dividends
19.7 Payment of Dividend
19.8 Dividends on Preference Shares
19.9 Scrip Dividend
19.10 Kinds of Dividends
19.11 Auditor's Duty
19.12 Summing Up
19.13 Answers to Check Your Progress
19.14 Model Examination Questions
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19.16 Glossary

19.0 AIMS AND OBJECTIVES

The aims of this unit are to discuss the meaning of dividend, sources of dividends, powers of directors and shareholders regarding declaration of dividends, kinds of dividends and the duty of an auditor relating to dividends.

After going thorough this unit, you would be able to:

- identify the sources of dividends;
- understand the payment of interest and dividend to sharesholders;
- recognise the powers of directors and shareholders regarding declaration of dividends;
- understand kinds of dividend including scrip dividends.

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19.1 INTRODUCTION

It is the continuation of the previous unit wherein we have discussed the divisible profits as dividends. The power to declare and pay dividend is inherent in a company and the Articles of Association of the Company usually regulate the manner in which the dividends are to be declared. They are usually declared and paid at the end of each accounting year. This unit presents the sources of dividends, payment of dividends, kinds of dividends, etc. It also presents the powers and shareholders regarding declaration of dividends and auditor's duty in this regard.

19.2 MEANING OF THE TERM DIVIDEND

Dividend, as commonly understood, is that part of the profit received by the shareholders of the company on the amount of capital invested by them in the company. The term,

dividend', is defined as "the sum paid and received or the quotient forming part of the divisible sum payable to the recipient". The Companies Act, 1956 does not define the term, 'dividend', nor does it give any specific power to the companies to declare and pay dividend. Simply stated, dividends are the trading profits distributed among the shareholders of the company in proportion to the shares held by them.

19.3 SOURCES OF DIVIDENDS

Sec.205 of the Companies Act specifies the sources from which dividends can be paid and makes it obligatory for a company to provide for depreciation before declaring dividends, Sec.205(2-A) of the Act gives power to the Central Government to make rules regarding transfer of profits to its reserves.

Dividends may be declared out of the following three sources:

(i) out of current profits;
(ii) out of past reserves; and
(iii) out of monies provided by Government.

(i) Out of current profits : Dividends may be declared out of current profits of the company after providing for depreciation. However , a company is also required to transfer a prescribed percentage of its profits (not exceeding 10%) to its reserves before declaring dividends. The rules framed by the Central Government in this behalf are as given hereunder:

(1) Where the proposed dividend exceeds 10% but does not exceed 12.5% of the paid-up capital, the amount to be transferred to the reserve shall not be less than 2.5 per cent of the current profits.

(2) Where the proposed dividend exceeds 12.5 per cent but does not exceed 15 per cent of the paid-up capital, the amount to be transferred to the reserve shall not be less than 5 percent of the current profits.

(3) Where the proposed dividend exceeds 15 percent but does not exceed 20 percent of the paid-up capital, the amount to be transferred to the reserve shall not be less than 7.5 percent of the current profits.

(4) Where the proposed dividend exceeds 20 per cent of the paid-up capital, the amount to be transferred to reserves shall not be less than 10 per cent of the current profits.

However, no amount is required to be transferred to reserves if the proposed dividend is less than 10 per cent. The term, "current profits", means profits after tax deduction or after statutory transfer to development rebate reserves. The arrears of depreciation, if any, must also be provided for before arriving at the amount of profits. The term, "Dividend", implies only equity dividend.

(ii) Out of past reserves: Dividends may be declared out of profits of the previous financial years ascertained after providing for depreciation. Sec.205-A (3) inserted by the Companies (Amendment) Act, 1974 states that dividend can be declared out of reserves only in accordance with the rules framed by the Central Government, in this respect. The rules framed by the Central Government, provide that in the event of inadequency or absence of

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profits in any year, dividends may be declared by the company out of past accumulated profits when the following conditions are fulfilled:

1. The rate of dividend does not exceed the average of the rates at which dividend was declared by the company in the immediate preceding 5 years or 10 percent of its paid up capital, whichever is less.

2. The total amount to be drawn from the past accumulated profits and transferred to the reserves does not exceed an amount equal to one-tenth of its paid-up capital and free reserves and the amount so drawn should first be utilised to set off the losses incurred in the financial year before any dividend is declared in respect of preference or equity shares.

3. The balance of reserves after such withdrawal does not fall below 15 per cent of its paid-up share capital.

Check Your Progress - 1

What are the sources of dividends?

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19.4 DIVIDENDS AND CAPITAL

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Dividends must be paid only out of profits. Dividends can never be paid out of capital. Even if the Memorandum and Articles have given power to the company to do so, such power is invalid as per the judgement in *Verner Vs. General and Commercial Investment Trust Ltd. (1984).* The provisions of Companies Act, 1956 also has the same view and any provision contained in Articles in contravention of this principle is ultravires. It is accepted by all that the capital contributed by the share-holders must always be kept in tact.

If dividends are paid out of capital, it would result in the depletion of assets of the company, and leave the creditors helpless on account of reduced security which they hold on the assets. It also results in the reduction of the capital of the company which is not allowed by sec.100 of the Companies Act, 1956 except in the cases where certain formalities are observed and when the courts permission is obtained.

In case dividends are paid out of capital, the consequences that follow are serious and the directors will be jointly and severally held liable for it. The directors may be called upon to make good the amount with interest. But they may not be held liable, if they have relied upon bonafide valuation by the trusted officials of the company. The share-holders also may be required to pay the amount, if they have participated in the distribution of dividends knowing that they have been paid out of capital. *In Kingston Cotton Mill Co., (1896)* case, it was decided that the directors would be personally held liable to make good the amount of dividends if they had paid dividends out of capital knowingly. *In Stringer's case (1869),* it was held that the directors would not be held liable if they had relied upon the bonafide valuation of the assets of the company. In *Davy Vs. Cory (1910)* case, it was held that the directors could rely upon the trusted officials of the company for the reports and valuation

given by them, provided that they had no ground for suspicion. The directors have a right of indemnity against the shareholders of the company who received dividends knowingly that they were paid out of capital as was decided in *Maxham Vs. Grant (1900)* case.

19.5 PAYMENT OF INTEREST TO SHAREHOLDERS

Sec. 208 of the Companies Act provides for payment of interest to shareholders, in the cases where they cannot be paid dividends due to long gestation. In the case of a company formed to undertake construction work or provision of any plant, etc., where it will not be possible to earn profit for a long period, the company can pay interest on the paid-up capital and debit the same to the construction account, etc. Such payment of interest is possible only when the Articles of the Company provide for the same or when the Central Govt., has given its sanction for such payment. The other conditions laid down in this connection are that the payment of interest is to be made for a period determined by the Central Govt., that the rate of interest should not exceed 4% per annum or at the rate that may be notified by the Central Govt., and that the period for which the interest can be paid should not exceed six months after the half year of the completion of the work or the installation of the plant. It is to be noted that the payment of such interest will not operate as a reduction of the share capital of the company.

19.6 POWERS OF DIRECTORS AND SHAREHOLDERS REGARDING DECLARATION OF DIVIDENDS

The directors of the company are usually given discretionary power by the Articles of the company to recommend payment of dividend to the shareholders if they think it proper in the interest of the company. The directors may not recommend any dividend and set aside the whole of profits to be transferred to the reserves. In such an event, the shareholders cannot insist on payment of dividends. In *Band Vs. The Barraw hacmatite Steel Co., Ltd., (1902)* case, it was held that the preference shareholders could not compel the directors to pay preference dividends as a matter of right even though the profits were available, if the directors thought it proper to transfer the profits to the reserves. Clause 85 of Table A of the Companies Act, 1956 provides that "the company in general meeting may declare dividend, but no dividend shall exceed the amount recommended by the Board of Directors". Thus, it may be noted that the shareholders can sanction the rate of dividend in the general meeting of the company within the limits recommended by the directors. The shareholders however, can reduce the limits but cannot enlarge them, and they have to pass a resolution sanctioning the dividends without which they have no right to receive them.

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19.7 PAYMENT OF DIVIDENDS

A company which has declared dividends must pay within 42 days of the date of declaration Sec. 207. In the case of any non-compliance of this provision, every officer of the company, who is knowingly a party to it (default) shall be punished with simple imprisonment for a term which may extend to seven days and shall also be liable to pay a fine. However, no offence shall be deemed to have been committed, when the dividend could not be paid by reasons of the operation of any law, where the shareholders, instruction regarding the payment of dividend could not be complied with or where there is a dispute as to the right to receive the dividend etc.

It may be noted that the dividend once declared by the company becomes a debt to the company and the shareholders may sue the company for non-payment of such dividend. A share holder entitled to receive the dividend can recover it by suing the company within 6 years of the date on which it was declared, as decided in the following cases – (i) *Lalitha Vs. tata Iron and Steel Company Ltd., (1940)* and *Venkata Gurunatha R. Seshayya Vs. Sri. Tripurasundary Cotton Press (1940).* Therefore, a dividend once declared cannot be revoked except with the consent of the shareholders of unless it has been illegally declared by the company.

A company should pay dividend to its members in cash. The dividend may be paid either by cheque or by a warrant sent through post to all the registered shareholders of the company. sometimes, the articles of Association of the company may permit the directors to pay dividends in the form of bonus shares in case the company decides to capitalise the profits. According to Sec. 205 (3) of the Companies Act, no dividend shall be payable except in cash, but capitalisation of profits or reserves for the purpose of issuing fully paid bonus shares or for making partly paid shares as fully paid is allowed.

Unpaid Dividend

Any unpaid dividend should be transferred within 7 days after the expiry of the statutory period of 42 days the declaration to an account known as unpaid dividend account and it shall be shown on the liabilities side of the Balance Sheet. Any money transferred to the unpaid dividend account remaining unpaid for a period of three years form the date of such transfer shall be transferred by the company to the 'General Revenue Account' of the Central Govt.

Check Your Progress - 2

What is the accounting treatment of unpaid dividend?

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19.8 DIVIDENDS ON PREFERENCE SHARES

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The preference shareholders are entitled to get the dividend before any dividend is paid to the equity shareholders. The Articles of Association of a company generally empower the directors to declare and pay interim as well as final dividend on Preference Shares. However, the Preference Share-holders cannot compel the directors to declare the dividend in spite of the availability of profits. Income-tax must be deducted from the dividends to be paid to Preference Shareholders. Payment of dividend on Preference Shares without deduction of Income-tax is illegal.

Preference shares may be either cumulative or non-cumulative. In case the company has issued cumulative preference shares, the holders of such shares can claim arrears of these dividends, if they were not paid for any year and years. But arrears are payable only out of profits and when there are sufficient profits for the purpose. Until such time the arrears of

dividend and the Income-tax payable on them should be shown as a contingent liability in the form of a note to the Balance Sheet.

19.9 SCRIP DIVIDEND

Dividends are generally paid in cash. Sometimes the companies make payment of dividends in the form of shares or debentures. Such dividends are known as scrip dividends. Usually, finance companies resort to this method of payment of dividend.

19.10 KINDS OF DIVIDENDS

Dividends can be of two kinds viz, (i) final dividend, and (ii) interim dividend

(i) Final Dividend: When the dividend is declared at the end of the financial year after preparing the Profit and Loss account, it is known as final dividend. A company declares final dividend at the end to its trading period after the accounts have been drawn up and the visible profits ascertained. The directors recommend the amount of dividend keeping in view the amount of reserves to be maintained, the financial position of the company future prospects of the company, etc. They should also see that the provisions of Sec. 205 regarding depreciation and writing off of the previous losses are complied with before recommending the dividend.

Dividend may be declared "Free of Tax" or "Less Tax". If dividend is declared free of income tax, the shareholders will be paid the gross amount of dividend without any deduction. If it is declared less tax, the shareholders will be paid only the net amount of dividend after deducting income-tax at the prescribed rate from the gross dividend. Generally, the dividends are declared less tax unless it is otherwise specifically mentioned.

(ii) Interim Dividend: Interim dividend is the dividend, which is declared in between two annual general meetings of the company. It is declared before the final dividend is declared. The directors are usually empowered by the Articles to declare an interim dividend. Clause 86 of Table A of the Companies Act also provides that the Board of Directors may from time to time pay to the members such an interim dividend as appears to it to be justified by the profits of the company. The interim dividend should not be paid if the Articles do not permit such payment. The shareholders meeting need not be convened and their sanction obtained for the declaration of interim dividends. If an interim dividend is paid out of capital by mistake, the amount paid can be recovered form those shareholders which have received the same (*Maxham Vs. Grant (1900)*. The declaration of interim dividend does not constitute a debt and the directors can rescind it by a resolution before the payment is made. Much responsibility rests with the directors when they decide to pay an interim dividend. Sometimes they may seek the advice of the auditor with regard to the declaration of interim dividend.

The auditor should carefully study the situation and give advice on the matter of payment of interim dividends. he would generally see whether the Articles of the company empower the directors to declare interim dividends, whether interim accounts have been prepared to ascertain profits, whether necessary adjustments relating depreciation etc., have been made before arriving at the amount of profit,

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whether the financial position of the company will be affected by payment of such interim divided, etc. The auditor should advise the directors to see that the rate of interim divided lower then the rate of final dividend that is usually declared by the company. But it should be noted that he is not obliged to give suggestions and advice in the matter of interim dividend unless he is requested by the directors.

Check Your Progress - 3

What is the difference between declaration of dividend 'free of tax' and declaration of dividend 'less tax'?
....
....
....
....

19.11 AUDITOR'S DUTY

The auditor of a company must be very careful while vouching the payment of dividends be they final dividends or interim dividends. He should keep in mind the following pints while verifying the payment of dividends:

(i) He should go through the Memorandum of Association and Articles of Association of the Co., to ascertain the rights of different types of shares issued by the company. He should also examine whether the directors have the power to declare interim dividends.

(ii) He must see whether the various provisions of the Companies Act have been duly complied with while declaring and making payment of dividends.

(iii) He should examine the minute book of directors to know the rate of dividend recommended by them and also examine the minute book of shareholders to go through the resolution declaring the dividends.

(iv) He should ensure that the profits made available for payment of dividends can legally be distributed among the shareholders.

(v) He should check dividend list with the register of members to ensure correct calculation of dividends.

(vi) He should check the company's bank pass book, along with the returned dividend warrants, in case the dividends are paid through bankers. The auditor must also verify the transfers made out of profits to dividend account, the amount actually paid and the amount remaining unpaid.

(vii) He should see that the unclaimed dividend has been properly shown in the Balance Sheet and that the legal formalities are complied with.

(viii) In case the unclaimed dividend is forfeited after the expiry of a specific period, he should refer to the resolution passed by the Board and the Articles of the Company.

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UNIT - 20 : AUDIT REPORT

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20.0 AIMS AND OBJECTIVES

This unit aims at explaining you the contents of an audit report, the different forms of opinion expressed by the auditors and the provisions applicable in preparing a company audit report. After going through this unit you will be able to :

- distinguish between a certificate and an audit report
- explain what are the contents of an audit report
- what are the different types of opinions expressed by an auditor
- contents of a company audit report

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20.1 INTRODUCTION

The final product of the entire process of audit is the audit report. The entire exercise by the auditor of planning for the audit, preparation of audit programme, carrying out the audit by applying various techniques, gathering information from different sources culminates into preparation of audit report. An auditor expresses his opinion on the financial statements through an audit report. One thing, which needs to be understood, is that audit report is not a certificate. We shall shortly discuss the differences between an audit report and a certificate.

20.2 DISTINCTION BETWEEN REPORTS AND CERTIFICATES

The guidance note on Audit Reports and Certificates for special purposes issued by the Research Committee of the Institute of Chartered Accountants of India states that 'a certificate is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion'.

To put it in a nutshell a certificate confirms the accuracy of facts stated therein. To give an example, a certificate issued by a Chartered Accountant would read as under:

"We hereby certify that on the basis of documents verified by us M/s X & Co has exported goods worth Rs 1.21 crores during the financial year 2001-2002."

Here the certificate mentions certain facts like the amount of goods exported during a particular financial year by a certain entity and this is certified by the auditor. Here there is no estimate or opinion. It is confirmation of certain facts.

On the other hand, a report is usually made after enquiry and examination of books and records and it states the opinion of the auditor on the financial statements. Thus when an auditor gives an audit report he expresses his opinion on the truth and fairness of the financial statements he has audited. Thus the most important thing to remember here is that a report is 'an expression of opinion'.

20.3 TYPES OF OPINION

Different types of opinion expressed by the auditor can be explained under the following heads.

a. Unqualified Opinion
b. Qualified Opinion
c. Adverse or Negative Opinion
d. Disclaimer of Opinion

Unqualified Opinion

When an auditor gives his audit report without any reservations it is called an unqualified opinion. This is also referred to as a clean report. A typical unqualified report would read as under:

' in our opinion and to the best of information and according to the explanations given to us, the balance sheet and the profit and loss account give a true and fair view of the state of affairs and the working results ....'

