AUDITING

O.P. Agarwal

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AUDITING

For Banks and Insurance Companies
(B.Com. Banking and Insurance Syllabus)
Revised Course 2014-15

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PREFACE TO SECOND EDITION

New Companies Act, 2013 has been implemented in the country since 12th Sept. 2013 and onwards making redundant, the old Companies Act, though partially. Due to tremendous changes in the entire Act, there were compelling reasons to revise this book completely. Auditing of companies, public or private, banking and insurance companies have numerous words and phrases judicially. Further, the revision of B.Com. (Banking and Insurance) Course of Mumbai University also made it essential to revise the book after 7 years period and add new Chapters in it, bring the recent changes in the auditing area. All the new sections in the Companies Act, 2013 are 470 in number while such sections were 650 with XIV schedules in the old Companies Act, thus reducing/merging the incomplete and ineffective legal sections. Auditing chapters have been dealt with from sections 136 to 148 in addition to sections 407 to 431.

Inclusion of topics like audit of Ltd. Companies/Branch Audit/Joint Audit/Special Audit/Divisible profits/Contents of annual report/Audit procedure vouching and verification of assets and liabilities, etc., have enhanced the scope of auditing knowledge of the students of B.Com./M.Com./Bank employees vividly.

It will be proper to express my sincere thanks to my wife Mrs. Veena O. Agarwal M.A. (Eco.) and my daughter Prof. (Mrs.) Shubha Govil, M.Sc. (Microbiology) for their support and help in revision of this book.

The publishers of this book M/s. Himalaya Publishing House Pvt. Ltd., Mumbai for their speedy publication of the book and timely delivery to students/readers and professors.

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PREFACE FOR FIRST EDITION

One cannot become a professional accountant unless the person has got enough knowledge and understanding of auditing, which is the very purpose of knowing fair and true state of affairs of the financial statements of the organisation. There are numerous books on auditing in the market throughout India but a need was felt for knowledge to banks' officials, about auditing, exclusively for their purpose. Banks, insurance companies and public companies are required to have statutory audit every year and the officials of the accounts or finance department do require in advance, knowledge as to the requirements of the auditors' before audit, as a first hand preparation.

In view of the above, I have endeavoured to write this book exclusively for the students of B.Com., M.Com. and C.A. alongwith practical knowledge to bankers/insurance persons. The book has not been made bulky to deter the reader from reading or studying. The book is also written as per syllabus of the Mumbai University for the students of B.Com. (Banking and Insurance) specially.

Readers can refer any number of books on auditing, if they want detailed information and uncovered syllabus, but if they need concise, relevant and as per provisions of Companies Act, 1956 and Chartered Accountants Act, 1949, my effort would be useful. In the continuous requirements of speedy and instant knowledge, I have given to the readers, books on Laws Relating to Insurance and Banking, Financial Management, Basics of Banking and Finance, Modern Banking of India, International Business, Business Laws, Advanced Financial Management as in my other publications.

Let me express my thanks to Shri. Himanshu Redkar, Chartered Accountant, for his support in collection of information in publication of this book.

I am also indebted to my daughter and son-in-law, Smt. Shubha S. Govil and Shri Shrikant D. Govil, for their timely encouragement and favour, much caring about my health especially after my by-pass heart surgery in Jan. 2006.

I would be failing in my duty, if I do not express my sincere thanks to my wife Sau. Veena Agarwal, M.A. (Eco.), who spared me from the duties, which I should have done, by shouldering them herself.

Readers are requested to convey their views for improvement.

Mumbai
Dated. 7th September, 2006

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SYLLABUS – AUDITING
(2014-15)

UNIT I: Introduction:

Meaning, Objects, Basic Principles and Techniques. Classification of Audit, Audit Planning. Internal Control, Internal Check and Internal Audit, Audit Procedure — Vouching and Verification of Assets & Liabilities. Special Areas of Audit: Special Features of Cost Audit. Tax Audit and Management Audit. Recent Trends in Auditing: Basic Considerations of audit in EDP Environment.

UNIT II: Audit of Limited Companies:

- Qualification, Disqualification, Appointment, Removal, Remuneration of Auditors.
- Audit Ceiling — Status, Power, Duties and Liabilities of Auditors.
- Branch Audit — Joint Audit — Special Audit.
- Maintenance of Books of Account — Related Party Disclosures — Segment Reporting.
- Divisible Profit, Dividend and Depreciation (Companies Act, Standards on Accounting, Legal Decisions and Auditor's Responsibility),
- Representations by Management — Content of Annual Report (A Brief Idea).
- Definition — Distinction between Report and Certificate — Types of Reports/Opinion

UNIT III: Audit of Bank and Insurance Companies

- Banks — Legislation Relevant to Audit of Banks, Approach to Bank Audit, Internal Control Evaluation, Non Performance Assets (Concept, Provisions), Long Form Audit Report.
- Insurance Companies — Legislation Relevant to Audit of Insurance Companies (Life and General Insurance), Review of Internal Control, Audit Report (Matters as per IRDA).
- Role of Regulatory Authorities like Department of Company Affairs, SEBI, RBI, IRDA and Comptroller and Auditor General of India.