Qualified Opinion

When an auditor gives his opinion subject to certain reservations it is called a qualified opinion. Qualified opinion or making a qualification in a report are the same. When a qualified report has to be made the following points should be kept in mind by the auditor:

a. Qualification should always be made in the main report and it is not sufficient that the auditor simply draws attention of the reader to a certain point in the notes to accounts.

b. Qualification should be made when the effect of deviation or any other matter is going to effect the true and fair disclosure of the financial statements. In other words the effect should be material. For small variations or deviations found it is not necessary to qualify the report.

c. Qualification should be made in specific terms and then the audit report should say 'Subject to the above' or ' Except the above'.

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d. When a qualification is made, the effect of the qualification on the profit or loss stated in the Profit & Loss account should be quantified and mentioned in the audit report itself. If the same cannot be quantified an estimate should be obtained from the management and these facts should be made clear in the audit report.

An example of a qualification in an audit report could be as under:

The business entity has not provided for depreciation on its fixed assets. Had the depreciation been provided as per rates given in Schedule XIV of The Companies Act, the profit would have been lower by an amount of Rs 3,65,000.

Subject to the above, in our opinion ....

In the above example the business entity has not calculated depreciation on any of its fixed assets and because of this the profit and loss account stands undercharged to the extent of Rs 3,65,000. As this is a material fact and as it effects the profit shown by the entity substantially the same has been brought out in the audit report by way of a qualification.

Adverse or Negative Opinion

An adverse or negative opinion would mean that the auditor is not satisfied that the financial statements give a true and fair view of the state of affairs or the profit or loss of the business entity. This type of report is not very common and it is given only when the auditor is confident that because of a number of material errors or frauds or deviations the profit or loss shown is not a correct profit or loss and the assets and liabilities shown in the Balance Sheet do not reflect the true state of affairs. Let us take the following example:

The profit shown by a business entity is Rs 8 Lakhs. The total turnover shown is Rs 90 Lakhs. The auditor finds that purchases of Rs 4 lakhs have not been booked at all. He further finds that a telephone bill amounting to Rs 48,000 has not been paid and booked. He also finds that factory repair bills of Rs 1,40,000 have not been paid and have not booked as expenditure. Added to the above he finds that Sundry Debtors to the extent of Rs 16 lakhs are non-existent and non-recoverable.

The above facts are brought to the notice of the management but the management refuses to rectify its books of account. It should be remembered that an auditor cannot compel the management to change or rectify any entries in the books of account even if he thinks that they are patently wrong. In the above situation the auditor has to give an adverse or negative opinion by making mention of all the above facts in his audit report and further stating that:

"Because of the errors and facts mentioned as above the Balance Sheet does not show a true and fair view of the state of affairs of the business entity as on the Balance Sheet date and the Profit & Loss Account does not show a true and fair view of the profit shown by the entity."

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Disclaimer of Opinion

After going through all the books and records and other material evidence if the auditor is not able to arrive at any conclusion as to whether the accounts show a true and fair view or not the auditor will give a disclaimer of opinion. In other words what he will say is that ' we are not able to express any opinion on the financial statements of the entity'. Even for giving such type of opinion the auditor has to give reasons and bring out the important facts on which he is basing his opinion.

In our above example if the auditor knows that some of the purchases have not been booked but he is not able to quantify them. He knows that some of the debtors are not recoverable but he does not have enough information to quantify the same. Or if the management does not provide him with say, the cash book, even though all other books have been provided. It would impossible for the auditor to say whether the financial statements are correct or not. In such a situation he would say that he is not in a position to express any opinion.

20.4 AUDIT REPORT IN THE CASE OF A COMPANY

Section 227 of the Companies Act specifies the matters on which a company auditor should report. Reporting requirements can be discussed under the following three heads:

1 Matters contained in Section 227 (1A)
2 Matters contained in Section 227 (2) and Section 227 (3)
3 Matters contained in Section 227 (4A)

1 Matter contained in Section 227(1A)

This section specifies the following 6 matters which should be specifically enquired into by every company auditor. The auditor is required to comment on these matters or any of them only if he sees any adverse feature. Otherwise, they need not be specifically brought out in his report.

a. Whether the loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members;

b. Whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company

c. Where the company is not an investment company within the meaning of section 372 or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company

d. Whether loans and advances made by the company have been shown as deposits

e. Whether personal expenses have been charged to revenue account

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f. When shares are stated to be allotted for cash, whether cash has been received or not.

2 Matters contained in Section 227 (2) and Section 227 (3)

Matters contained in these sub-sections need to be mentioned specifically in every audit report. These are the most important matters and they form the actual text of the audit report. The matters to be reported are:

a. Whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for his audit
b. Whether in his opinion proper books of account as required by law have been kept or not.
c. Whether the Balance Sheet and Profit & Loss Account comply with the accounting standards prescribed or not.
d. Whether the Balance Sheet and Profit & Loss Account are in agreement with the books of account and returns.
e. Whether any director is disqualified from being appointed as director.

3 Matters contained as per provisions of Section 227 (4A)

Under section 227 (4A) of the Companies Act the Central Government has made an order called the 'Manufacturing and Other Companies (Auditor's Report) Order, 1988(MAOCARO). The order requires that the auditor's report on the accounts of specified classes of companies for every financial year shall include a statement on the matters contained in the order. Students should remember that this order is applicable to almost all companies except a very few and hence reporting as per the requirements of the order is a must in all company audit reports.

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A specimen audit report containing the matters as per the provisions of Section 227 (2) and (3) as well as matters contained as per MAOCARO, 1988 is given hereunder:

To the members of
.... Limited

AUDIT REPORT

We have audited the attached Balance Sheet of ......Limited as at ..... and the Profit & Loss Account for the year ended on that date annexed thereto and report that :

1 As required by the Manufacturing and Other Companies (Auditor's Report) Order, 1988 issued by the Company Law Board in terms of Section 227 (4A) of The Companies Act, 1956 we enclose in the annexure a statement on the matters specified in paragraphs 4 & 5 of the said order.

2 Further to our comments in the annexure referred to in paragraph 1 above we state that

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

c. The Balance Sheet and the Profit & Loss Account referred to in this report are in agreement with the books of account

d. In our opinion, the Balance Sheet and Profit & Loss Account dealt with by this report are prepared in compliance with the accounting standards referred to in Subsection (3C) of Section 211 of the Companies Act, 1956, to the extent applicable.

e. In our opinion and based on information and explanations given to us, none of the Directors are disqualified as on from being appointed as Directors in terms of clause (g) of sub-section (1) of section 274 of the Companies act, 1956

f. In our opinion and to the best of our information and according to the explanations given to us, the said Balance Sheet and Profit & Loss Account read together with the notes thereon give the information required by The Companies Act, 1956 in the manner so required and give a true and fair view

   i. in so far as it relates to the Balance Sheet, of the state of affairs of the company as at .... and

   ii. in so far as it relates to the Profit & Loss Account, of the profit of the company for the year ended on that date.

For ....

Chartered Accountants

Partner
Date:
Place :

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ANNEXURE REFERRED TO IN PARAGRAPH 1 OF OUR REPORT OF EVEN DATE

1. The company has maintained proper records showing full particulars including quantitative details and situation of fixed assets. All the assets have not been physically verified by the management during the year but there is a regular programme of verification which in our opinion is reasonable having regard to the size of the company and the nature of its assets. No material discrepancies were noticed on verification.

2. None of the fixed assets have been revalued during the year.

3. The stocks of finished goods, stores, spare parts and raw materials have been physically verified during the year by the management. In our opinion the frequency of verification is reasonable.

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

5. The discrepancies noticed on verification between the physical stocks and the books records were not material.

6. On the basis of our examination of stock records we are of the opinion that the valuation of stocks is fair and proper in accordance with the normally accepted accounting principles and is on the same basis as in the preceding years.

7. In our opinion the rate of interest and other terms and conditions on which loans have been taken from companies, firms or other parties listed in the register maintained under section 301 and from the companies under the same management are not, prima facie, prejudicial to the interest of the company.

8. In our opinion the rate of interest and other terms and conditions on which loans have been granted to companies, firms or other parties listed in the registers maintained under section 301 and to the companies under the same management are not, prima facie, prejudicial to the interest of the company.

9. In respect of loans and advances in the nature of loans given by the company, parties have repaid the principal amounts as stipulated and have also been regular in payment of interest.

10. In our opinion and according to the information and explanations given to us there are adequate internal control procedures commensurate with the size of the company and the nature of its business with regard to purchases of stores, raw materials including components, plant and machinery, equipment and other assets and with regard to the sale of goods.

11. In our opinion and according to the information and explanations given to us, the transactions of purchases of goods and materials and sale of goods, materials and services, made in pursuance of contracts or arrangements entered in the registers maintained under section 301 and aggregating during the year to Rs 50,000 or more in respect of each party have been made at prices which are reasonable having regard to prevailing market prices for such goods, materials or services or the prices at which transactions for similar goods, materials or services have been made with other parties.

12. As explained to us the company has regular procedure for the determination of unserviceable or damaged stores, raw material and finished goods. Adequate provision has been made in the accounts for the loss arising on the items so determined.

13. In our opinion and according to the information and explanations given to us the company has complied with the provisions of Section 58A of the Companies Act, 1956 and the Companies (Acceptance of Deposits) Rules, 1975 with regard to the deposits accepted from the public.

14. In our opinion, reasonable records have been maintained by the company for the sale and disposal of realisable by-products and scrap.

15. In our opinion, the company has an internal audit system commensurate with the size and nature of its business.

16. We have broadly reviewed the books of account maintained by the company pursuant to the order made by the Central Government for the maintenance of cost

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records under section 209(1)(d) of the Companies Act, 1956 and are of the opinion that, prima facie, the prescribed accounts and records have been made and maintained.

17. According to the records of the company, provident funds and employees state insurance dues have been regularly deposited during the year with the appropriate authorities.

18. According to the information and explanations given to us no undisputed amounts payable in respect of income tax, wealth tax, sales tax, customs duty and excise duty were outstanding as at .... for a period of more than six months from the date they became payable.

19. According to the information and explanations given to us no personal expenses of employees or directors have been charged to revenue account other than those payable under contractual obligations or in accordance with generally accepted business practices.

20. The Company is not a sick industrial company within the meaning of clause (o) of sub-section (1) of section 3 of The Sick Industrial Companies (Special Provisions) Act, 1985.

For ....
Chartered Accountants

Partner

20.5 SIGNING OF AUDIT REPORT

Section 229 of the Companies Act provides that only the person appointed as auditor of the company, or where a firm is so appointed, only a partner in the firm should sign the audit report and the name of the person who is signing has to be mentioned.

Check Your Progress

1. What are different types of opinion usually expressed by the auditor after carrying out the audit work?

....
....
....
....

20.6 SUMMING UP

The distinction between a certificate and an audit report is that a certificate confirms the accuracy of facts stated therein. On the other hand, a report is usually made after enquiry and examination of books and records and it states the opinion of the auditor on the financial statements.

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The different types of opinion expressed by an auditor can be summed up as an unqualified report, a qualified report, disclaimer of opinion and adverse or negative opinion.

Audit report in the case of a company has to cover the matters given under the following sub-sections of section 227 of the Companies Act.

1 Matters contained in Section 227 (1A)
2 Matters contained in Section 227 (2) and Section 227 (3)
3 Matters contained in Section 227 (4A).

All audit reports should be signed by the person appointed as auditor or where a firm is appointed, then only by any one partner of the firm.

20.7 ANSWERS TO CHECK YOUR PROGRESS

1. Different types of opinion expressed by the auditor after carrying out the audit work are as follows:
   a. unqualified Opinion
   b. qualified Opinion
   c. adverse or Negative Opinion
   d. disclaimer of Opinion

20.8 MODEL EXAMINATION QUESTIONS

A Answer the following questions in about 15 lines

1 What is the difference between a certificate and an audit report.
2 Discuss the following briefly
   a. Qualifications in audit report
   b. Disclaimer of opinion
   c. Adverse or negative opinion

B Answer the following questions in about 30 lines

3. What are the reporting requirements in the case of statutory audit of a company. Discuss with reference to requirements under the provisions of section 227 of the Companies Act.

20.9 GLOSSARY

Certificate : A certificate confirms the accuracy of facts stated therein.

MAOCARO : Manufacturing and Other Company's (Auditor's Report) Order, 1988

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UNIT – 21 : RIGHTS, DUTIES AND LIABILITIES OF AUDITOR

Contents

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21.0 AIMS AND OBJECTIVES

This unit will give you a broad idea as to the rights and duties of an auditor in relation to the audits done by him. It will also throw light on the liabilities of an auditor. After going through the unit you will be able to:

explain the rights, duties and liabilities of an auditor.

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21.1 INTRODUCTION

To enable the auditor to discharge his duties effectively the Companies Act gives him certain rights or powers. In discharging his duties an auditor is also required to use his professional skills, take reasonable care in evaluating the evidence and express his opinion on the truth and fairness of the financial statements. Any negligence on his part in discharging his duties efficiently or any false statement made by him would attract liabilities not only under the civil law but also under the criminal law. The various rights and duties of the auditor as well as the liabilities he would face are discussed in this unit.

21.2 RIGHTS AND DUTIES OF AN AUDITOR

In relation to the audit assignment given to an auditor, he enjoys certain rights and powers which should be made use of to discharge his functions in a most efficient way. Similarly there are certain duties which are enjoined on him. Let us discuss these things in detail:

Rights of an Auditor

a. Right of access to books and records

The auditor of a company has access to all the books and records of a company, at all times, which are relevant for his audit. When we say books and records these would include not only the regular books like the cash book, bank book, ledger etc but also all relevant documents and registers like the supporting bills, delivery challans, stock registers, attendance registers, costing records etc. Thus all records, which have a bearing on any financial transaction entered into by the company can be accessed by the auditor. Apart from this the auditor can also go through any of the statutory registers like the fixed assets register, register of charges, register of contracts etc.

b. Right to get information and explanation from the staff

To carryout the audit in an effective and efficient manner the auditor can ask for information from any of the departments and staff members of the organisation being audited and he can also call for explanations from the staff members. Thus, to take an example, he can ask for the quotations and tenders file from the purchases department and he can also seek explanations from the purchase personnel as to why quotations were not called for in a few cases of purchases or tenders were not floated.

c. Right to attend general meeting

The auditor of a company has a right to attend any general meeting of the company. This right is not restricted to the general meeting where accounts are approved but all the other general meetings also. At such meetings he can bring to the notice of the shareholders any matter which has come to his notice after the signing of the report or where he feels that the directors are deliberately trying to suppress any important facts.

d. Right to receive notice

If another auditor is being appointed in place of the retiring auditor, the retiring auditor has a right to receive a notice of such change and make representation at the general meeting where a new auditor is being appointed.

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Duties of an Auditor

As has been discussed in an earlier unit a company auditor is required to report on certain matters as are specified under section 227 of the Companies Act.

Section 227 (1A) of the Companies Act requires that an auditor has to enquire into all the following six matters in the case of every company audit. He is required to report on these issues only if there is any adverse feature. The six matters are as under:

a. whether the loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members;

b. whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company
c. where the company is not an investment company within the meaning of section 372 or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company
d. whether loans and advances made by the company have been shown as deposits
e. whether personal expenses have been charged to revenue account
f. when shares are stated to be allotted for cash, whether cash has been received or not.

Section 227 (2) and (3) enjoin a duty on the auditor to report on the following points:

a. whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for his audit
b. whether in his opinion proper books of account as required by law have been kept or not.
c. whether the Balance Sheet and Profit & Loss Account comply with the accounting standards prescribed or not.
d. Whether the Balance Sheet and Profit & Loss Account are in agreement with the books of accounts and returns.
e. whether any director is disqualified from being appointed as director.

Under the provisions of Section 227 (4A) of The Companies Act, the Central Government has issued an order called as the Manufacturing and Other Company's (Auditor's Report) Order, 1988 which contains specific clauses on which the auditor is required to report. The contents of this order have been reproduced in the unit titled "Auditor's Report ". It is the duty of the auditor to report on all the points contained in this order.

It is to be remembered that all the above duties are specifically contained in The Companies Act. And all these are in addition to the auditor's duty to exercise reasonable skill and care and investigate matters in regard to which his suspicion is aroused.

21.3 LIABILITIES OF AN AUDITOR

In Govind Piraji Uplap Vs G N Oka (1952) 22CC 168 Chief Justice Chagla stated interalia as under:

"Any Chartered Accountant putting his signature to the Balance Sheet, when he knows that the Balance Sheet is not a correct Balance Sheet, is guilty of serious professional misconduct.......

A Chartered Accountant is the only guarantee that the shareholder has that the affairs of the company are as shown in the Balance Sheet. If that guarantee disappears and if Balance Sheets are signed merely because directors represent certain facts to the Chartered Accountants, then indeed a very serious situation will arise in the affairs of a company."

The above remarks sum up the importance of signing a Balance Sheet by an auditor and why he is liable for any negligence in not correctly doing so.

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Liability of an auditor can be discussed under the following heads.