UNIT IV: Other Thrust Areas

- Systems Audit — Social Audit — Environment Audit
- Energy Audit — Forensic Audit — Peer Review (Concepts, Objectives and Regulatory Requirements).
- Ethics in Auditing — Auditor's Independence.
- Auditing in CIS Environment.
- Standards on Auditing (Concepts, Purpose and Present Position as to Number and Title as issued by ICAI).
- Professional Liability of Auditors — Code of Ethics with special reference to the relevant provisions of The Chartered Accountants Act, 1949 and the Regulations thereunder with Case Studies
- Role of Auditor *vis-à-vis* Audit Committees and Corporate Governance Principles.

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ABOUT THE BOOK

This book is written for the use of banks and insurance companies officers/executives for preparing themselves in advance before the start of statutory annual audit.

The book is also useful for the students of B.Com/M.Com/C.A. courses. The book comprises:

Types of Audit — Cost audit/Internal audit/Bank audit/Management audit/Environmental audit/ Social audit/Energy audit.

EDP Auditing — Types of EDP Accounting Specific problem of EDP Special audit techniques Uses of CAATs.

Qualification of Reports — Distinction between Audit Report and Certificate Rectifications on Qualified Reports.

Role of Regulatory Authorities — Role of SEBI, Role of RBI, Role of IRDA, Role of Comptroller and Auditor General of India

Portfolio of Auditor — Independence of an Auditor/Powers and Duties of Auditor/Specific Duties in Relation to Banks and Insurance Companies.

Role of Ethics and Regulations — Procedure in Misconduct Appointment of Auditor.

Audit Committees — Formation/Power of Audit Committees/Role of Auditor *vis-à-vis* Audit Committees/Peer Review Committee.

Corporate Governance Principles — In Banks/Strategic Objective Strengthening Practices in Banks/Sound Banking and Corporate Governance/Key Elements/Ownership and Health of Banks/ Efficient Customer Services and Corporate Governance.

1

INTRODUCTION AND TYPES OF AUDITS

1. OBJECTIVES OF AUDITING

Auditing along with other disciplines such as accounting and laws, equips one with all knowledge that is required to enter into auditing as a profession. Authenticity of financial statements is essential. It is more essential for those who have invested their money in the business, but cannot take part in its management, for examples, shareholders in a company, such persons certainly need an assurance that the annual statements of accounts sent to them are fully realiable. It is AUDITING, which ensures that the accounting statements are **authentic**. Independent audit of an entity's financial statements is a vital service to investors, creditors and other participants (like banks and financial institutions) in economic exchange. Auditing can be understood as an examination of accounting records undertaken with a view to establishing whether they completely reflect the transactions correctly for the related purposes. Auditing is defined as a systematic and independent examination of data, statements, records, operations and performances or an enterprises for a stated purposes. Auditing is a unified function of the process of examination and appraisal. An audit is independent examination of financial information of every entity, whether profit-oriented or not, and irrespectively of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon.

1.1. TYPES OF AUDITS

There are mainly two types of audits, *viz.*, required under law and voluntary audits,

(*i*) Audit under Laws are required for the following organisations:

(*a*) Companies governed by Companies Act.

(*b*) Banking Companies

(*c*) Electric Supply Companies

(*d*) Cooperative societies registered under Cooperative Societies Act

(*e*) Public and charitable trusts registered under various Regions and Endowment Acts.

(*f*) Corporations set up under an Act of Parliament or State Legislature, *viz.,* L.I.C.

(*g*) Specified entities as per Income Tax Act, 1961.

(ii) The Voluntary Category are the audits of the accounts of *proprietary entities, partnership firms, Hindu Undivided Families (H.U.F.)* etc. In respect of such accounts, there is no basic legal requirements of audit. Many of such enterprises, as a matter of internal rules, require audit. Some may be required to get their accounts audited on the directives of Government for various purposes like sanction of grants, loans, etc. But the important motive for getting accounts audited lies in the advantages that follow from an independent professional audit. This is the reason, why large numbers of proprietary and partnership business get their accounts audited.

Non-profit making institutions like schools, colleges, clubs, hospitals, etc., a provision, about the requirement of audit, is inserted. Any surplus which may arise can only be used for achieving the objects of the institution. Educational institutions, hospitals, associations, etc., irrespective of any internal rules, get their accounts audited because most of them enjoy government or municipal grants, and generally, for this purpose, audited accounts are insisted upon.

Trusts, however, stand on different footing, they may be public trusts or private trusts. Trusts can carry on business as well. In the majority of cases trustees are private persons. TRUSTS generally have TWO CLASSES of beneficiaries, TENANTS FOR LIFE AND REMAINDERS. Persons, to whom the accounts is the supreme importance, are often *widows* and *minors,* who cannot criticize the accounts in any effective manner. Though the audit of trusts, except for public trusts, is not COMPULSORY, most of the trusts deeds contains a clause for audit of accounts.

In addition to above, two main categories of types of audits, the other higher categories (sub-divisions) are:

(*a*) Cost Audit

(*b*) Internal Audit

(*c*) Financial Statement Audit

(*d*) External (Statutory) Audit

(*e*) Due Diligence Audit

(*f*) Management Audit

(*g*) Proprietary Audit

(*h*) Environment Audit

(*i*) Social Audit

(*j*) Auditing in a Computerized Environment

Let us discuss these audits in details.

1.2. COST AUDIT

It is an audit process for verifying the COST OF MANUFACTURE or *production* of any articles, on the basis of accounts as regards utilization of material or labour or other items of costs, maintained by the company. According to Section 148(2) of the Companies Act, 2013, a Cost Auditor, shall be appointed by the Board of Directors of the Company within next 30 days139(8) and with the previous approval of the National Company Law Tribunal (NCLT). Further it has been provided that before the appointment of any cost auditor is made, by the Board a *written certificate* shall be obtained by the Board from the *auditor* (proposed to be so appointed) to the effect that the appointment, if made, will be in accordance with the provisions of Sec. 139. Such a company is required under section 2(13) of the Act to include in its book of accounts, the particulars referred to therein including books for items of cost as may be prescribed under section 148 in the case of a company. The *cost audit* is in addition to, and *independent of normal financial audit* carried out permanent to the appointment under section 139 of the Act. The *Cost Auditor* shall have the *same powers* and duties as are prescribed under section 143, for the auditors appointed under section 139.

Qualification of a Cost Auditor: Under the provisions of sections 2(28) of Companies Act, 2013 such an audit is to be conducted by a Cost Accountant as defined in section 2(b)(1) within the meaning of Cost and Works Accountants Act, 1959.

Disqualifications for a Cost Auditor — Disqualifications are:

(*i*) Disqualifications as stated in section 141(3) and 141(4) of the Act, *viz.*, a body corporate/officer or employee of the company a person who is a partner/person indebted to the company for amount exceeding ₹ 1,000 or a guarantor to third person, a person who is a director or member of a private company, a person who is director or holder of shares exceeding 5% in nominal value/any body corporate which is that company's subsidiary of holding company.

(*ii*) Holding appointments as the first Auditor under sections 139 (In case of a company in which not less than 25% of the subscribed share capital is held by a public financial institutions or Government Company or Central/State Government any financial institutions established by State Government and holding not less than 51% shares *or* a nationalized bank or an insurance company carrying on general insurance business.

(*iii*) On becoming subject to any of the disqualifications mentioned in (*i*) and (*ii*) and above after being appointed as the Cost auditor.

The Central Government has issued Cost Audit (Report) Rules, 2001 specifying the forms of the report and the additional information which should be, included therein in the form of annexure.

The auditor must further report on the *adequacy of cost accounting records,* maintained by the company as prescribed by the Government under Sec. 128 of the Act to conform that they give a true and fair view of the cost of production processing, manufacturing or mining activities as the case may be. If there is any additional information that auditor would like to furnish he may include in the annexure to the report. The Government has required these under section 128 to confirm that they give a true and fair view of the cost of the production. Each industry concerned is expected to complete the schedule within 3 months from the expiration of the last date of the period to which it relates. It is the duty of the Cost-auditor to report on the correctness of the figures given in the schedule. Some of the industries covered by the cost (Record) Rules, issued under section 128 are as below:

Cement or clinker or both/cycles and components thereof/caustic soda/rubber tyres or tubes or both/refrigerators/storage batteries used in automobiles/electric lamps or fluroscent tubes or bulbs/room air conditioner/motor vehicles/electric fans and other items (totalling 19 items).

The Government's view, so far as it can be ascertained from the pronouncement is that *cost audit will not be required annually* but only for the financial year or years specified in the order.

The copy of the cost audit, report sent to the Central Government should be sent to the company concerned simultaneously. The company shall within 30 days, from the date of the receipt of the copy of the report, furnish the Central Government with full information and explanations on every reservation or qualification contained in such report. The Central Government after consideration of the report, and the information and the explanations furnished by the Company, may seek further explanation from the company if it so needs. The Central Government may direct the company concerned to circulate to its member alongwith the notice of the annual general meeting to be held for the first time after submitting of the relevant cost audit report, the whole or part of the report as it may specify.