21.3.1 Civil liability for negligence or fraud

Civil proceedings can be initiated against an auditor for damages incurred because of negligent work or for any fraud committed by him. An auditor is required to exercise professional skills while carrying out any audit assignment and the absence of the requisite skill or failure on the part of the auditor to exercise it can lead to a civil suit for recovery of damages. The question is who can file a suit and what can be recovered in such cases.

An auditor is appointed by the shareholders, in the case of a company, and by the proprietor or partners in the case of other entities. Hence he owes a primary duty towards the shareholders or the owners of the entity being audited and if the company or the organisation incurs a loss or damage because of the negligent work of the auditor, he will be held responsible for the loss or damage suffered.

The other question is whether the auditor can be sued by a third party ? The answer to this question depends upon the facts and circumstances of the case. If the auditor knows or he ought to have known that his report would be read by a third party and if the third party suffers a loss because of the negligent work of the auditor, he would be liable to the third party also.

We have discussed the civil liability of an auditor in case of negligent work. From the above it is clear that the auditor is not liable to every third party even if he has been negligent in his work. However, in case the auditor has been involved in a fraud or has given a report fraudulently he will be liable to every person who reads such report and suffers a loss or damage.

21.3.2 Liability under the Companies Act

Under the provisions of The Companies Act the auditor is liable for negligence or misstatements made by him. Under certain provisions of the Act the auditor is considered as an officer of the company and hence he is liable as an officer of the company.

Under section 628 of The Companies Act an auditor is liable to penalty for false statements. Under certain other provisions an auditor can even be prosecuted. Thus, under the Companies Act the auditor can attract both civil and criminal liabilities.

One case which has been decided with reference to the Companies Act is that of 'The Irish Woollen Co Ltd Vs Tyson and Others' wherein it was held that an auditor is liable if dividends have been improperly paid out of capital due to such understatement of the liabilities of the company as could have been discovered by the exercise of reasonable skill and care.

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21.3.3 Liability under the Income Tax Act

The Income tax Act prescribes prosecution and imprisonment for a person who makes or induces another person to make a false statement, false account or false declaration and if an auditor makes a false report he would also be covered under these provisions.

21.3.4 Criminal Liability

Apart from the criminal liability specifically provided under the Companies Act and the Income tax Act the auditor can also be prosecuted under the provisions of the Indian Penal Code for furnishing false information or false statements.

21.3.5 Liability for negligence of assistants

An auditor, while performing the audit, relies heavily on the work done by his assistants. What happens if the assistant is negligent and because of which an incorrect report is given. One thing which should be understood is that an audit engagement is a contract involving personal skills and qualifications. The auditor is expected to guide and supervise the work of his assistants and ultimately he is responsible for the work done by his assistants also.

In Superintendent of Police Vs M Rajamany it was held that no auditor can escape from personal liability of taking shelter under the misconduct of his own employees. It was further held that an auditor who does not personally look into the accounts but merely delegates it to his assistants cannot be said to be acting with due skill and care.

21.3.6 Reliance on findings of internal auditor

The statutory auditor cannot escape his liability by saying that internal audit did not report on certain vital issues or by saying that he relied on the findings of the internal auditor. He is required to independently conduct the audit, apply all the necessary audit techniques, gather all information as is required, apply reasonable professional skills and express his opinion.

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21.3.7 Disciplinary action by the Institute of Chartered Accountants of India

All practicing Chartered Accountants who are eligible to do statutory and other audits are members of the Institute of Chartered Accountants of India and they are governed by a code of conduct and other rules and regulations of the ICAI. If an auditor is found guilty of negligence or fraud the ICAI is authorized to take such disciplinary action as is prescribed and as the Institute thinks fit and proper. Thus if an auditor is found negligent in discharging his duties he would be proceeded against by the Institute also apart from all the other parties described above.

Thus in the case of B V Warerkar the Chartered Accountant was found guilty when he did not report that the value of investments in the balance sheet of a bank was inflated and consequently the profit and loss account also did not show a true picture.

In yet another case (Registrar of Companies Vs V P Bagadthey) the auditor was found guilty for his failure to report that the liabilities of a company were understated and that

the previous year's figures were not given in the corresponding columns of the Balance Sheet.

In the case of Deputy Secretary to the Government of India Vs SN Das Gupta the High Court found the auditor guilty for not verifying cash-in-hand in the case of a Bank Audit and he was suspended him from membership for two years.

21.3.8 Libel Suits

Once question, which needs to be answered in relation to the liability of auditors, is that can a libel suit be filed for qualifications made in the audit report, which possibly defame the directors or any management personnel. The answer would be that if an audit report has been prepared with no *malafide* intentions then even if some remarks or qualifications made by the auditor are likely to defame any person, no libel suits can be brought in.

Check Your Progress

1. What are the rights of an auditor?

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21.4 SUMMING UP

Rights of an auditor
a. Right of access to books and records
b. Right to get information and explanation from the staff
c. Right to attend general meeting

The duties of an auditor are given under section 227 of the Companies Act which include the matters on which the auditor is required to make specific enquiry as well as all matters given in the MAOCARO, 1988.

An auditor is liable to shareholders or other owners of the audit entity as well as to those third parties who the auditor knew or ought to have known that they are going to read and make use of the audit report. The auditor is also liable as per the provisions of the Companies Act, Income tax Act and also under the Indian Penal Code. He can also be proceeded against by the ICAI for any misstatements, negligent or fraudulent statements.

21.5 ANSWERS TO CHECK YOUR PROGRESS

1. The rights of an auditor are as follows:
   a. right of access to books and records
   b. right to get information and explanation from the staff
   c. right to attend general meeting

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21.6 MODEL EXAMINATION QUESTIONS

A. Answer the following questions in about 15 lines

1.Explain the Rights of an auditor

2. Explain the duties of an auditor

B Answer the following questions in about 30 lines

3.Explain in detail the liabilities of an auditor.

21.7 RECOMMENDED BOOKS

1. Kamal Gupta : Contemporary Auditing (Tata Mc. Graw-Hill Publishing Co. Ltd., New Delhi)

2. B.N. Tandon : Practical Auditing (S.Chand and Co., Ltd., Ram Nagar, New Delhi)

3. Spicer & Pegler : Practical Auditing (Allied Publishers Pvt. Ltd., New Delhi)

4. Dinkar Pagare : Principles and Practice of Auditing (Sultan Chand & Sons, 23, Darya Ganj, New Delhi)

5. T.R. Sharma : Auditing (Sahitya Bhavan, Hospital Road, Agra)

21.8 GLOSSARY

ICAI : Institute of Chartered Accountants of India.

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BLOCK – V

SPECIAL AUDITS

Unit – 22 : Audit of Banking Companies

Unit – 23 : Audit of Insurance Companies

Unit – 24 : Audit of Hotels Educational Institutions, Hospitals and Co-operative Societies

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UNIT - 22 : AUDIT OF BANKING COMPANIES

Contents

22.0 Aims and Objectives
22.1 Introduction
22.2 Definition of Banking Business
22.3 Restriction of Banking Business
22.4 Accounts and Accounting Systems
  22.4.1 Accounting System
  22.4.2 Books Required to be Maintained
  22.4.3 Preparation of Annual Accounts
22.5 Internal Audit
22.6 Internal Check
22.7 Audit of Accounts
22.8 Auditor's Duties
22.9 Summing Up
22.10 Answers to Check Your Progress
22.11 Model Examination Questions
22.12 Glossary

22.0 AIMS AND OBJECTIVES

This unit aims at discussing the need for and the procedure of conducting audit for banking companies in accordance with the provisions under Banking Regulation Act, 1949. After going through this unit you will be able to :

- explain the meaning of banking business
- describe the restrictions on the banking business
- understand the accounting system in banks
- understand the internal check and internal audit systems
- explain certain norms relating to accounting
- auditor's duty regarding the audit of banking companies.

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22.1 INTRODUCTION

Banking companies are the important organs of an economy. The trends in the economy can be influenced or controlled through banks to a larger extent. Banks are financial institutions. They deal with money. The number of transactions, amount of transactions and parties involved in a bank would be large and, therefore, the accounting process requires to be designed in such a manner that the mistakes are minimized and manipulations are avoided or can be easily traced. In view of this, the audit of banking companies also becomes quite necessary.

The banking companies in India are governed by the Banking Companies Regulation Act, 1949 and also by certain provisions of Companies Act, 1956.

22.2 DEFINITION OF BANKING BUSINESS

According to Sec. 5(b) banking is defined as 'the accepting, for the purpose of lending or investment, of deposits of money from the public repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise'. No company can carry on banking business in India, unless it holds a license issued by the Reserve Bank of India.

22.3 RESTRICTIONS ON BANKING BUSINESS

Apart from the accepting of deposits and investing or lending these amounts, the banks can engage in certain other classes of business which are incidental to business of banking. But it cannot buy, sell or deal in any goods except in connection with the realization of securities held by it. Thus, there are many restrictions in respect of the business to be carried on by banks. They are as follows:

(i) A bank can't engage in any business other than banking.

(ii) It cannot engage in trading activities.

(iii) It cannot take loans or give advances on the security of its own shares.

(iv) It can not grant unsecured loans or advances to any of its directors or to a firm in which any of its directors is a partner

(v) The Reserve Bank of India has powers to control loans and advances and to prohibit loans and advances which are not in the interest of the depositors.

(vi) A banking company can not hold immovable property except for its own use.

(vii) A scheduled bank shall maintain deposit with RBI, at least 3% of its time and demand liabilities

(viii) Every bank shall maintain cash, gold or other approved securities at a level which is not less than 25% and not more than 40% of the total time and demand liabilities.

(ix) Every bank has to transfer 20% of the profit each year to a Statutory Reserve until it becomes at least equal to the share capital.

(x) No banking company shall pay any dividend on its shares until all its capital expenses have been completely written off.

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22.4 ACCOUNTS AND ACCOUNTING SYSTEM

22.4.1 Accounting System

The accounting system prescribed for banks is different from that of trading and manufacturing companies. The main features of a bank's accounting system are :

(i) Postings in personal and general ledgers are directly made from vouchers. Books of prime entry or journal are avoided.

(ii) Trial balance of the general ledger is extracted and agreed every day.

(iii) Trial balance of the personal ledgers is prepared generally once in every fortnight

(iv) Two vouchers are prepared for every non-cash transaction, one for debit and the other for credit. However for cash transactions, only one voucher is prepared.

23.4.2 Books Required to be Maintained

A few important books that a bank is required to maintain are given below:

(i) Cash Book for receipts and payments separately,
(ii) Deposit Ledgers – Separately for fixed, savings bank and demand deposits.
(iii) Investment Ledger
(iv) Bills Purchased and Discounted Ledger
(v) Loans Ledger
(vi) Cash Credits Ledger

23.4.3 Preparation of Annual Accounts

A bank has to prepare its final accounts in the prescribed forms. The Banking Regulation Act provides form 'A' in the third schedule for Balance Sheet and form 'B' for profit and loss account. The banks are required to close their books on every March 31. These accounts shall be furnished to the Reserve Bank of India within 3 months from the date of closing the books, and shall also submit 3 copies of these accounts to the Registrar of Companies. These accounts shall be published in a news paper within 6 months.

22.5 INTERNAL AUDIT

In view of numerous transactions and number of branches, it is not possible for the auditors to check every transaction. Therefore banking companies appoint their own internal auditors and inspectors who check the accounts continuously throughout the year.

The Institute of Chartered Accountants of India has made following suggestions regarding the internal audit of a bank.

(i) The internal auditor should fix the audit programme in consultation with the external auditor.

(ii) The external auditor may call for the report of the internal auditor.

22.6 INTERNAL CHECK

The accounting system and its operation in a bank is devised in such a manner that there exists a perfect internal check system. In this system, the work done by a clerk is immediately verified by another clerk or officer. For carrying out every transaction a minimum of two employees are involved.

The main features of the internal check system are given below:

(i) The work done by one clerk should be checked by another clerk at the end of the day.

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(ii) The cashier should not have access to the customers ledger. Similarly, the ledger-keeper should not have access to Cash Book.

(iii) The duties of the clerks should be shifted from one counter to another from time to time.

(iv) Surprise visits and checks should be conducted by the internal auditors and inspectors.

(v) The balances in current accounts and other deposit accounts should be checked by responsible officials.

(vi) Securities lodged with the bank against loans, cash credits, overdrafts should be verified by responsible officers.

(vii) Any discrepancies and irregularities, if found, should be reported to the top management by the internal auditors for thorough investigation.

(viii) Clearing house transactions should be scrutinized every day.

22.7 AUDIT OF ACCOUNTS

The accounts of the Indian banking companies shall be audited by a chartered accountant. In case of a foreign company, the auditor should be qualified as per the law of the country in which it is incorporated.

The provisions of the companies Act (Sec. 224 to 233) dealing with appointment, removal, qualifications etc., shall also be applicable to banking companies.

In case of nationalized banks and their branches, the appointment of auditors is made by the central government.

22.8 AUDITOR'S DUTIES

The auditor should pay special attention to the following matters.

1. He should attend the bank on the last day of the accounting period and verify cash, cheques, stamps etc., and tally them with their respective book figures.

2. Confirmation certificates should be obtained from the banks concerned in respect of the balances with RBI and other banks.

3. Check the drafts, cheques etc., which are yet to be sent to clearing house.

4. He should check the balances in deposit accounts and loan accounts.

5. Money at call and short notice should be verified with the call deposit receipts

6. The securities obtained by bank against loans granted should be examined.

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7. The resolutions of the Board should be examined for the investments purchased by the bank.

8. The classification of the loans into "performing assets" or "non-performing assets" should be examined.

9. In case of non-performing assets (NPAs), it should be examined whether the provisions are made properly as per the latest rules / directions of RBI.

10. Interest on certain NPAs should not be accounted for, as per the directions of RBI.

11. He should examine the bills discounted and the rebate on bills discounted.

12. Various statements, returns and accounts sent by branches should be properly incorporated by the Head Office.

13. He should scrutinize foreign currency transactions.

14. He should see whether the limits imposed on different types of loans are properly adhered to by the branches.

15. He should verify the fixed assets like buildings, furniture, vehicles, etc.

16. He should also see whether the Profit and Loss Account and Balance Sheet are prepared exactly as per the requirements of the Banking Regulation Act.

17. Any secret reserve maintained by the bank is not misused by the directors.

18. The auditor has to see that the investments are valued properly. They should not represent over-valuation or under-valuations, which results in unfair presentation of accounts.

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Check Your Progress

1. Define a banking company according to the Banking Companies Regulation Act.

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2. How is the internal check system operated in banks?

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22.9 SUMMING UP

Banks are financial institutions. They accept deposits from public and such deposits are used for (i) investment in government securities and other securities and also (ii) for

granting loans to public. These banks are governed by the Banking Regulation Act, 1949 and operational aspects of banks are controlled by Reserve Bank of India. There are many restrictions on banks imposed by law, for e.g., Banks cannot acquire permanent assets except for its business use, they have to transfer 20% of their profits to a statutory reserve and the banks can't pay dividends unless all the 'capital expenses and deferred expenses' are totally written off.

The banks adopt a perfect internal check system under which each transaction is carried out by two persons and the work done by a clerk is immediately checked or counter-verified by another clerk or officer. The banks follow the financial as their accounting year and close their books on March 31 every year. In view of millions of transactions that a bank and its branches have, it is not possible for the auditor to check each and every transaction. Hence they depend on the internal auditors.

Auditors will verify all the assets, deposits, loans, performing and non-performing assets, bills discounted, bills for collection etc.

22.10 ANSWERS TO CHECK YOUR PROGRESS

1. The Banking Regulation Act, 1949 defines banking business as 'accepting, for the purpose of lending or investment, of deposits of money from the public repayable on demand or otherwise and with drawable by cheque, draft, order or otherwise.

2. The internal check system is a system under which the work done by a clerk is immediately checked by another clerk or officer. Further, each transaction is carried by two or more stuff members. There will be two vouches prepared for a non-cash transaction and one voucher for a cash transaction. The ledger balances are checked through the control accounts and trial balances are prepared periodically, i.e., weekly or fortnightly.

22.11 MODEL EXAMINATION QUESTIONS

A. Answer the following questions in about 15 lines each.

1. Define the banking business and narrate the restrictions on it in India.
2. What do you mean by internal cheek in a bank? What are its main features? How does it differ from internal audit?

B. Answer the following questions in about 30 lines each.

3. Discuss in detail how would the internal check system is carried on in the banks. Distinguish between internal audit and internal check systems.
4. What are the important points that an auditor should observe keenly while he takes up the audit work of a branch.

22.12 GLOSSARY

1. Banking Business : Banking means the accepting of deposits of money from the public for the purpose of lending or investment repayable on demand or otherwise and withdrawal cheque draft or otherwise.

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2. Reserve Fund : As per the Banking Companies Act, every bank has to maintain a reserve fund and transfer a sum equal to 20% out of the profits.

3. Annual Final Accounts : A Banking company incorporated in India is required to prepare Profit and Loss Account and a balance Sheet at the end of every financial year.