1.2.1. Types of Cost Audit

Cost audit is basically carried out at the instance of the management for obvious advantages. The different types of cost audit that we come across may be the following:

(1) Management decisions: The main object of this audit is to see that the cost data placed before the management are verified and reliable and they are prepared in such detail, as will serve the purpose of the management, in taking appropriate decisions.

(*a*) Establishing the accuracy of the cost of materials used, allocation of wages into direct and indirect etc.

(*b*) Ensuring of cost accounting through collection, segregation, analysis and compilation of data.

(*c*) Abnormal losses and gains ascertaining alongwith relevant causes.

(*d*) Determination of the unit cost of production in a precise but practicable manner.

(*e*) Absorption of overheads in the cost so that there is no significant over or under recovery of expenses.

(*f*) Fixation of contract price and determination of the additional or supplementary charge that can be raised against customers for alterations.

(*g*) Improving the quality of cost accounting system by audit observations and suggestions of cost auditor.

(2) For customer decisions: In case of cost plus contracts, often the buyer or the contractee insist on a cost audit to satisfy himself about the correct ascertainment of cost. The cost of production arrived at for this purpose may differ from the cost of production ascertained for internal purposes.

(3) For government decisions: Sometimes, government is approached with requests for *subsidies, protection* etc. In such cases, government may prefer cost of product determined on the basis of cost audit to satisfy itself whether the need is genuine and also for ascertaining the fair price of any product.

(4) For trade associations: Where the activities of a trade association include maintenance of a price of the products manufactured by the member units or where there is POOLING or CONTRIBUTION arrangements. The trade associations may seek full information on the costing system, level of efficiency, utilization of capacity etc.

1.2.2. Advantages of Cost Audit

Cost Audit will prove to be useful to the management, society, shareholders and the government. The advantages are:

(a) To Management:

(*i*) It will get reliable data for its day to ay operations like price fixing, control, decisions making etc.

(*ii*) A close and continuous check on all wastage will be kept through a proper system of reporting to management.

(*iii*) Inefficiencies in the working of the company will be brought to light to facilitate corrective action.

(*iv*) Management by exception becomes possible through allocation of responsibilities to individual managers.

(*v*) The system of budgetary control and standard costing will be greatly facilitated.

(*vi*) A reliable check on the valuation of closing stock and work-in-progress can be established.

(*vii*) It helps in the detection of errors and fraud.

(b) To Society/Consumers:

(*i*) Cost audit is often introduced for the purpose of fixation of prices for consumers, who are saved from exploitation.

(*ii*) Since price increase by some industries is not allowed without proper justification as to increase in cost of production, inflation through price hikes can be controlled and consumers can maintain their standard of living.

(c) To Shareholders:

Cost Audit ensures that proper records are kept as to purchases and utilization of materials and expenses incurred on wages etc. It also makes sure that the valuation of closing stocks and work in progress is on a fair basis. Thus, the shareholders are assured of a FAIR RETURN on their investment.

(d) To Government:

(*i*) Where it enters into a cost plus contract, cost audit helps government to fix the price of the contract at a reasonable level.

(*ii*) Cost audit helps in fixation of ceiling prices of essential commodities and thus undue profiteering is checked.

(*iii*) Cost audit enables the government to focus its attention on inefficient units.

(*iv*) Cost audit enables the government to decides in favour of giving protection to certain industries.

(*v*) Cost audit facilitates settlement of trade disputes brought to the government.

(*vi*) Cost audit and consequent management action can create a healthy competition among the various units in an industry. This imposes an automatic check in inflation.

1.3. INTERNAL AUDIT AND INTERNAL CHECK

It is a review of the operations and records, sometimes continuously undertaken, within a business, by specially assigned staff. But INTERNAL AUDIT is different from INTERNAL CHECK. Internal check CONSISTS of a set of rules or procedures that are part of the accounting systems, introduced so as to ensure that accounts of a business shall be correctly maintained and the possibility of occurrences of frauds and errors eliminated. On the other hand, internal audit is a thorough examination of the accounting transactions as well as that of the system according to which they have been recorded, with a view to reassuring the management that the accounts are being properly maintained and the systems contains adequate safeguards to check any leakage of revenue or misappropriation of property or assets and the operations have been carried out in conformity with the plans of the management. However, the routine process by which an internal audit is carried out are broadly the same as those followed for professional audit. But *internal audit* often *differs* in its scope and emphasise is more MANAGERIAL than ACCOUNTING, also its form is varied, depending on the size of the organisation. For instance, whereas a professional auditor is primarily concerned with the legality or validity of transactions entered into by a business, an internal auditor in addition is expected to ensure that the standards of economy and efficiency are being maintained. On that account the internal auditor must ascertain that orders for the purchase of stock are placed only after inviting tenders, sales are effected at the highest ruling rates, standard procedures as regards requirement of staff are followed, losses in manufacturing process suffered during the period under review, are not higher than those in the earlier periods and soon. He must further confirm that there has been no leakage of stocks, or revenue, overpayment of expenditure or pilferage or misappropriation of stocks or of any other assets, reconciling the physical accounting records and physical balance. The nature and extent of checking, that he should carry out, also would depends on the size and type, of the business organization.