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UNIT – 23 : AUDIT OF INSURANCE COMPANIES

Contents

23.0 Aims and Objectives
23.1 Introduction
23.2 Appointment of Auditors
23.3 Special Provisions Relating to Insurance Companies
23.4 Other Provisions
- 23.4.1 Registration
- 23.4.2 Agents
- 23.4.3 Registers of Policies and Claims
- 23.4.4 Prohibition of Rebates
- 23.4.5 Deposits
- 23.4.6 Management
- 23.4.7 Commission
- 23.4.8 Investments

23.5 Audit of Insurance Companies
23.6 Auditor's Duty – Certain Points
23.7 Summing Up
23.8 Answers to Check Your Progress
23.9 Model Examination Questions

23.0 AIMS AND OBJECTIVES

This unit aims at discussing the need, importance and procedure for conducting the audit for insurance companies. The audit of life insurance and general insurance business in India requires the knowledge about the relevant laws. After reading this unit, you will be able to:

- explain special provisions relating to insurance business.
- narrate the procedure for registration
- describe the restrictions on the management
- recognize the investment pattern
- explain the auditor's duty relating to insurance business.

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23.1 INTRODUCTION

Insurance business is divided into two types. (1) Life insurance and (2) General insurance. Both types of the business is governed by the Insurance Act 1938 in India. Life Insurance Corporation Act, 1956 was passed to nationalize the whole of life insurance business. However, the privatization of life insurance business has been initiated by the government of India during the late 1990s. The non-life or general insurance business comprising fire, marine and miscellaneous business was also nationalized by passing the General Insurance Business (Nationalisation) Act in 1972. According to this Act, the general insurance business does not include capital redemption business and certain annuity business.

23.2 APPOINTMENT OF AUDITORS

The accounts of the life and general insurance corporations are required to be audited. The auditors are appointed by the corporations with prior approval of the Central Government. The remuneration for the auditors is fixed by the Central Government. The auditors will have access to all the books and documents of the companies. The audit report should be submitted to the companies and a copy of the same should be forwarded to the Central Government.

23. 3 SPECIAL PROVISIONS RELATING TO INSURACNE COMPANIES

The insurance companies follow the provisions given below pertaining to accounting and finance aspects.

1. The insurance companies shall maintain revenue account and life assurance fund account separately for each type of business. Profit and Loss accounts and Balance Sheet have to be prepared as per the Act.

2. The insurance companies are required to maintain a minimum reserve of 50% the net income in the case of fire and miscellaneous insurance business in the year and 100% in the case of marine insurance business in the year.

3. A minimum security margin of Rs. 50 lakhs or 10% of the premium income whichever is higher. In the case of small companies, the amount of minimum security may be reduced.

4. Premium should be collected before commencement of the risk. It is exempted when a bank guarantee covers the premium.

5. Information in respect of premium, commissions, refund of claims and administrative and development expenses should be readily made available.

6. Any expenditure above Rs. 50 should be paid through crossed or order cheques. Commission to agents should be paid only through crossed or order cheques.

7. Commission to agents should be paid only through crossed or order cheques.

8. All the claims should be paid through crossed or order cheques

9. All the management expenses are shown under one head in the revenue account duly classified into various sub-heads as given in the proforma in Form–D of schedule-III in case of life insurance and Form-F of schedule-III for general insurance business.

10. Every life insurance company shall get its financial position investigated, including the valuation of liabilities by an actuary every year.

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23.4 OTHER PROVISIONS

The other provisions relating to general and life insurance as per the Insurance Act of 1938 are briefly stated below:

23.4.1 Registration

Section 3 provides that no person shall begin to carry on any class of insurance business in India unless a certificate of registration is obtained from the controller. The controller has power to cancel the registration wholly or related to any particular class of business. The registration has to be renewed every year on payment of a prescribed fee.

23.4.2 Agents

Controller or any officer authorized by the controller, may receive application in a prescribed manner along with a fees, and sanction licence to the applicant to act as an agent for an insurer (Sec. 42). The insurer has to maintain a register of agents showing the details of their names, addresses, date of appointment and date of termination (Sec. 43).

23.4.3 Registers of Policies and Claims

According to Sec. 14, every insurance company has to maintain a register of policies with the details of the type of the name of the policy holder, date of commencement, nominations etc. Similarly they have to maintain a register of claims wherein the names and addresses of the claimants, the date of claim, date of payment, extent of claim discharged, rejections and reasons therefor are recorded.

23.4.4 Prohibition of Rebates

According to Section 41, no rebate shall be allowed, wholly or partly, in the amount of commission or premium. This prohibition applies to both the payer of rebate and receiver.

23.4.5 Deposits

The following are the amounts to be deposited by the insurance companies according to the type of business it carries on.

a) For fire insurance business - Rs. 1,50,000.
b) For marine insurance business - Rs. 1,50,000.
c) For miscellaneous insurance business - Rs. 1,50,000
d) For any two businesses of the above three - Rs. 2,50,000
e) For all the three businesses - Rs. 3,50,000

23.4.6 Management

The managements of the insurance companies shall have to follow the restrictions imposed by the Act as below.

1) The insurance companies should not be managed by a company or a firm or by managing agents.

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2) It cannot be managed or directed by any person whose remuneration, wholly or partly, is payable by way of commission or bonus in respect of general insurance business.

3) No person concerned in the management can nominate his successor.

4) If the remuneration paid to any person is more than standard remuneration, the Central Government may issue directions to the company to reduce the remuneration within six months.

5) If the insurance funds of a company are Rs. 50 lakhs or more, it must have a whole time manager or managing director.

6) In case of any Indian Insurance Company, the central Government may nominate two directors who will be entitled to the same fees, allowances, etc.

23.4.7 Commission

Section 40 of the Insurance Act prohibits payment of commission to any body except to agents. The commission payable should not exceed 15% of the premium relating to fire and miscellaneous insurance while the ceiling is 10% in case of marine insurance.

23.4.8 Investments

A general insurance company can invest its funds in any of the following investments.

a) Government Securities - issued or guaranteed by Central or State Governments.

b) Debentures and other securities issued by the Central or State Governments, Port Trusts, Municipal Corporations etc.

c) Other than the above, the company can invest in other approved securities. But the amount of investment in these securities should not exceed 25% of the companies total assets.

The amount of investment in shares of any one single banking / investment company should not be more than 10% of the company's total assets or 2% of the banking / investment company's capital and debentures together, whichever is less.

23.5 AUDIT OF INSURANCE COMPANIES

Any insurance company, unless it is subject to audit under the Indian Companies Act, be audited annually by an auditor. The auditor shall have the powers, can exercise functions and shall discharge duties and be subject to the liabilities and penalties as per the Companies Act. Further, any body, whoever makes a false statement in any report or certificate shall be punishable with imprisonment or fine or both.

23.6 AUDITOR'S DUTY – CERTAIN POINTS

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In addition to the general auditing procedures, the following points have to be considered by an auditor of an insurance company.

1. The auditor should have complete knowledge about the Indian Companies Act, Insurance Act, Life Insurance Corporation Act and General Insurance Business Act.

2. He should examine whether the internal check system and internal control system are adequate in the company.

3. He should vouch the cash book. Counter foils of the direct and re-insurance premium receipts have to be used for vouching of premiums.

4. Claims paid should be vouched with the bank pass books and claims register and policies. Surveyor's report for each claims should be observed.

5. In case of re-insurance claims, the surveyor's report should be obtained from the company concerned.

6. In case of outstanding claims, the auditor should see that 'claims intimated and accepted', 'intimated and not yet accepted' and 'intimated and not accepted' should be provided for. Incase of disputed claims also, the provisions should be made reasonably.

7. Agents commission should be vouched with the receipts, returns submitted by them.

8. Incase of re-insurance (ceding) companies, the premiums receivable and commission payable and net amounts receivable, funds with the reinsurance companies should be verified.

9. Similarly, accounts of the reinsurance (accepting) companies be verified and the balances be ascertained.

10. Auditor of an insurance company shall have to ensure that interest and dividends on investments have been duly collected and the outstandings have been accounted for.

11. The auditor has to verify the adequacy of reserves, against each type of business. The provisions of the Insurance Act should be adhered to.

12. In case of investments, the market values must be correctly ascertained. Cash balances in hand, with banks, and with RBI should be verified as on the date of the balance sheet.

13. Any contingent liability should be properly disclosed.

14. The annual accounts should be prepared in accordance with the formats provided in the Act, for each type of business separately.

15. Bonus declared to policy holders should be checked in relation to the resolutions of the Board of Directors and the provisions of the relevant laws.

16. As per the requirement of the Law, the auditor is required to certify (i) that he has verified the cash balances and the securities relating to insurer's loans and advances (ii)

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to what extent he has verified the investments and transactions relating any trust under taken by the insurer as trustee.

Check Your Progress

1. What are the reserves to be maintained by an insurance company in respect of each class of business.

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2. Mention the commission payable to insurance agents.

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3. What are the contents of the register of policies maintained by insurance companies.

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23.7 SUMMING UP

The insurance business is broadly divided into two types, viz., life insurance and general insurance. The general insurance is further divided into three types. viz., fire insurance, marine insurance and miscellaneous insurance.

The annual accounts of an insurance company have to be audited by a qualified auditor appointed by the company with prior approval of the Central Government. The auditor's powers duties and responsibilities shall be same as those stated in the Companies Act.

Insurance companies shall maintain a minimum reserve of 50% of net income in case of fire business and 100% in case of marine business. There are many restrictions/ guidelines in respect of deposits, investments, agents' commission etc. Auditor has to carry on the vouching and verification process in respect of premiums, claims, incomes by way of dividends, interests, commission, bonus, re-insurance etc.

23.8 ANSWERS TO CHECK YOUR PROGRESS

1. The insurance companies are required to maintain a minimum reserve of 50% of net premiums in case of fire and miscellaneous business and 100% of net premiums received in case of marine insurance business. These reserves are maintained towards unexpired risks on policies.

2. The amount of commission payable to insurance agents and principal agents shall not exceed 5% of loss premiums in case of fire insurance and 10% in case of marine insurance.

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3. Every insurance company is required to maintain two registers

a) **Register of Policies:** It should contain the name and address of the policy holder, the date on which the policy was taken and the details of any transfer or nomination of such policy made, type of the policy, Amount of premium, mode of payment of premium etc.

b) **Register of Claims:** It should contain the name and address of the claimant, the amount of claim, the date of submission of each claim, the date of discharge of the claim, rejections if any, and the reasons for rejections etc.

23.9 MODEL EXAMINATION QUESTIONS

A. Answer the following questions in about 15 lines.

1. What are the special provisions relating to insurance companies?
2. What are the registers that an insurance company should maintain and what are their contents?
3. What are the guidelines in respect of investments that an insurance company can hold?

B. Answer the following questions in about 30 lines.

4. What are the duties of an auditor in connection with the insurance companies.
5. Narrate various provisions relating to Insurance Business in India.

23.10 GLOSSARY

Life Insurance Business : It was nationalised by passing Life Insurance Corporation Act, 1956.

General Insurance Business : It was nationalised by passing the General Insurance Business Act, 1972.

Controller of Insurance : He is the authority to issue a Certificate of registration for carrying on Insurance Business in India.

Registration : To carry on type of Insurance business a certificate of registration must be obtained from the Controller of Insurance.

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UNIT-24 : AUDIT OF HOTELS, EDUCATIONAL INSTITUTIONS, HOSPITALS AND CO-OPERATIVE SOCIETIES

Contents

24.0 Aims and Objectives
24.1 Introduction
24.2 Audit of Hotels
24.3 Audit of Educational Institutions
24.4 Audit of Hospitals
24.5 Audit of Co-operative Societies.
  24.5.1 General Introduction
  24.5.2 Auditor's Duties
24.6 Summing Up
24.7 Answers to Check Your Progress
24.8 Model Examination Questions
24.9 Recommended Books
24.10 Glossary

24.0 AIMS AND OBJECTIVES

This Unit is dedicated for discussing about the need for and importance of conducting the audit of certain special organisations. The auditing procedure is also discussed briefly. The special organisations covered are Hotels, Educational Institutions, Hospitals and Co-operative Societies .

After going through this Unit, you should be able to know:

- the audit procedure for hotels.
- the audit procedure for educational institutions.
- the audit procedure for hospitals and
- the provisions and the audit procedure of co-operative societies.

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24.1 INTRODUCTION

Hotels, educational institutions, hospitals and cooperative societies can be regarded as special organisations in view of the unique style of operation and business carried on by them. Some of them are trading concerns and some others are service or non-profit organisations. They are governed separately by Respective Acts and rules. The audit procedure for any organisation depends upon its nature of business and the books to be maintained according to relevant laws.

24.2 AUDIT OF HOTELS

The following are the main points that an auditor shall keep in mind while carrying on the audit of a hotel.

1. The hotels may be organised as sole trader firms or partnership firms or companies. If it is a partnership, the auditor should study the contents of the partnership deed and in case of companies, their memorandum of association and articles of association should be kept in view.

2. The auditor should see the system of book keeping and note down what books of account are maintained and should also observe the person incharge of these books.

3. He should evaluate the system of internal check, particularly in respect of
   a) collection of proceeds of daily sales, meals boarding charges etc.
   b) purchase of provisions, foodstuffs, wines, linen, crockery and others.
   c) issue of these items, its procedure, periodicity etc.,
   d) payments in respect of these purchases.

4. He should verify the cash memos and see that all the cash receipts are recorded in the cash book.

5. The auditor should examine the register of the persons staying in the hotel, i.e., in the lodging section. This register is known as 'visitors register'. He should also verify the advance bookings. The bills in respect of these customers should be checked.

6. The food, wine and others supplied to the visitors staying in hotel should be charged to their individual accounts. The bills and the individual visitor's account should be verified.

7. The auditor shall vouch the payments in respect of
   (i) remuneration to the staff
   (ii) taxes pertaining to hotels, and
   (iii) rents and other charges.

8. The auditor should verify the closing stocks of provisions, stores, wines, crockery etc.
9. The auditor should also carry on the vouching of the purchases of furniture and other equipment. Proper distinction should be made between the capital and revenue expenditure.

10. He should ascertain whether proper provision has been made for depreciation on crockery, furniture, linen etc. The consistency in the method of depreciation and revaluations made in case of certain articles should be verified.

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24.3 AUDIT OF EDUCATIONAL INSTITUTIONS

The educational institutions, comprising of schools and colleges, may be run by the government or private organisations. In case of government institutions, the rules under education code will be applicable. In case of private institutions, the rules prescribed by the government and universities have to be followed. If the institutions are sponsored by the educational societies, registered under the Societies Registration Act or Co-operative Societies Act, the bye-laws of the society must be verified. The auditor should pay attention to the following while auditing the accounts of educational institutions.

I. General

(1) Examine the bye-laws of the institutions which effect the accounts directly or indirectly.

(2) Verify the minutes book of the managing committee

(3) Evaluate the internal check system and internal control system existing in the institutions.

II. Fees

(4) The fees collected from students should be checked with reference to the counter foils of the receipts.

(5) Sub-division of fees, if any, into admission fees, laboratory fees, library fees etc. should be verified.

(6) Check the system of depositing the fees into the bank.

(7) Check up fees reconciliation statements, i.e., fees receivable and actual fees received.

(8) Compare the admission fee with the number of students admitted and if any fee-waivers are given, see whether they have the approval of the management.

(9) If fees is received in advance, it should be accounted for properly.

III. Other Receipts

(10) Fines collected, collections for educational tours and for conduct of science fairs etc., should be accounted for separately.

(11) Donations received must be vouched with the duplicate receipts. Verify the approval of the management and also the conditions laid down by the donor. Check whether the amount of donations and the income thereon are used for the purpose prescribed by the donor.

(12) Grants received from government and other authorities should be vouched with reference to the correspondence and instructions received form the authorities.

(13) If the institution has other incomes like rent from buildings, interest on securities, tenders from canteen, parking stand etc., they should be verified with the agreements and receipts given.

IV. Deposits

(14) Deposits such as caution money. library deposits, laboratory security deposits etc., should not be clubbed with the routine fees collected. They should be credited to separate accounts.

(15) Incase of loss of books or breakage of laboratory apparatus etc. their cost should be charged to the students and it is deducted from their deposits.

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V. Expenditure

(16) The auditor should verify the salaries paid to teaching and non-teaching staff with the staff register. The rules and regulations pertaining to allowances should be examined. He should see that the deductions from the salaries are also accounted for properly. Remittances of provident fund and gratuities should also be checked.

(17) Check the expenses like stationery, conveyance, printing with the vouchers, cash memos, invoices etc.,

VI. Verification

(18) Verify the cash in hand and bank balances.

(19) Verify the closing stocks of stationery etc.,

(20) Verify the investments, if any.

24.4 AUDIT OF HOSPITALS

Hospitals are run by government and by private people. The government hospitals are maintained according to the rules framed by the government. The private hospitals may be sponsored by individuals or societies. In both the cases, the auditor has to verify the accounting system adopted by the management. He should follow the points given below while proceeding with the audit programme.