1.3.1. Objects of Internal Audit

1. To verify the ACCURACY and AUTHENTICITY of the financial accounting and statistical records presented to the management.
2. To ascertain that the standard accounting practices, as have been decided, to be followed by the organization, are being adhered to.
3. To establish that there is a proper authority for every acquisition, retirement and disposal of assets.
4. To confirm that liabilities have been incurred only for the legitimate activities of the organisation.
5. To analyse and improve the system of internal check in particular to see (*i*) that it is working (*ii*) that it is sound, and (*iii*) that it is economical.
6. To facilitate the prevention and detection of frauds.
7. To examine the protection afforded to assets and uses to which they are put.
8. To make special investigations for management.
9. To provide a channel whereby, new ideas can be brought to the attention of management.
10. To review the operation of the overall internal control system and to bring material departures and non-compliances to the notice of the appropriate level of management, the view also generally aims at locating unnecessary and weak controls for making the entire control system effective and economical.

As per Standard Accounting Procedure SA-7, **the scope and objectives** of internal audit vary accordingly and are dependent upon the size and structure of the entity and the requirements of its management.

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

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

(b) Examination for management of financial and operating information: This may include review of the means used to identify, measures, classify and report such information and specify enquiry into individual items including *detailed testing* of transactions, balances and procedures.

(c) Examination of the economy, efficiency and effectiveness of operations: Generally, the external auditor is interested in the results of such audit work including non-financial controls of the organization, when it has an important bearing on the reliability of the financial records.

(d) Physical examination and verification: This would generally include examination and verification of physical existence and conditions of the tangible assets of the entity. The Institute of Internal Auditors, USA defined **"internal auditing as an independent appraisal function, established within an organization to examine and evaluates its activities as a services to the organization. The objective of internal auditing is to assist members of the organization in the effective discharge of their responsibilities. To this end, internal auditing furnishes them with analysis, appraisals, recommendations, counsel and information concerning the activities reviewed."**

The institute of internal auditors, has further reviewed its definition as, "internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. Its helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve **the effectiveness of risk management, control and governance process.**"

The main trust of the revised definition is to re-emphasize the increasing scope of internal audit with a view to achieving *maximum organizational effectiveness.* In the new century the scope of internal auditing increased considerably from financial to non-financial activities. With the passage of time, the internal audit came to be recongnised as a valuable resource to achieve overall growth objectives of the organization.

The internal auditor's report contains conclusions and recommendations on the activities audited which are expected to be accepted and acted upon by the management. The management may also use the report to evaluate the performance of the internal auditor.

1.3.2. Essential Features

The contents of an internal audit report are influenced by various factors such as the nature of internal auditing function in the organization, level of reporting, degree of management support and capabilities of internal audit staff. However, for preparing a good internal audit report, the following general rules may be observed:

(i) ***Objectivity:*** To maintain the credibility of internal audit function the comments and opinions expressed in the report should be as objective and unbiased as possible.

(ii) ***Clarity:*** The language used should be simple and straightforward. As far as practicable use of technical terms and Jargon should be avoided. Each draft of the report should be reviewed by a senior who should attempt to read it from the point of view of the users of the report.

(iii) ***Accuracy:*** The information contained in the report, whether quantified or otherwise, should be accurate. Where approximation or assumption have been made the fact should be clearly stated alongwith reasons, if material.

(iv) ***Conciseness:*** Brevity is vital subject, of course, to the condition that important information should not be omitted.

(v) ***Constructiveness:*** Destructive criticism should carefully be avoided in the report. The report should clearly demonstrate that the internal auditor is trying to assist the auditor is an effective discharge of his responsibilities.

(vi) ***Readability:*** The reader's interest should be captured and retained throughout by the use of appropriate paragraph heading.

(vii) ***Timeliness:*** The report should be submitted promptly because if the time lag between the occurrence of an event and its reporting is considerable, the opportunity for taking action may be lost or a wrong decision may be taken in the absence of information.

(viii) ***Findings and conclusions:*** These may be given either department wise or in the order of importance. All the facts and data pertaining to the situation should be assembled classified and analysed. Each conclusion and opinion should normally follow the findings.