I. General

1. The auditor should first examine the internal check and internal control systems existing in the hospitals.

II. Receipts

2. The major source of revenue for hospitals is the fees and charges paid by the patients. These are vouched with the counter foils of the receipts given.
3. The hospitals if sponsored by societies, they receive subscriptions from members. They should be verified with the receipts given.
4. Donations from other charitable institutions, philanthropists may also be received. The purpose for which the donations have to be used may be specifically, mentioned by the donors. If they are meant for construction of buildings or purchase of equipments, these donations must be capitalised.
5. If the hospital has its own buildings and it is receiving rents, it must be verified with the rents agreements, and vouchers - similarly, there may be other incomes like interest, dividends on investments, which have to be vouched as usually.

III. Payments

6. Vouch the payment of salaries to the members of staff and other expenses as usual.

IV. General

7. The depreciation on equipment and furniture should be adequately provided.
8. He should verify the closing stock.
9. The budgets formulated buy the committees should be compared with the actuals and the reasons for variations should be identified.
10. Supply of stores to various departments like different wards, operation theatre, outpatient unit, etc. should be checked.

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24.5 AUDIT OF CO-OPERATIVE SOCIETIES

24.5.1 General Introduction

The Co-operative Societies are established under the Co-operative Societies Act, 1912. Each state has passed its own Co-operative Societies Act for regulation of the co-operative societies. Registration, management, accounts and audit are to be carried out according to the provisions of these Acts.

A cooperative society should have a minimum of 10 members and the management of the society will be done by a committee consisting of elected members. Every society shall have its own bye-laws. The shares to be allotted to any member shall not be more than 10% of the total shares.

24.5.2 Auditor's Duties

The auditor of a co-operative society is appointed by the Registrar of Co-Operative Societies.

1. The auditor is supposed to have the knowledge of the Co-operative Societies Acts of Central and State Governments.

2. Register of members, counter foils of the receipts for the share capital received shall form the basis for vouching share capital.

3. Deposits accepted from members and non-members shall be vouched with the counterfoils of the receipts. Acceptability of deposits from non-members is subject to conditions laid down in the bye-laws.

4. The correspondence and vouchers have to be verified to vouch the loans from Central Cooperative Bank.

5. The rules regarding the loans to be given to members should be carefully observed and the auditor should see that the loans are not beyond the permissible limits.

6. Vouch the receipt of interest and recovery of loans from the borrowers with the agreements and rules and regulations of the society.

7. Vouch all the expenses with the receipts or vouchers.

8. If the society has surplus of incomes over expenses,. 25% of such profit be transferred to the Reserve Fund and 10% to Welfare Fund.

9. Vouch all the purchase of assets and see that the depreciation charged is appropriate.

10. If the society has deposited its surplus funds in Government Savings Bank and in other securities specified, the balances should be verified. Similarly the interests on such balances should also be accounted for.

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11. The auditor should see that the dividend payable to members does not exceed 6 ¼%.

12. The closing stocks should be physically verified and he should examine the method of valuing the closing stock so as to ensure that the stocks represent correct values.

13. The accounts are prepared by societies according to the provisions of the Societies Act. The Income Tax Act also has certain provisions relating to identification of income for societies. The auditor has to carry on his duties in accordance with these two Acts.

14. He should physically verify the cash and satisfy himself that the balance of cash agrees with the balance shown in the cash book.

15. The auditor should ensure that the Balance Sheet and Profit and Loss account are prepared in accordance with the requirements of the Co-operative Societies Act.

Check Your Progress

1. How do you vouch the incomes of a hotel?

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2. How do you verify the fees received by a school?

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3. If a hospital receives donations, as an auditor, how do you vouch them?

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4. Briefly state a few special points in respect of audit of a cooperative society.

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24.6 SUMMING UP

In every organization, the auditor should first assess the internal check existing therein.

In case of Hotel business, the auditor should pay special attention towards the visitors register. It is also necessary to vouch the purchase of provisions, wines, etc, and also their issues.

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In case of an educational institution the auditor has to verify the fees collected from students. Sub-division of fees into admission fees, tuition fee, games fees, library fees etc, should be separately, accounted for. The expenses for salaries, stationery, games and sports material should be vouched. All the assets, library books, sports material should be physically verified and valued.

In case of hospitals special attention is required towards fees collected from patients, purchase of medicines, purchase of equipment and other assets. The donations and legacies should be accounted for.

In case of cooperative societies, the auditor is appointed by the Registrar of Cooperative Societies. The auditor has to verify the Share capital, deposits form members and non-members, loans given to members and the incomes and expenses related to the main business of the society. The provisions of the Cooperatives Act and the bye-laws of the society must be kept in mind while proceeding with audit of a society.

24.7 ANSWERS TO CHECK YOUR PROGRESS

1. The incomes of a hotel comprise of sale proceeds of food stuffs and rents from the visitors (for the lodging). These incomes are vouched with the copies of the hotel-bills given to customers and the copies of the receipts given to visitors. Advance booking of rooms, food-items supplied to visitors are examined from the Visitors Book/Register.

2. The fees received from students is vouched from the copies of the receipts. The auditor should see that the fees are subdivided into various components such as tuition fees, sports and games fees, library fees. They should be separately accounted for. Each component should be verified with the budget allocations and the amounts spent.

3. It is very common for hospitals to receive donations and legacies from charitable institutions and philanthropists. The purpose for which these amounts are to be used may be specified by the donors. The auditor should verify the correspondence and agreements and should see that these funds are correctly used. The funds have to be divided between capital and revenue based on their purpose of use.

4. (i) The auditor should see that a member does not hold more than 10% or the capital of the Society.

   (ii) The share capital is vouched through the cash book, copies of the receipts given and the register of members.

   (iii) Borrowings from central Cooperative Banks should be vouched on the basis of the correspondence resolutions passed by the managing committee and the bank vouchers.

   (iv) The auditor should physically verify the assets, cash. The depreciation on the fixed assets should be appropriately calculated.

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BLOCK -VI

INVESTIGATION

Unit – 25 : Investigation – I

Unit – 26 : Investigation – II

Unit – 27 : Investigation – III

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24.8 MODEL EXAMINATION QUESTIONS

A. Answer the following questions in about 15 lines.

1. Explain the audit procedure in respect of a hospital.
2. What is a cooperative society? How is it registered?
3. How do you verify the fees collected from students of an educational institution?
4. Briefly state the vouching pertaining to visitors registers.

B. Answer the following questions in about 30 lines.

5. Draft an audit programme for the audit of the accounts of a high school.
6. A hospital is run by a charitable institution. It is rum with the help of the donations received from various donors. No charges or fees are collected from patients. How do you proceed to audit the hospital?
7. Give a detailed audit programme for the audit of a hotel which is providing boarding and lodging facilities.
8. What are the duties of an auditor with regard to the audit of a cooperative society?

24.9 RECOMMENDED BOOKS

1. Kamal Gupta : Contemporary Auditing (Tata Mc.Graw-hill Publishing Co.Ltd., New Delhi)
2. B.N. Tandon : Practical Auditing (S.Chand and Co., Ltd., Ram Nagar, New Delhi)
3. Spicer & Pegler : Practical Auditing (Allied Publishers Pvt. Ltd. New Delhi)
4. Dinkar Pagare : Principles and practice of Auditing (Sultan Chand & Sons, 23, Darya Ganj, New Delhi)
5. T.R. Sharma : Auditing (Sahitya Bhavan, Hospital Road, Agra)

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24.10 GLOSSARY

1. **Co-operative Society** : A Co-operative Society is formed with a minimum number of 10 persons and established under the Co-operative Societies Act, 1912. Each state will have one Registrar.

2. **Educational Institutions** : They are governed by the Charters. Trust deeds and University Acts.

UNIT – 25 : INVESTIGATION – I

Contents

25.0 Aims and Objectives
25.1 Introduction
25.2 (A) Meaning
(B) Definitions
25.3 Differences between – Investigation and Auditing
25.4 General Principles of Investigation
25.5 Duties of Investigator
25.6 Investigator's Report
25.7 Summing Up
25.8 Answers to Check Your Progress
25.9 Model Examination Questions
25.10 Glossary

25.0 AIMS AND OBJECTIVES

This unit aims at explaining (i) the term Investigation (ii) difference between Auditing and Investigation and (iii) General Principles of Investigation.

Having studied this unit, you will be able to:

- explain the meaning of the term Investigation;
- distinguish between Investigation and Auditing;
- recognize the general principles of Investigation.

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25.1 INTRODUCTION

Investigation is a short of special audit with a particular purpose in view. It is actually conducted in addition to the regular audit of accounts and is thus, enquiry into facts behind the books of accounts. Thus it is a special kind of audit with limited or extended scope depending on the purpose or the necessity of the situation for which it is conducted, hence, there is a need to know instance or circumstances where the investigation is conducted. In this unit the principles of investigation are discussed. The different circumstances where the investigation is conducted are discussed in the subsequent two units.

25.2 (A) MEANING

The term, 'Investigation', means a systematic examination of or an inquiry into the accounts and records of a business for a special purpose. It is a sort of special audit. It is critical, analytical and retrospective in its approach. The purpose of such an enquiry may be to ascertain the true financial position of the concern or the true earning capacity of the concern or to find out the extent of fraud or mismanagement, etc. Investigation is thus, a purpose oriented activity.

Investigation is conducted in addition to the regular audit of accounts. It is more than the verification of the financial statements and is not confined to financial statements or books

of account. It involves an inquiry into the facts behind the accounts. Thus, it is a special kind of examination of accounts and records carried out to bring out the reality of the situation or the true facts concerning it.

It is important to note that an investigation is analytical in nature. It, therefore, requires the capacity for observing, evaluating and collecting facts. An investigator does not accept a fact as correct until it is substantiated. For example, a professional accountant is appointed to investigate the alleged misappropriation of goods belonging to the concern. His objective is to find out substantive evidence in support of the quantitative and monetary figures of the opening stock, production, sales and closing stock. For this he would check all the related records or transactions thoroughly and scrutinize various transactions till he is able to find out exactly what he is looking for.

(B) DEFINITIONS

Investigation has been defined in different ways by different authors. There is no precise and universally acceptable definition of investigation. A few definitions are given below which should prove helpful to knowing what investigation is or means. According to Taylor and Perry, Investigation involves inquiry into facts behind the books and accounts, into the technical, financial and the economic position of the business or organization.

Dicksee has defined investigation as here under :

"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 object 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".

According to R.A. Irish, "While auditing procedure may be adopted for a great deal of work in investigation, an investigator must approach his work in a critical and perhaps, with suspicious state of mind. He may be deeply concerned about what should have been done rather confirmation of what has been done". Further, an investigator may be intensely interested in question of policy, a problem which is legally outside the scope of an auditor's liability.

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Definitions of investigation given above differ from one another in certain respects but they indicate the nature and characteristics of investigation.

Characteristics of an Investigation

From the definitions given above we can draw the following Characteristics of investigation:

i) Investigation is critical in nature and involves verification of specific records.

ii) Besides the detailed analytical study of books of accounts, the investigator may personally examine individuals, viz., Directors, Auditors and other officers of the concern.

iii) It involves the examination of not only the financial aspect but also the technical, political, social and economic and other aspects.

iv) Investigation is voluntary and contractual in nature, except in the case of companies. No specific rules and statutory regulations are prescribed for the purpose.

v) The Investigation is conducted for a specific purpose with limited or extended scope as the case may be.

vi) Finally the investigator submits the 'report' to his client/authority who has appointed him.

25.3 DIFFERENCES BETWEEN INVESTIGATION AND AUDITING

Investigation is a special kind of audit conducted for a specific purpose. It is of much wider scope than an audit. It differs from audit in its objectives and general approach adopted in carrying it out. The main differences between them are as here under:

1. The person who conducts the audit is called an 'auditor' and the one who conducts investigation is called an 'Investigator'.

2. Audit is conducted on behalf of the owners of the business, while investigating is conducted on behalf of the owners of the business where the fraud is suspected or on behalf of outsiders those who wish to join as a partner in the firm or who wish to lend money, etc.

3. Audit is legally compulsory in the case of companies, whereas investigation is voluntary and contractual in nature.

4. The audit is conducted to ascertain whether the Balance sheet exhibits true and fair view of the business concern, while investigation is conducted for a special purpose (e.g., to ascertain the true financial position or earning capacity of the concern).

5. Auditing is general, while investigation is specific in nature.

6. Audit covers an examination of books of account of a concern, where as investigation covers not only a thorough and critical examination of accounts but also an inquiry into facts behind the books of account.

7. Audit is periodical. It usually covers a period ranging from six months to a year. But investigation is not periodical and may cover a period ranging from three to seven years.

8. Audited accounts are not audited again except in the case of a special audit of a company under Section 233 A, but an investigation in most of the cases is conducted after the accounts have been audited.

9. In the case of audit the auditor has to see whether the method of the valuation of stock and other accounting principles have been consistently followed. That in the case of investigation, the investigator is not concerned whether the financial policy of the company is being followed or not. Further, the investigation is not at all bound by the accounting principles.

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10. In the case of audit the accounts of a company can be audited only by a qualified auditor, while an investigation can be conducted even by one who is not a qualified auditor. But usually experienced auditors will be appointed for conducting investigations.

11. In the case of audit an auditor is concerned with the prima facia evidence and he assumes that if there is nothing suspicious the figures and facts are true. That in the case of investigation the investigator looks for substantive and conclusive evidence and does not accept a situation unless it is supported with facts.

12. The 'report' of the auditor is sent to the Managing Director/Chaiman of the company, while the report of the investigator is sent to the party who appointed him for the purpose of investigation.

Thus, auditing and investigation are both involved in fact finding, but because of their basic nature and purpose differ in scope and degree of conclusiveness.

Check Your Progress - 1

What is the major point of difference between auditing and investigation?

25.4 GENERAL PRINCIPLES OF INVESTIGATION

The following are the general principles and rules to be observed while conducting an investigation. These principles and rules are helpful to the investigator in drafting his report also.

1. The investigator should obtain from his client clear instructions in writing regarding the objectives of investigation, the period to be covered and the limits, if any.

2. He should chalk out a programme according to the purpose of the investigation, and the period to be covered which will enable him to determine how much assistance he will need to carry it out.

3. He should exercise the utmost care, skill and diligence in carrying out an investigation.

4. He should act honestly and must not be influenced by any interested parties e.g., Directors, Managers, etc. It is only then that he will be able to set forth his findings in the most objective manner.

5. Wherever he finds it necessary he should not hesitate to get an expert's opinion.

6. He should keep in view that the report of the investigation should be relied upon by the client as well as the other parties.

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7. He should be very careful in drafting his report. Any misleading statement in the report may make the investigator liable for damages caused to his client.

8. The report should be precise and clearly worded. It should include the objectives, the scope of study/investigation and the limitations imposed, if any.

25.5 DUTIES OF THE INVESTIGATOR

The approach to be followed in connection with an investigation depends on the objectives, nature and the scope of the investigation. However, the following points in general may be kept in view while carrying on the investigation:

i) Identification of the objectives

Before commencing the investigation the investigator should clearly know what he is expected to do. It is often found very difficult for the investigator to decide upon what is to be one, when it is to be done and how it is to be done. Even if the broad objectives are set forth the investigator should get them so specified as to cover the desired aspects.

ii) Chalking out of the Investigation Programme

Having identified the objectives, the investigator has to prepare the investigation programme according to the objectives and scope of the investigation. This will enable him to complete the work within the stipulated time.

iii) Collection of Evidence and Investigation

Usually the investigation of accounts is carried on after the books of account have already been subjected to the regular audit.

In such circumstances the work of the investigator becomes simplified since he can assume that the accounts would be at least arithmetically correct. He can also make use of the auditors report.

But even then he should realize that investigation work is different from auditing work. He must collect the oral evidence of the officers of the concern and consider the following points:

i) he must find out whether there is any internal check system and whether there is any chance for misappropriation of goods,
ii) it is desirable to ascertain the general reputation of the promoters and the other parties associated with it. This will help him in conducting his investigation,
iii) wherever he finds it necessary he should consult the experts and obtain the necessary information,
iv) he should examine all the related items and bills,
v) he must take care to preserve all the working papers and notes made during the course of investigation for future reference,
vi) finally, he should draw his own conclusions and draft a report.

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Check Your Progress - 2

List out the duties of an investigator.

25.6 INVESTIGATOR'S REPORT

The investigator after completing the investigation as required shall submit a report of his investigation to his client. The report of the investigation must be drafted carefully. The investigator should analyse the data collected by him. He should draft the report with an unprejudiced mind. The report should include the following :

i) objectives of the investigation;
ii) scope of the study and the limitations imposed, if any;
iii) if the investigator does not want to assume responsibility with regard to the accounts, he should qualify his report to the extent;
iv) a brief account of the investigation and the result of his investigation;

The factors to be considered will depend upon the purpose for which the investigation is conducted. The conclusion of the investigation should be precise, to the point, and unambiguous, and the language in which it is drafted should be clearly worded.