(ix) ***Recommendations:*** An internal audit report usually includes recommendations for potential improvements. In order to enable the management to accept and implement the recommendations the internal auditor should be able to convince the management that the conclusions are logical and valid.

(x) ***Auditee's views:*** The auditee's views about audit conclusions or recommendations may also be included in the audit report in appropriate circumstances.

(xi) ***Summary:*** A summary of conclusions and recommendations may be given at the end. This is particularly useful in long reports.

(xii) ***Supporting information:*** The internal audit should be supported by such documents and data which adequately and convincingly support the conclusions.

(xiii) ***Draft Report:*** Before writing the final report, the internal auditor should prepare a draft report. This would help him in finding out the most effective manner of presenting his reports.

(xiv) ***Writing and issuing the final report:*** Before issuing the final report, the auditor should discuss conclusions and recommendations at appropriate levels of management. The report should be duly signed.

Follow-up — The internal auditor should review whether follow-up action is taken by the management on the basis of his report. If no attention is taken within a reasonable time he should draw the attention of the management.

1.3.3 Internal Control and Audit

When we speak of the objective, we rationalise the thinking process to formulate a set of attainable goals, with reference to the circumstances, feasibility and constraints. In money matters, frauds and errors are common place of occurrence. Apart from this, the statements of account have their own purpose and use of portraying the financial state of affairs. The objective of audit, naturally, should be to see that what the statements of account convey is true and not misleading and that such errors and frauds do not exist as to distort what the accounts really should convey.

In the early days of auditing, the business structure was rather simple and there were not many conflicting interests in a business. Business enterprises were small in size, their activities seldom crossed local frontiers and management and ownership were joint. Management was concerned only about frauds and errors perpetrated by employees. Auditing at that time was carried out to locate frauds and errors. When corporate enterprises started to grow, the result was distinct separation of management from ownership. In course of time organised and institutional loans and borrowings came to play a significant role in the running of industry and business. Gradual expansion of the idea of social responsibility of the state led to introduction of regulatory enactments in the sphere of business and commerce, specially joint stock companies. In this manner, diverse interest in business grew and developed. The objective of audit correspondingly changed in emphasis from time to time and through the legislative process, the audit of companies became compulsory with a defined audit objective.

Auditors of such companies were asked to report whether the statements of account under audit showed a true and correct state of affairs. This was primarily intended to bring before the eyes of the owners the true and correct state of financial affairs and profits and to ensure that the funds of the shareholder entrusted to the management were employed to carry out and further the objectives for which the company was formed and for no other purpose.

Till recently, the principal emphasis was on arithmetical accuracy; adequate attention was not paid to appropriate application of accounting principles and disclosure, for ensuring preparation of accounting statements in such a way as to enable the reader of the accounting statement to form a correct view of the state of affairs. Quite a few managements took advantage of the situation and manipulated profit or loss and assets and liabilities to highlight or conceal affairs according to their own design. This state of affairs came up for consideration in the *Royal Mail Steam Packet Company's* case as a result of which the Companies Acts of England and India were amended in 1948 and 1956 respectively to require the auditor to state *inter alia* whether the statements of account are true and fair. This is what we can take as the present day audit objective. The implication of the substitution of "true and correct" by "true and fair" need to be understood. There has been a shift of emphasis from arithmetical accuracy to the question of reliability to the financial statements. Mind you, a statement may be reliable even though there are some errors or even frauds, provided they are not so big as to vitiate the picture. The word "correct" was somewhat misplaced as the accounting largely consists of estimates.

However, you should not infer that the detection of errors and frauds is no longer an audit objective: it is indeed an audit objective because statements of account drawn up from books containing serious mistakes and fraudulent entries can be considered as a true and fair statement. To establish whether the financial statements show a true and fair state of affairs, the auditors must carry out a process of examination and verification and, if errors and frauds exist they would come to his notice in the ordinary course of checking. But detection of errors and frauds is not the primary aim of audit; the primary aim is the establishment of a degree of reliability of the annual statements of account.

If there remains a deep laid fraud in the accounts, which in the normal course of examination of accounts may not come to light, it will not be construed as failure of audit, provided the auditor was not negligent in the carrying out of his normal work. This principle was established as early as in 1896 in the leading case in *Re-Kingston Cotton Mills Co.* It was held that, "auditor must not be made liable for tracking out ingenious and carefully laid schemes of fraud, when there is nothing to arouse their suspicions and when those frauds are perpetrated by tried servants of the company and are undetected for years by the directors. So, to hold, would make the position of an auditor intolerable". Nowadays another feeling is gaining ground that prevention is better than cure. Management, in order to protect and preserve the assets, introduce internal control procedures and checks. It is the duty of the auditor to review the adequacy of these with a view to isolating the area where control and checks are weak and then devote more careful attention to them. In this manner, he ensures that the statements of account are reliable; but he does not try to track down each possible fraud or error. Taking note of the weakness found by him, the auditor makes suggestions to the management for minimising the possibility of errors, frauds, waste, etc. This practice has now become a part of the audit function. If the suggestions made by the auditors are acted upon, it would go a long way to ensure reliable records and statements of account of the clients in future, making the tasks of the auditor himself lighter.