25.7 SUMMING UP

Investigation is a thorough enquiry into the facts behind the books and records of a business concern. Investigation is conducted, in addition to the regular audit, for a special purpose. It is critical and analytical in nature and requires substantial evidence in support of facts or figures. The investigator should keep in view the principles such as objectives, period of investigation etc., before he proceeds the work of investigation. After completing the investigation, the investigator is required to submit a report on his investigation to his client.

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25.8 ANSWERS TO CHECK YOUR PROGRESS

1. Investigation is conducted in addition to the regular audit of accounts and is thus, a sort of a special audit with a particular object in view. Investigation is a thorough examination of accounts and records of a business concern pertaining to a period extending over three to seven years, whereas audit of accounts is usually for a year or six months.

2. i) Identification of the objectives.
   ii) Chalking out the investigation programme.
   iii) Collection of evidence and investigation.

25.9 MODEL EXAMINATION QUESTIONS

A. Answer the following questions in about 15 lines

1. What is Investigation? What are the characteristics of investigation?
2. State the principles to be born in mind before taking up investigation.
3. Write a short note on investigator's report.
4. What are the duties of investigator?
5. What are the general principles of investigation?

B. Answer the following questions in about 30 lines

6. Distinguish between investigation and auditing.
7. Define investigation? State what points the investigator should consider before he proceeds to investigation work.

25.10 GLOSSARY

1. **Investigation** : It is a thorough examination of books of accounts of business concern. It is a sort of special audit conducted for a special purpose.

2. **Investigator** : The person who conducts the investigation work is called investigator.

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UNIT – 26 : INVESTIGATION – II

Contents

26.0 Aims and Objectives
26.1 Introduction
26.2 Investigation on behalf of an incoming partner
26.3 Investigation on behalf of a lender of money
26.4 Investigation on behalf of a purchaser of business
26.5 Investigation on behalf of an investor
26.6 Summing up
26.7 Answers to Check Your Progress
26.8 Model Examination Questions
26.9 Glossary

26.0 AIMS AND OBJECTIVES

This unit aims at discussing the investigation on behalf of such persons as i) an incoming partner, ii) a lender of money, iii) a purchaser of a business and iv) an investor, who wish to know the earning capacity and the financial position of the concern.

Having studied this unit, you would be able to :

- Explain the various types of objects for which investigation are conducted.

26.1 INTRODUCTION

There are various types or objects for which investigations are conducted. But the usual circumstances which most frequently call for an investigation of accounts are :

1. Investigation on behalf of a person who wishes to become a partner in an existing firm;
2. Investigation on behalf of a client who intends to lend money to a concern;
3. Investigation on behalf of an individual or a firm proposing to purchase a business;
4. Investigation on behalf of an investor who wishes to invest in a company;
5. Investigation in case of a suspected fraud;
6. Investigation under the provisions of the Companies Act, 1956, and
7. Investigation in connection with the tax liability.

In this unit we shall consider the first four cases and discuss them in detail. The remaining three will be discussed in the subsequent unit.

26.2 INVESTIGATION ON BEHALF OF AN INCOMING PARTNER

A person who wishes to join an existing business as partner naturally desires to know the earning capacity, profitability, soundness and solvency of the firm. The help of an investigator may be sought to get the desired information. The investigator in such a case has to carry out the kind of historical study of the concern's earning capacity, profitability, financial position, etc. He has to take certain steps and conduct certain enquiries.

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Preliminary Steps

The investigator has to take the following preliminary steps, when called upon by his client who wishes to join an existing firm as a partner.

i) He must get clear instructions in writing from his client as to the purpose, period, and the scope of the investigation.
ii) He must study the internal check system, if any, in the organization
iii) He must obtain copies of financial statements for the period to be covered by investigation, and
iv) Finally he must chalk out his investigation programme.

Having considered these preliminary steps, the investigator should pay attention to the following points.

1. The reasons why the continuing partners wish to admit a new partner.

If one of the partners is leaving the organization the investigator should try to know the real cause for his leaving the organization. If the old partner is leaving the firm because of disputes, mismanagement etc., the investigator can straight away advise his client not to join the firm.

2. Whether the firm is financially sound or not and whether the partners are financially sound or not is to be found out.

3. The investigator should examine the partnership deed of old partners and the proposed partnership deed to make sure that there is nothing in it which would prove detrimental to the interest of the incoming partner.

4. If the new partner is admitted in place of a deceased or retiring partner, it has to be ascertained whether the business will suffer for want of skill, expert knowledge possessed by the deceased or retiring partner, and to what extent loss is likely to be made good by the incoming partner.

5. He should find out the earning capacity and the financial position of the business and should make comparative examination of the Trading and Profit and Loss accounts of the firm of the preceding few years, since the client's interest will be affected if there have been heavy losses. He should also examine the Balance Sheet of the firm to ensure that the values placed against various assets and liabilities are correct. There will be an adverse effect on the incoming partner in the event of over-valuation of assets or any omission of liabilities.

6. If the incoming partner is required to pay for goodwill, the investigator should ensure that the financial estimate of goodwill has been made on the recognized and accepted basis.

7. The investigator must find out whether the capital to be introduced by the new partner will be used for paying off old liabilities or for utilizing it as additional working capital or for the expansion of business. He should ascertain whether the

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capital to be brought in by the new partner will be sufficient for the proposed expansion.

8. He should ascertain the probable amount of profits that the intending partner would get, which will help him to know whether his client would be able to get a reasonable return on his capital.

9. He should examine the tax liabilities of the continuing partners to make sure that the tax liability is not required to be met by the incoming partner.

10. He should study the relations between the existing partners as personal relationship count more than anything else in partnership.

After considering all the points mentioned above, the investigator should prepare a report embodying all the information which he secured in the process of investigation and submit it to the client to enable his client to come to a right decision.

Check Your Progress - 1

Generally on what aspects, the investigator will pay attention to find out facts in the case of investigation on behalf of incoming partner.

26.3 INVESTIGATION ON BEHALF OF A LENDER OF MONEY

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Generally, banks and financial institutions are the main sources for borrowing money, the lending of money may be in the form of loans, overdrafts or the discounting of the bills, etc. These institutions, therefore, would like to know the financial position of the prospective borrower. The bank may lend money after examining the latest audited Balance Sheet of the borrowing concern, when the amount involved is a small one. But when the amount involved is a large one, the bank may hesitate to lend money even after examining the audited Balance Sheet of the borrowing concern. In such circumstances an accountant is appointed to investigate into the financial position of the borrower and suggest whether money should be lent or not. Investigations may also be conducted on behalf of a private money lender.

The basic objectives in this regard are

i) to judge whether the applicant will be able to generate enough funds to repay the debt along with the amount of interest; and

ii) to find out the effect of loan with regard to the earning capacity and the repaying capacity of the borrower.

The investigator should obtain the past and projected financial statements from the applicant for scrutiny, so as to determine the repaying capacity of the borrower. Further, the investigator should pay attention to the following points.

1. The reason for taking the loan: The investigator should find out whether the additional fund thus raised is to be utilized for productive purpose or otherwise.

2. a) He should know whether the borrower has already tried to obtain the loan from other institutions and

   b) If they have refused to give him loan, what the reasons have been for refusing it.

3. The nature and the exact value of the securities offered for obtaining the loan should be ascertained. He should see whether the security offered is adequate. Further, the investigator should find out whether the security offered against the loan has already a prior charge and if so, what the value of that charge is and what effect it has had upon the client's position.

4. He should ascertain the exact standing of the concern by preparing a statement of its assets and liabilities so that the repayment capacity of the concern can be known.

5. He should find out the details with regard to contingent liabilities, if any, of the concern, which arise due to bills discounted, accommodation bills or guarantee given, etc. These contingent liabilities, when they become actual, will have affect the capacity to pay back to loan.

6. He should find out the ratio of current assets to current liabilities and the debt equity ratio, which reveal the solvency of the concern.

7. He should find out the normal earning capacity of the borrower. This can be ascertained by examining the profit and loss accounts for the preceding several years, and if required, he should obtain a copy of the projected financial statement for the following 5 to 7 years. The loan would be 'safe', if the earning capacity of the borrower is good.

8. Particulars of any capital commitments of the concern should be ascertained.

9. He should also make inquiries about the ability, experience and character, etc., of the borrower to make sure that the loan will be repaid in time.

10. In the case of a public limited company the investigator should ascertain the borrowing powers of the directors by looking into the Memorandum of Association and Articles of Association, and he should ensure that the proposed loan is within the borrowing powers of the directors.

11. Finally, he should find out the fluctuations in respect of the business, if any, through a study of the trends.

Check Your Progress - 2

What are the main aspects to be examined in the case of investigation on behalf of a lender of money.

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26.4 INVESTIGATION ON BEHALF OF A PURCHASER OF A BUSINESS

When a person intends to purchase a running business he would be interested in knowing (i) the true worth of fair value of its present financial position and (ii) future prospects of the business. An accountant, when called upon by his client to conduct an investigation of this type, should obtain as much information about that business as possible because to a very large extent the client's decision in this regard will be based on his report. Therefore, he should pay attention to the following points.

1. The reasons for the proposed sale by the vendor of the business should be ascertained. If it is on account of severe competition in that particular business, which in turn has resulted in poor turnover it would not be advisable to purchase such concern.

2. He should find out whether any skill or technical knowledge is required for carrying on the business.

3. He should see whether the proposed business will face any new competition in the near future.

4. He should decide whether the vendor is to be allowed to carry on a similar business and if so, he is to be restrained from soliciting the old customers with whom he used to deal. However it would be better if the vendor is not allowed to carry on a similar business.

5. He should examine the previous year's 'Audit Report' if any.

6. He should ascertain the true 'earning capacity' of the business, which can be found out by a careful analysis and examination of the past results as in the following ways:

   i) Careful examination of the Profit and Loss Account for the period covered by the investigation;
   ii) Calculation of percentages of various items to the turnover to see whether there is any marked variation in the previous percentages from year to year. If it is so, he should probe deeper into the matter.
   iii) Detailed examination and vouching of books of accounts, particularly capital and revenue expenditure as well as the deferred revenue expenditure.
   iv) Calculation of average normal profit, which the concern is expected to earn out of such a business.

7. He should make sure that the assets and liabilities as shown in the Balance Sheet have been properly valued and whether the depreciation provided on these assets is sufficient and whether provision made for bad and doubtful debts is sufficient.

8. He should ascertain the value of the goodwill of the concern unless it has already been agreed upon, paying attention to the method of its valuation.

9. He should consider the reasonability of purchase consideration agreed to and the value of goodwill estimated keeping in view the future earning capacity of the business.

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10. He should find out the amount of working capital and ensure that it is adequate to carry on the business.

11. He should ascertain whether the change in ownership will affect the customers and the employees' attitudes.

12. Capital and revenue expenditure should be properly vouched. He should see whether proper allocation has been made between the two. Further, he should see whether in respect of deferred revenue expenditure some of the amounts have been debited to the profit and loss account, which ought to have been written off.

13. Further, he should pay special attention to the following points:

    a) stock taking procedures, costing methods and valuation procedures;

    b) the expenses to ensure that they are reasonable. Some times, the Profits of the concern may be inflated by:
       i) inflation of closing stock;
       ii) inclusion of fictitious sales
       iii) inclusion of goods on sale or return basis in the sales
       iv) commission of purchases
       v) capitalizing of the revenue expenditure
       vi) commission of wages, and other expenses
       vii) treatment of capital income as revenue income
       viii) inadequate provision for depreciation or less provision for bad and doubtful debts, etc.

Whenever the profits of a concern are inflated, the investigator should pay attention to the above-mentioned points and make the necessary adjustments in order to arrive at correct profits.

14. He should see whether the reserves are adequate.

15. He should check the amounts of debtors and creditors to be taken over.

16. He should make sure that all outstanding liabilities and contingent liabilities are brought into account.

17. Finally, macro studies should be made regarding the return on investments, assets turnover, current liabilities to current assets, stock value to turnover and profit earning ratio etc., so that the future prospects of the concern can be known.

In case the business proposed to be acquired is a limited company, the investigator should pay special attention to the following points:

1. Memorandum of Association, Articles of Association and the prospectus of the company should carefully be examined.

2. He should find out the amount of authorized, issued , called up, and paid up capital of the company.

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3. He should find out the amount of uncalled capital, reserve capital and calls in arrears.

4. He should also examine the rights of different classes of shareholders of the company.

5. The rate of dividend which was paid in the past and whether there is any arrears of dividends to be paid should be ascertained.

6. The present value of the shares of the company quotes in the stock exchange should be found out.

7. He should make a correct valuation of all the assets of the company proposed to be taken over and make sure that all the liabilities have been brought into account.

The accounts having been investigated, it is assumed that the profits shown by the books of accounts of the concern to be taken over are correct, However , certain adjustments have still to be made on the profits in order to arrive at the probable normal earning capacity of the concern in the future.

The following items usually be found necessary to add back to the Profits:

i) Rent; if the purchaser is going to purchase the business premises which is being utilized by the vendor, who has been paying rent on it.

ii) Interest on the partner's capital and current accounts, partners salaries if any (as they will not have to be paid after the purchase)

iii) interest on loans and overdrafts, if any, when the purchaser is not assuming then to be taken over.

iv) Exceptional loss not resulting from the ordinary course of the business, e.g., loss by fire, theft, costs and damages incurred by litigation or loss arising from speculation, etc.

v) Capital loss, i.e., loss on sales of any fixed assets which was debited to the Profit and Loss Account.

vi) Capital expenditure items, wrongly charged to the profits and loss account, if any.

vii) Discount on purchases, if any,

viii) Excessive reserve made for bad and doubtful debts or depreciation, etc.

The following items should be deducted from the profits

i) Rent : if no charge has been made for this in the profit and loss account, and the purchaser is not going to purchase the business premises.

ii) Interest on the partner's drawing, which was credited to the profit and Loss account.

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iii) Any managerial remuneration expected to be incurred by the purchaser.

iv) Exceptional profits not arising from the ordinary course of the business; e.g., speculative profits.

v) Capital profits such as profits on sales of investments or other fixed assets.

vi) Revenue expenditure, if wrongly capitalized.

vii) Insufficient reserve, if any, made in respect of bad and doubtful debts or depreciation, etc., it should be deducted to the extent to which it has not been adequately provided for.

viii) Income from assets not being taken over by the purchaser.

After making all these adjustments, the investigator will be in a position to find out the profits which the intending purchaser will be able to earn after acquiring the business.

Having thoroughly investigated all the facts to his satisfaction, the investigator should prepare the report and submit it to his client. The report must be worded in clear and unambiguous language. It may be unwise to fashion the report in terms of buy or don't buy which is an entrepreneurial decision. But the report must be clear, concise, correct and must give full material information on all the important points that would help the client to come to a correct decision.

Check your progress - 3

Mention any two important points to be investigated by the investigator in the case of investigation on behalf of a purchaser of a business.

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26.5 INVESTIGATION ON BEHALF OF AN INVESTOR

A person or firm intending to invest in a company, in the form of shares or debentures or otherwise in the form of deposit would like know the following:

a. reasonable price that can be paid for the shares;
b. safety and security of the amount invested;
c. rate of return on the amount invested; and
d. the future prospects of the business.

For the purpose, the investigator may be called upon to ascertain the earning capacity of the company, or in other words, to ascertain whether it will be profitable or not to make such an investment.

An investigation for this purpose, will cover the same aspects as an investigation on behalf of a lender of money, except that the investigator in the present case should pay special attention to the maintainable profits and the trend of business. Further he should inquire into (i) Preference Shares, (ii) Equity Shares and (iii) Debentures.

Preference Shares

Where it is proposed that an investment should be made in the Preference shares of the company, the investigator will have to inquire into the following:

1. The investigator should study the Memorandum of Association and Articles of Association to ascertain the following :
    i) the terms and conditions with regard to issue of Preference shares,
    ii) voting rights of different class of shareholders
    iii) rights of preference shares

2. whether these preference shares are listed in the stock exchange

3. He should find out what the rate of dividend is and whether the rate fixed is reasonable. The rate should be compared with the interest rate prevailing in the market. Further he should ascertain whether the dividend is cumulative or non-cumulative. The cumulative dividend is always preferred.

4. If the shares are quoted in the market, their present values should be ascertained, so as to determine the price of the shares on the basis of current level of interest prevailing in the market.

5. He should examine the marketability of these shares.

6. If shares are redeemable, the date on which the redemption can be effected and the premium, if any, should be ascertained.

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Equity Shares

If the prospective investor proposes to invest in the ordinary shares of company, the investigator will have to pay the following points:

1. The investigator should study the provision of the Memorandum of Association and the Articles of Association pertaining to :

    a) Proportion of the equity shares to the preference shares,
    b) The rights of equity shares and preferences shares,
    c) Any other extra rights granted to preference share holders, and
    d) Whether company has the right to issue further preference shares and if so, to what extent it will affect the position of the equity shareholders.

2. He should study the rate of dividend, and make a comparative study of the rate of dividend declared on equity shares and other companies engaged in a similar business.

3. He should examine the various provisions of reserves which may limit the rate of dividend on equity shares. The funds to be set aside out of the profits of the company

may be (a) for the redemption of the preference shares or debentures or (b) for making a provision for working capital.