The nature of audit objectives was also highlighted in the leading case *Re The London and General Bank Ltd. [1895]*. It was held that an auditor must ascertain that the books of account show the true financial position of the company. For the first time, the duties of the company auditor were spelled out in specific terms. Lord Justice Lindley observed, "It is no part of an auditor's duty to give advice either to directors or shareholders as to what they ought to do. An auditor has nothing to do with the prudence or imprudence of making loans without security. It is nothing to him whether the business of company is being conducted prudently or unprudently, profitably or unprofitably; it is nothing to him whether dividends are properly or improperly declared, provided he discharges his own duty to the shareholders. His business is to ascertain and state the true financial position of the company at the time of the audit and his duty is confined to that."

The Statement on Standard Auditing Practices-2 issued in April 85 on "Objective and Scope of the Audit of Financial Statements" states that the objective of an audit of financial statements, prepared within a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements. Further it clarifies that "the auditor's opinion helps determination of the true and fair view of the financial position and operating results of the enterprise. The user, however, should not assume that the auditor's opinion is an assurance as to the future viability of an enterprise or the efficiency or effectiveness with which the management has conducted the affairs of the enterprise". So it follows from above that it is no part of the auditor's duty to probe into the propriety of business conduct. This contention has been held perfectly valid as it has been asserted that the conventional financial audit is concerned with examination of the transactions to ascertain the true and fair nature of the financial statements. The auditor is merely concerned with evaluating the evidence in support of transactions but need not examine the regularity and prudence of various decisions taken by the management. However, of late, this has undergone a change as some of the requirements of law introduced in the past require the company auditor to go beyond the functions of reporting and express an opinion about the propriety or prudence of certain transactions in certain specific areas. section 143 of the Companies Act, 2013 contain various such matters. It may also be clarified that the usage of words "true and fair" is restricted to certain countries such as U.K. while in other countries like United States the expression "full and fair" is prevalent. However both expressions aim to convey same meaning.

On a consideration of what has been discussed, it may be summed up that auditing has the principal objective of seeing whether or not the financial statement portray a true and fair state of affair and of reporting accordingly. An incidental and secondary, but by no means significant audit objective, flowing from the former, is detection of errors and frauds and making recommendations to prevent their occurrence.

Errors and Frauds

Accounting is a device for collecting and presenting useful information in financial terms about a business enterprise. It should as well be recognised that accounting data may contain errors for a variety of reasons, and those who rely on accounting data frequently have no way of determining for themselves the reliability of data presented. Even today, the human element is the most significant element for recording and processing the accounting data. Human beings as they are, they are always open to personal failures and allurement. The audit objective, in the past was, primarily concerned with the detection of errors and frauds and now, though the general audit engagement do not specifically require their detection, they do not rule them out and in fact stipulate their detection on the premise that no statements of account can be considered true and fair if substantial errors and frauds remain to distort the picture. Another presumption about errors and frauds which has wide recognition, is that the audit techniques and process, if carried on conscientiously would bring to light errors and frauds even though the examination was not specifically directed to reveal them. In the context of auditor's role in detection of frauds, a significant development in the sphere of management is the installation of control devices by the management to ensure compilation of reliable statements of account. These are designed to plug the possibilities of errors and frauds as they provide means for their early detection. It is true that management is responsible for prevention of errors and frauds. It can be argued that the auditor's role in their detection is very much conditioned by these developments. The auditor can achieve a lot by a purposeful review of those control systems and their operation. While conducting audit, the auditor may come to know the area where control is not fool proof or where control measures have not been properly operated with a view to ensuring better control over errors and frauds. In such instances, the auditor may provide the management with practicable suggestions for alteration or modification of the controls and checks. This is a safety for the future. It is a matter of safety for the business because by acting on the expert suggestions, a better assurance for obtaining reliable accounts is there. It is a safety for the auditor, if in future he is hauled up before the Court to defend a charge of negligence for non-detection of errors and frauds; it would be to his defence that he had already made the management aware of the weaknesses in the book-keeping system and procedures and the management had failed to act on his suggestions [*Re S. P. Catterson & Sons Ltd. (1973)*]. If the books of account are not properly maintained and if the control system is weak, the possibility of frauds and errors are enormous and the auditor, even with the best of his efforts, the auditor may not be able to detect all of them. The fact is recognised by the Courts as is obvious from a study of the various judgments. The auditor's performance is judicially viewed by applying the following tests:

(*a*) Whether the auditor has exercised reasonable care and skill in carrying out his work;

(*b*) Whether the errors and frauds were such as could have been detected in the ordinary course of checking without the aid of any special efforts;

(*c*) Whether the management has taken all reasonable care to prevent errors and frauds;

(*d*) Whether the auditor had any reason to suspect the existence of the errors and frauds; and

(*e*) Whether the error or fraud was so deep laid that the same might not have been detected by the application of normal audit procedures.