4. He should find out the fair value of the equity shares of the company. To get a rough idea, he should ascertain at what price the shares of the company were purchased and sold in the past. The current value may be determined either on the basis of the net assets of the Company or on the basis of yield or profits of the company.

a) On the basis of the net assets of the company

Under this method, the total amount of liabilities is deducted from the total value of the assets. The balance so arrived at is divided by the number of shares to ascertain the fair value of shares.

For example : A company has the assets worth Rs.1,80,000 and liabilities amounting Ra. 60,000 and issued 10,000 equity shares.

$$\text{Values of shares} = \frac{\text{Total assets} - \text{total liabilities}}{\text{No .of shares.}}$$

Therefore,

$$\text{The value of share} = \frac{\text{Rs. 1,80,000- Rs. 60,000}}{10{,}000} = \text{Rs. 12/-}$$

b) on the basis of the yield or profits of the company

Under this method, the investigator should:

i. ascertain the amount of profit available to ordinary shareholders and
ii. find out the average rate of income from investment in other companies of similar nature.
iii. ascertain the capitalized value, The capitalized value so arrived at is divided by the number of shares to get the desired results.

For example, if the amount of profit available to ordinary shareholders is Rs. 10,000 and if the average income rate of other concerns engaged in similar business is about 10%

The capitalized value of the equity shares at the rate of 10% is

10 100
10,000 ....?

$$\frac{\text{Rs. 10,000 x Rs 100.}}{10} = 1{,}00{,}000$$

Therefore, the value of the shares is

$$\frac{\text{Rs. 1,00,000}}{\text{Rs. 10,000}} = \text{Rs. 10/-}$$

Hence, the value of each share will be Rs.10/-

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Thus , the investigator should determine the value of share and decide whether the price to be paid by his client is reasonable or not

5. He should enquire into the business fluctuation, if any;

6. He should project the future trends capacity of earning of the company by making an analytical study of the profit and loss account and the Balance Sheet of the previous two or three years. A comparative study of the percentages of turnover to gross profits of the company for the past two to three years may also be made.

7. The investigator should examine the expansion programme and estimate the proportion of future profits

Debentures

If it is proposed to invest in the 'debentures' of the company or to lend money to it, the investigator will have to proceed on the following lines:

1. The purpose of obtaining long term loan or issue of debentures should carefully be inquired into. If it is for the purpose of expansion of the business, the earnings of the concern would be increased in order that the investment may be safe.

2. He should study the provision of the Article of Association to ascertain the borrowing powers of the directors of the company and the various resolutions passed in its General Body meetings.

3. The terms and conditions of the issues of debentures should carefully be scrutinized.

4. He should pay special attention to the rate of interest on debentures to see whether it is reasonable. It should be compared with the rate of interest prevailing in the market. Further, it should be ascertained whether the company has been paying to its lenders regularly.

5. He should study the nature, stability and earning capacity of the business. The more the company earns, the greater would be the security to the investor.

6. The marketability of the debentures should be ascertained.

7. Whether the debentures are free, mortgaged ,having fixed charge, or floating charge should be scrutinized.

8. He should ascertain the time and terms of redemption of debentures. In case the sinking fund is created for the purpose, there would not be any problem for the redemption of debentures.

Thus, the investigator should prepare his report covering all the material facts. The report should be factual and expressed in clear terms so as to enable the client to take the right decision. An investigator is not expected to assure any guarantee regarding the rate of return on investment. He should not do so; if he does and if that particular concern incurs loss, the investigator may become liable for it.

B R A O U

Check your progress - 4

On what aspects, the investigator is required to find out facts when a person intending to invest in a company?

26.6 SUMMING UP

Investigation on be half of an incoming partner involves a thorough enquiry of facts such as profitability, financial position, solvency of the firm, partnership deeds, reasons why continuing partners wish to admit a new partner etc.

The money lenders are interested in knowing the financial position of the firm / borrower, the reasons for taking the loan, contingent liability ,if any, the liquidity position of the company, etc.

A person intends to purchase a running business is interested in knowing the present financial position of the concern and the future prospects of the business.

The prospective investor would be interested in knowing the safety and security of the amount invested, rate of return of the business, market price for shares, etc.

After a thorough investigation, the investigator should report, covering all material facts, to his client to take the right decision.

26.7 ANSWERS TO CHECK YOUR PROGRESS

1.The investigator will examine thoroughly the following aspects on behalf of incoming partner:

i) partnership deed of old partners and the proposed partnership deed;
ii) financial position of the business concern and good will of the business in market;
iii) relationship and co-operation between existing partners.
iv) Tax liability of firm, etc.

Depending up on the situation or financial position of the firm, the investigator advises his client to join or not to join the firm.

2. The following are the main aspects to be examined in the case of investigation on be half of a lender of money.

i) the financial position of the prospective borrower
ii) the liquidity ratios such as current ratio and quick ratio. i.e., liquidity position of the borrower
iii) reasons for borrowing,
iv) contingent liability, if any.

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3. i) the true worth of fair vale of its present financial position, and
   ii) future prospects of the business.

4. i) safety and security of the amount invested,
   ii) rate of return on the capital invested,
   iii) price for the shares in the capital market,
   iv) future prospects for the business

26.8 MODEL EXAMINATION QUESTIONS

A. Answer the following questions in about 15 lines.

1. What are the purposes for the which investigation may be conducted.
2. Explain the yield basis of valuation shares of a company.
3. Investigation is always for a particular purpose where as auditing is for a particular period. Discuss.
4. If a company shows inflated profits in its books of accounts. On what aspects, the investigator would enquire into matter?
5. If the prospective investor proposes to invest in Debentures of a company, on what matters the investigator will have to enquire into ?
6. If the investor intends to invest his money in the preference shares of a company, how would you investigate?

B. Answer the following questions in about 30 lines.

7. If you are asked by a bank which proposes to lend a large sum of money to existing business, how would you undertake the investigation?

8. A client of yours intends join a in firm as a partner and requests you to undertake an investigation for the purpose, how would you proceed?

9. What points would you bear in mind in conducting as investigation on behalf of an individual proposing to buy a running trading concern?

10. What points would you consider necessary in the valuation of shares of a company?

26.9 GLOSSARY

1) Incoming Partner : A person who wishes to join in existing firm as a partner is called incoming partner.

2) Lender : One who lends money on the condition that it would be returned later.

3) Investor : One who invests his money, in a growing business, to make more money out of something (investment) that will increase in value.

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UNIT – 27 : INVESTIGATION –III

Contents

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27.0 AIMS AND OBJECTIVES

This unit aims at discussing (i) investigation into fraud,(ii) investigation under the provisions of the Companies Act.1956, (iii) investigation in connection with tax liability, and (iv) special audit of companies.

Having gone through this unit, you will be able to:

- know different aspects of investigation into fraud
- understand the procedure of investigation under the provision of the companies Act, 1956;
- recognize the investigation in connection with tax a liability; and
- understand the procedure of special audit of companies.

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27.1 INRODUCTION

This unit is a continuation of the previous unit under which we have discussed the four types or objectives for which investigation is conducted. In this unit, the other types of investigation such as investigation into a fraud, investigation under the companies Act, investigation in connection with tax liability will be discussed. In addition to the above, this unit highlights the procedure of special audit of companies

27.2 INVESTIGATION INTO A FRAUD

When an investigator is called upon to investigate a case of a suspected fraud, he should exercise the greatest care and skill in the conduct of such an investigation . It is not an easy task. He must act like a detective. He should first inquire into the nature of the fraud suspected.

It is very difficult to set forth different methods of fraud, as there are various ways of committing fraud. Usually, the fraud arises from want of effective internal check system. According to Kohler, fraud may be defined as "the successful practice of deception or artifice with the intention of cheating or injuring another". Fraud involves stealing of cash or cheques, defalcation of goods, followed by steps to conceal the theft by misrepresentation of

facts. Fraud is usually committed in the following three ways :

A. Misappropriation of cash
B. Misappropriation or defalcation of goods
C. Manipulation of accounts.

Let us discuss each of these cases and the line of action to be followed by the investigator in each case:

A. Misappropriation of Cash

Misappropriation of cash means stealing or embezzlement of cash or pilfering cash from the cash box. Generally the cashier who has access to the books of accounts prepares this type of frauds. However, case of fraud is misappropriation of cash, which may vary in accordance with the nature of the business and the opportunities available to the employees.

It would be impossible to list out all the methods of misappropriation of cash as they are limitless in number. Cash may be misappropriated in any of the following ways.

i. Pilfering cash from the cash box, which will result in shortage of balance;
ii. Omitting to record the receipts of cash in whole or in part
iii. Not recording some of the credits sales. i.e., when cash is received from the buyers, it is misappropriated;
iv. Not entering the goods returned from a customer and then misappropriating the cash realized from the subsequent sale of the same;
v. Recording fictitious payments;
vi. Entering amount in excess of what has been actually paid, etc.

Preliminary steps

Before he actually commences the examination of the books of account the investigator should take certain preliminary steps which will facilitate his tasks to a great extent. They are the following.

i. He should ascertain from his client the period or the date from which he should commence the investigation .
ii. He should study the internal check system that is in force in the business;
iii. He should know from his client about the nature of the fraud suspected;
iv. He should find out from his client if he suspects any particular individual for the fraud. If it is so, he should carefully note down his duties and the extent of his control cover the books of account.

Having ascertained the particular nature of the business, and the nature of fraud, the investigator should plan his line of action that is to be adopted.

Procedure of investigation

The line of procedure that is to be adopted depends upon the nature of the fraud suspected. The investigator should follow the line of action as far as possible. Matters which may require close examination include the following:

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1. The investigator should first acquaint himself with the nature of the fraud and obtain a complete list of books of accounts maintained by the concern.

2. He must examine the system of internal check which is in force with regard to cash receipts and payments.

3. He must also know the respective duties of the employees in order to find out the opportunities if any, which they may have for misappropriation .

4. He should also examine the method of recording the transactions in the Cash Book and other subsidiary books.

5. He should vouch the cash book very carefully. If the internal check is not effective, he will have to check the cash in detail, i.e., the opening and closing balances of cash in hand and cash at bank and comparisons of the receipts as shown by the cash memos with the entries in cash book etc. If he finds any cash memos missing or any alterations in the cash memos he must ask for explanations.

6. In the absence of internal check, the whole of the cash book and the postings should be checked in detail.

7. He should check the discounts appearing in the cash book and see that all the discounts allowed are in order and correct.

8. All cash payments with the help of supporting invoices or receipts should be carefully vouched. If the payments have been made through cheques, he should ascertain the names of the payees. He should also find out who is to authorize to sign and endorse the cheques. Further, he should verify carefully the petty cash transactions as they are usually a sources of fraud.

9. The payments in respect of salaries and wages should be verified to ensure that they are bonafide, and duly authenticated.

10. The bank transactions should be checked with the Bank Pass Book should be compared with the cashbook after reconciling the bank balance.

11. All erasures and alterations of figures should be scrutinized carefully.

12. Lists of bad debts' should be obtained and ascertain whether the bad debts written off are really 'bad debts'.

13. He should obtain duplicates for all missing vouchers.

14. He should compare the counter foils of pay-in-slips with the entries in the cash book. If there is any difference between the two, a proper explanation must be asked for. Further, it is necessary to check the 'teaming and lading'. This means that where identical amounts are received from different customers periodically, the cash received from one customer may be misappropriated and cash received from another customer credited to the first customer's account, and later on when cash is received from a third customer it is credited to the second customer and so on. Thus, accounts receivables get

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the same treatment as that of delayed credit except in the case of the last one in the series, which is not recorded.

15. Special attention should be paid towards unusual receipts. Such as cash received from debtors which might have been written off as 'bad debts' in the past, and sale of waste material etc., which might have been misappropriated.

16. All the transactions relating to Bills, especially those concerning Bills receivable, Bills in hand and dishonored bills, etc., should be carefully examined.

The investigator should thus investigate all irregularities and probe into them.

B. Defalcation or Misappropriation of goods

Defalcation of goods is more common in organizations than any other and it is usually done by the trusted employees. Defalcation of goods means the stealing or pilfering of goods. Often minor thefts of goods add up huge monetary losses to the organization. It would be extremely difficult to identify those responsible for this type of fraud, specially in the case of (a) a manufacturing organisation, where the process of raw material, work in progress and finished goods are involved; and (b) where the goods are not voluminous but very costly.

The investigator will have to devise the line of investigation according to the circumstance of the case. However, the following points may be helpful in detecting the pilfering of goods;

1. The investigator should ascertain whether any internal control system is in force or not if not so, it should thoroughly be investigated.

2. He should study the system followed by the business with regard to receipt and despatch of goods.

3. He should see whether proper stock account is maintained or not.

4. Where inward consignment goods are dealt in, he should see that these goods are not mixed up with sales.

5. He should ensure that all the returns relating to purchases and sale of goods are supported by the proper debit note and credit notes. If there is any loop-hole must be probe into the matter.

6. He should compare the stock records with the entries in the financial books.

C. Manipulation of Accounts

The fraudulent manipulation of accounts without corresponding defalcations, usually takes place in the form of the inflation of assets or the omission of liabilities. The manipulation of accounts means the misrepresenting of certain facts of figures. Which renders the financial statements misleading. Accounts may be manipulated by:

a) Owners: to show more profits for the purpose of raising additional finance or to show less profits to pay less income tax;

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b) Directors and Major shareholders: to show more profits so as to get higher dividends;

c) Managers: to show more profits aiming at earning more commission or remuneration;

d) Employees: to hide discrepancies for which they are responsible.

In all these situations there will be a falsification of records to conceal the true position. There are various ways of manipulating the accounts. Usually, the manipulation of accounts takes place in the following ways.

a) Showing less profits: Profits less than those actually earned are shown by recording :

i) more expenses or fictitious expenses; ii) less sales; iii) under valuation of closing stock; iv)omission of accrued income; v) debiting capital expenditure to revenue expenditure and; vi) wrongly enhancing advertising or organization expenses and so on.

b) Showing more profits : Profits which are more than those actually earned are shown by :

i) omitting to record expenses; ii) debiting the revenue expenditure to capital accounts; iii)over valuation of closing stock; iv) entering fictitious sales or v) treating goods sent on 'sales or return' as sales and including inward consignment stock in the closing stock, etc.

Investigation Procedure

The investigator should adopt the usual procedure of vouching and verification as discussed above in the case of misappropriation of cash and goods. In addition, he should pay attention to the following points :

1. He should see what accounting method is in force.

2. He should scrutinize the purchase and sale transactions.

3. He should verify the assets and liabilities.

4. He should examine the profit and loss account and compare the gross profit ratio and net profit ratio with those of the previous years. If there is any variation, he should inquire into the matter.

5. He should carefully examine all the connected documents and pay particular attention to any area or areas requiring value judgment.

The investigation having been completed, the investigator will report to his client on the frauds detected the conditions under which they were committed, the person or persons responsible for it and suggest ways and means to prevent such frauds from occurring in future.

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Check Your Progress - 1

List out the ways the fraud is usually committed.

27.3 INVESTIGATION UNDER THE PROVISIONS OF THE COMPANIES ACT, 1956.

For the investigation of the affairs of a company, the companies Act, 1956 has made certain provisions.

The first is an investigation into the affairs of a company under Section 235 or 237 including those of the related companies under Section 239.

The second one is an investigation into the ownership of a company or its associate ship under Sections 247, 248 and 249.

The Central Government may appoint inspectors to investigate into the affairs of a company in the following circumstances:

1. In the case of a company having share capital, on the application of 200 members or members holding not less than 1/10th of total voting power therein (Section 235 (a));

2. In the case of a company not having share capital, on the application of not less than 1/5th of total number of members (Section 235 (b))

In the two cases cited above, the applicants must support their application with evidence, showing that the applicants have good reasons for requiring investigation and furnish security of Rs. 1000 towards the cost of investigation (Sec.236)

3. The Registrar of the Companies make a written report to the Central Government (for the appointment of inspectors) complaining that;

   a) he has not received certain information or explanation which he required; or

   b) the books, documents or other information filed by the company, disclose an unsatisfactory state of affairs; or

   c) it has been represented to the Registrar that the affaires of the company have been carried on fraudulently (sec, 234)

4) The Central Government may also appoint inspectors in the following circumstances, it believes that
   a) the business of the company is conducted with the intention of defrauding its creditors, the members or any other persons; or

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b) the company is formed for a fraudulent or unlawful purpose; or

c) the person concerned with the formation of the company or the management have been quality of fraud, misfeasance or misconduct towards the company or any of its members ; or

d) The members of the company have not been given full information in respect of its affairs, including the commission payable to managing agents, managing directors, etc., of the company.

5) The central Government should appoint inspectors in the following two cases:

a) If the members of the company have passed a special resolution for the appointment of inspectors to get the affairs of the company investigated; or
b) If the court, by order, declares that the affairs of the company ,ought to be investigated by an inspector.

Ownership of the company (under section 247): The Central Government may appoint one or more inspectors to investigate and report on the membership of the company and other matters relating to the company for the purpose of determining the true persons.

a) Who are (or have been) financially interested in the success or failure, (whether real apparent) of the company or (b) those who are (or have been) able to control or materially influence the policy of the company.

The central Government may define the scope of investigation , the duration or the matter to be covered, while appointing such inspectors.

The cost of the investigation is borne by the Central Government out of the money provide by the Parliament. But the Government may order the recovery of the expenses from the persons on whose application the investigation has been ordered.

According to section 238. a firm, a body corporate or other association cannot be appointed, as inspector. A professional accountant can be appointed as inspector. The inspector so appointed has wide powers to examine any books of account, documents, vouchers etc., and can look into the ownership, controlling groups or the conduct of any Director, Managing Director, Managing Agents, Secretaries and Treasurers, etc., who are or have been connected with the company, its holding or subsidiary company. He can examine any officer of the company on oath (sec.240).If any such officer refuses to produce the books of account or documents etc., he is liable to be punished (Sec 240).

Where as inspector investigating the affairs of the company thinks it necessary to investigate the affairs of another company in the same management, he is empowered to do so. However , in some cases, the inspector has to obtain prior approval of the Central Government for the purpose.

The inspectors so appointed for the purpose shall pay special attention to the following points:

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1. Whether the funds of the company are properly used;

2. Whether the remuneration of the directors, managing director, managers, secretaries and treasurers, etc., have been paid according to the Companies Act;

3. Whether loans and advances to the directors, the interest charged on such loans and the security offered by directors etc., should be examined.

4. Whether the contracts entered into by the directors and managing agents with outsiders should be examined.

Powers of the Inspector (Sec. 240)

The inspector who has been appointed by the Central Government under Section 235 to investigate into the affairs of the company has the following powers.

1. He can demand the production of any books, documents, or papers, etc., from any officer, employees or the agents of the company or the related body corporate. Related companies include the company's subsidiary or subsidiary of its holding company, or a holding company of its subsidiary (Sec. 239)

2. Under the Companies (Amendment) Act, 1965, with the prior approval of the Central Government, he can demand any information, production of any books, documents, etc. If he thinks it necessary for the purpose of investigation from any other body corporate other than those specified above.

3. He can examine on oath any officer, employee or agent of a related body corporate. With the prior permission of the court, he can examine any other person whom he is not empowered to do so.

4. He can, with the prior approval of Central Government summon any other person and examine him on oath.

5. He can seize with the prior permission of Magistrate the books, documents, papers, etc., of the company or of any related body corporate and retain them till the conclusion of the investigation, if he is of the opinion that these books, documents, papers, etc., are likely to be destroyed, falsified, altered, or mutilated (Sec. 240 A).

With such permission he may also enter the place where the books are kept to search for the required books, papers, etc., and seize them.

If any officer, employee or the agent of the related body corporate fails to produce the books of account, documents, papers etc., or refuse to furnish any information sought by the inspector he will be punished with a fine upto Rs. 2000/- or imprisonment upto 6 months or with both.

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Duties of the Inspector

The inspector so appointed as above to conduct an investigation should first get the instructions in writing regarding the scope of inquiry its objects and the period which has to be covered and then he should consider the following points:

1. Whether the books of the company have been maintained in accordance with the provisions of the Companies Act.

2. Whether the authorities of the company are misusing their powers.

3. The contracts entered into by the authorities with other companies should be inquired into.

4. He should interrogate the directors and officers of the company. If he thinks necessary he may interrogate the directors and officers of related companies.

5. He should compare the profits of the company with those actually distributed by way of dividends.

6. The assets and liabilities of the company should be verified to ensure that they are properly valued.

7. Whether the funds of the company are properly used.

8. Whether the remuneration of directors, managing agents, secretaries, treasuries, etc., have been paid according to the Companies Act.

9. He should enquire into the inter-company dealings, if any;

10. He should check the Cash Book and the Pass Book to ensure that entries are recorded correctly.

11. And finally, he should ascertain whether the company has incurred loss due to negligence on the part of the authorities.

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After examining the affairs of the company, the inspector should carefully draft his 'report' mentioning the facts and submit an interim report (if required) or a final report to the Central Government, which in turn shall send a copy of the 'report' to the following:

i) The Registrar of the Companies.
ii) The registered office of the company.
iii) Any body corporate, managing agents, secretaries and treasurers specified under Section 239.
iv) Any applicant, if he so desires, on payment of prescribed fee.
v) The court under whose direction the inspector was appointed.
vi) Anybody corporate, which has been subjected to an examination.

The Central Government may get the report published.

On the receipt of the report from the Inspector the Central Government may:

i) proceed against any person who has been found guilty of any criminal offence to prosecute him; or

ii) pass orders for the winding up of the company; or

iii) institute criminal proceedings against any party who has committed fraud or misappropriation of property, on behalf of the company for recovery of damages; or

iv) make an application to the court for an order for prevention of oppression and mismanagement under Section 397 and 398.

Check Your Progress - 2

What are the important powers of the Inspector?

27.4 INVESTIGATION IN CONNECTION WITH TAX LIABILITY

A professional accountant at the request of the client usually carries out an investigation in connection with tax liability.

a) Where the revenue authorities have reason to believe that complete and accurate returns of income have not been submitted.

b) The investigation may also be undertaken where the assessments are re-opened under Sec. 147 of the Income Tax Act 1961. It may be done if the income Tax Officer has reason to believe that the assessee has failed to disclose the full material facts necessary for his assessment for that year. The object of such an investigation is to find out the amount of suppressed income for that year so that additional tax liability may be computed and the tax evasion prevented. This type of investigation may be described as 'back duty investigation'.

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The procedure to be followed in such investigations depends upon the circumstances of the case, since there are so many ways of suppressing income, inflating expenses and manipulating accounts.

It will be easy for the investigator to carry out his investigation, if the books of accounts are maintained according to the principles of accountancy and duly audited.

Before the investigator proceeds to investigate, he should secure the following information.

1. Audited books of accounts of business.
2. Bank Pass books in the name of the client or his spouse (wife).
3. Statements of all private assets and liabilities.
4. Schedules of all investments held.

5. Particulars of insurance policies, insurance maturities and capital receipts during the year.
6. Particulars of any other non-business property.
7. Details of all interest and dividend received and outgoings, if any.
8. Copies of all income-tax, wealth-tax and gift tax returns and receipts for taxes paid.

Having secured the information, the investigator should make an exhaustive inquiry into the matter to determine the total income of the business and assessee's private income.

Usually, to suppress his income the assessee would manipulate the accounts as follows:

i) omitting sales;
ii) inflating the purchases;
iii) inflating the various expenses;
iv) omitting incomes, and
v) making excessive provision for depreciation or reserves, etc.

The investigator will have to pay special attention to the above mentioned items, and probe into the matter. Often a small inconsistency in the records detected is helpful enough to detect the unscrupulous practice of the assessee. Thus, an intelligent overall check enables one to find out whether the accounting records and statements are basically consistent and correct.

In addition to those mentioned above, the investigator should undertake the following:

i) work out the turnover ratios, gross profit ratios, and identify the areas requiring further investigation;

ii) ascertain the payments made, the nature of payments and their treatment in the books of accounts;

iii) examine the bank Pass Book and the personal Cash Book to ensure that all deposits are properly accounted for;

iv) scrutinize, in the case of any cheques which could not be so traced, the cancelled cheques, if available apart from cash.

To trace the omission of any source of income, he will have to undertake an exhaustive checking of the receipts and payments of cash. He should prepare the statement of receipts and payments of cash for each individual, who is the subject of investigation, and find out if there is any excess of expenditure over the cash received. If it is so, it is evident that cash received from certain sources has not been disclosed. Such a possibility may be confirmed by making a detailed inquiry.

Thus, a detailed inquiry with regard to the receipts and payments made through cash and cheques would reveal the source of undisclosed income or the existence of assets purchased but not disclosed. Where the books of account have not been properly maintained by the assessee, the investigator will have to prepare the accounts on the basis of the information or documents available. The available sources may be bank statement, invoices or vouchers, creditors' statements, receipts for expenditure, etc. On the basis of accounts so prepared he should find out the gross profit of the assessee and taxable amount.

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In the absence of necessary information except that concerning total purchases, it may be possible for the investigator to estimate the amount of gross profit of the assessee by reference to the percentage on purchases normally earned in the particular trade. Where the available information is meager, it is impossible to prepare the Profit and Loss Account and find out the taxable income. The only method of estimating the profit will be by the preparation of statements of "net worth" at the beginning and at the end of the period under investigation. For this purpose, the assets and liabilities of the assessee should be found out. From the total so found, the assessee's living expenses and other non taxable items will be deducted to arrive at the net annual income.

Having completed the investigation, the investigator should draft his report in clear terms. He should mention in his report the following:

i) the limitations under which the investigation was carried out;
ii) deficiencies of the data available if any;
iii) the matters on which he could not get satisfactory explationations;
iv) the facts which led him to arrive at the assessable income of the assessee; and
v) the extent to which he is likely to assume responsibilities, etc.

Check Your Progress - 3

a) What information the investigator has to secure before he proceeds to investigate in connection with tax liability?
b) Generally what are the ways of suppressing the income of the assessee.

27.5 SPECIAL AUDIT OF COMPANIES

Section 233 A, of the Companies Act, 1956, empowers the Central Government to order a special audit for a specified period. Special Audit is merely a fresh audit of the accounts of a company which have already been audited by an auditor appointed under Section 227 of the Companies Act, 1956. A special audit is a kind of investigation with some special object in view. It is a fact-finding inquiry. The main objective of such an audit is to provide a critical review of a company's working and its state of affairs to the Central Government.

The Central Government may appoint a special auditor when it is of the opinion :

i. that the affairs of any company are not being managed in accordance with sound business principles or prudent commercial policy or

ii. that the company is being managed in a manner likely to cause serious injury or damage to interests of trade, industry or business to which it pertains; or

iii. that the financial position of the company is such that it may lead to insolvency.

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Dr. B.R. Ambedkar Open University

UNDERGRADUATE COURSE - B.Com III YEAR

GROUP-A : PAPER II

COURSE : AUDITING

ASSIGNMENT - 3

Note :

1. Do not copy the answer directly form any of the books
2. As far as possible, try to answer the questions independently in your own words
3. If it is necessary to quote from any source, give the correct reference
4. Use your own foolscap pages for writing the assignment
5. Leave sufficient margin for the comments of the evaluators
6. Completion of this assignment normally should not take more than 2 hours time

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SECTION – A

I. Answer the following questions in about 30 lines each

1. How do you audit the accounts of a Co-operative society?
2. What are divisible profits? What considerations should be kept in mind before declaring dividends?
3. What is Investigation? Describe the procedure you would adopt as an auditor in case the cashier is absconding and a defalcation of cash is suspected.

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SECTION – B

II. Answer the following questions in about 15 lines each

1. What points do you consider while verifying accounts of an insurance company?
2. What is meant by a special audit?
3. Distinguish between investigation and auditing?

inspectors. An investigation in connection with tax liability is usually carried out by a professional accountant at the request of client. The procedure to be followed in such investigation, depends upon the circumstances of the case, since there are so many ways of suppressing income, inflating expenses and manipulating accounts.

Section 233 A, of the Companies Act, 1956 empowers the Central Government to order a special audit for a specified period. Special audit is merely a fresh audit of the accounts of a company which have already been audited by an auditor. The main objective of such an audit is to provide a critical review of a company's working and its state of affairs to the Central Government.

27.7 ANSWERS TO CHECK YOUR PROGRESS

1. i) Misappropriation of cash
   ii) Misappropriation or Defalcation of goods
   iii) Manipulation of accounts.

2. The powers of Inspector are:
   i) he can demand the production of books, documents, papers or any information from any officer, employee, or related body corporate, if he thinks it necessary.

   ii) He can, with the prior approval of Central government, summon any other person or employee or officer of related body corporate and examine him on oath.

   iii) He can seize, with the prior permission of Magistrate, the books, documents papers etc., of the company or of related body corporate and retain them until the investigation is over.

3. a) The investigator has to secure the following information before he proceeds to investigation in connection with tax liability:

   i) audited books of accounts, pass books in the name of the client or his spouse.
   ii) Statements of all private assets and liabilities,
   iii) Schedule of all investments held,
   iv) Particulars of insurance policies and insurance maturities,
   v) Particulars of any other non business property etc.

   b) The ways of the suppressing the income are :
   i) omitting some sales,
   ii) inflating the purchases,
   iii) inflating the various expenses,
   iv) omitting some incomes, and
   v) making excessive provision for depreciation, reserves, etc.,

27.8 MODEL EXAMINATION QUESTIONS

A. Answer the following questions in about 15 lines.

1. Write a short note on manipulation of accounts.
2. What do you understand by defalcation of goods?
3. What is meant by special audit? Under what circumstances the Central Government is

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UNDERGRADUATE COURSE - B.Com III YEAR

GROUP-A : PAPER II

COURSE : AUDITING

ASSIGNMENT - 3

Note :

1. Do not copy the answer directly form any of the books
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SECTION – A

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3. What is Investigation? Describe the procedure you would adopt as an auditor in case the cashier is absconding and a defalcation of cash is suspected.

B R A O U

SECTION – B

II. Answer the following questions in about 15 lines each

1. What points do you consider while verifying accounts of an insurance company?

2. What is meant by a special audit?

3. Distinguish between investigation and auditing?

Dr. B.R. Ambedkar Open University

B.COM III YEAR (GROUP-A : PAPER II)
AUDITING
MODEL QUESTION PAPER

Time: 3 hours

Max. Marks : 100

SECTION – A

Note:
Answer any **four** of the following.

Each question carries 15 marks **4 x 15 = 60**

Answer the following questions in about 30 lines.

1. Explain the various types of audit.
2. What do you mean by continuous audit? Under what circumstances continuous audit should be useful?
3. What are the rights, duties and responsibilities of legally appointed auditor?
4. What do you mean by 'Vouching'? How will you vouch the purchase and sales books?
5. State the provisions of the Indian Companies Act, 1956 regarding appointment and removal of auditor.
6. How do you audit the accounts of a Co-operative Society?
7. What are the advantages of the audit of a partnership firm? What special points should be included in the audit report in respect of such an audit?
8. A fraud is suspected in a business and you are asked to carry out an investigation. Explain how would you proceed in the matter?

SECTION – B

Answer any **five** of the following questions in about 15 lines each.

Each question carries 8 marks **5 x 8 = 40**

9. What is the difference between book-keeping and auditing?
10. What do you understand by internal control?
11. How do you vouch sales returns book?
12. What is contingent liability?
13. What do you understand by internal check?
14. Explain the procedure of audit relating to Hotels.
15. What are divisible profits? What considerations should be kept in mind before declaring dividend?
16. What is misfeasance?
17. Distinguish between capital expenditure and revenue expenditure.
18. What are the general principles of investigation?

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UNDERGRADUATE COURSE - B.Com III YEAR

GROUP-A : PAPER II

COURSE : AUDITING

ASSIGNMENT - 1

Note :

1. Do not copy the answer directly form any of the books
2. As far as possible, try to answer the questions independently in your own words
3. If it is necessary to quote from any source, give the correct reference
4. Use your own foolscap pages for writing the assignment
5. Leave sufficient margin for the comments of the evaluators
6. Completion of this assignment normally should not take more than 2 hours time

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SECTION – A

I. Answer the following questions in about 30 lines each

1. Explain various type of audit.
2. What is vouching? How do you vouch the Cash Book?
3. What are the qualities of an auditor?

B R A O U

SECTION – B

II. Answer the following questions in about 15 lines each

1. What is continuous audit?
2. What is the difference between book-keeping and auditing?
3. What do you mean by 'internal audit'?

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UNDERGRADUATE COURSE - B.Com III YEAR

GROUP-A : PAPER II

COURSE : AUDITING

ASSIGNMENT - 2

Note :

1. Do not copy the answer directly form any of the books
2. As far as possible, try to answer the questions independently in your own words
3. If it is necessary to quote from any source, give the correct reference
4. Use your own foolscap pages for writing the assignment
5. Leave sufficient margin for the comments of the evaluators
6. Completion of this assignment normally should not take more than 2 hours time

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SECTION – A

I. Answer the following questions in about 30 lines each

1. What are the rights, duties and responsibilities of legally appointed auditor?

2. How do you verify and value intangible assets of a business?

3. What do you understand by depreciation? What are the various methods of calculating depreciation.

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SECTION – B

II. Answer the following questions in about 15 lines each

1. What is contingent liability?

2. What is the statutory meeting?

3. What are non-statutory books?

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UNDERGRADUATE COURSE - B.Com III YEAR

GROUP-A : PAPER II

COURSE : AUDITING

ASSIGNMENT - 3

Note :

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2. As far as possible, try to answer the questions independently in your own words
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B R A O U

SECTION – B

II. Answer the following questions in about 15 lines each

1. What points do you consider while verifying accounts of an insurance company?
2. What is meant by a special audit?
3. Distinguish between investigation and auditing?