We have so far discussed the general background and the position of the auditors as regards errors and frauds and we know that the auditor has a certain amount of responsibility for their detection.

We shall now analyse the causes and nature of errors and frauds. If an auditor is aware of these, detection becomes easier in the sense that he can direct his enquiry more objectively and plan his work having regard to general possibility of errors and frauds.

R.K. Mautz, in his book on *"Fundamentals of Auditing"* has classified the reasons and circumstances of errors and he has included fraud in the broad category of errors. The classifications are the following:

1. Ignorance on the part of employees of accounting developments, generally accepted accounting principles, appropriate account classification of the necessary reconciling subsidiary ledgers with controlling accounts and of good accounting practices in general.
2. Carelessness on the part of those doing the accounting work.
3. A desire to conceal the effect of defalcations of shortages of one kind or another.
4. A tendency of the management to permit prejudice or bias to influence the interpretation of transactions or events or their presentation in the financial statements.
5. An ever present desire to hold taxes on income to minimum.

A sixth cause may be added to those Mr. Mautz has listed and that is more serious in nature. It is the intentional effort committed by persons in position of authority to:

(*i*) Show the picture depicted by the statements;

(*ii*) Depress the picture depicted by the statements; and

(*iii*) Convert the error to a personal benefit.

Errors and frauds both distort the true picture either by omission or by commission but the distinction between the two lies in intent. Error is an involuntary act whereas fraud is a deliberate act. Mautz also has classified the types of errors. These are:

1. Self-revealing and not self-revealing.
2. Unintentional and intentional
3. Unconcealed and concealed
4. Affecting general ledger balances and not affecting general ledger balances.

Self-revealing errors are such errors the existence of which becomes apparent in the process of compilation of accounts. A few illustrations of such errors are given hereunder, showing how they become apparent.

(*i*)	Omission to post a part of a journal entry to the ledger.	Trial balance is thrown out of agreement.
(*ii*)	Wrong totalling of the Purchase Register	Control Account (*e.g.,* the Sundry creditors Account) balances and the aggregate of the balances in the personal ledger will disagree.
(*iii*)	A failure to record in the cash book amounts paid into or withdrawn from the bank.	Bank reconciliation statement will show up error.
(*iv*)	A mistake in recording amount received from X in the account of Y.	Statements of account parties will reveal mistake.

From the above, it is clear that certain apparent errors balance almost automatically by double entry accounting procedure and by following established practices that lie within the accounting system but not being generally considered to be a part of it, like bank reconciliation or sending monthly statements of account for confirmation.

Many other errors, however, are not revealed by either of these possibilities. If an item of expense which should have been charged to repairs account has been charged by mistake to the building account or if the amount of depreciation is calculated incorrectly, there is nothing in the book-keeping system which will bring the error to notice.

Suppose a debit entry is omitted to be posted in the ledger and there are one or more of such omissions of credit entries which exactly compensate the effect of the former omission, then another self-revealing error turns to be not so. Such mistakes may remain undetected indefinitely unless measures aimed at discovering such errors are applied.

Fraud: Fraud is the word used to mean intentional error. This is done deliberately which implies that there is an intent to deceive, to mislead or at least to conceal the truth. It follows that other things being equal, they are more serious than unintentional errors because of the implication of dishonesty which accompanies them. As per SA-240, fraud may involve an international act by one or more individuals among management, those charged with government employees or third parties, involviing the use of deception to obtain an unjust or illegal advantage (*w.e.f.* 01-04-2009).

(*a*) Manipulation, falsification or alteration of records or documents. For example, in a period of rising prices, sales contract documents may be antedated to record sales at prices lower than the prices at which sales have actually taken place;

(*b*) Misappropriation of assets. For example, cash sales may not be fully accounted for;

(*c*) Suppression or omission of the effects of transactions from records or documents. For example, goods sold may not be recorded as sales but included in inventories;

(*d*) Recording of transactions without substance. For example, goods delivered on consignment basis may be recorded as sales; or

(*e*) Misapplication of accounting policies. For example, where a contracting firm follows the 'completed contract' method of accounting but does not provide for a known loss on incomplete contracts.

Therefore, it is clear from the above that the 'fraud' deals with intentional misrepresentation but, 'error', on the other hand, refers to unintentional mistakes in financial information.

A great variety of intentional errors may be found. They range from efforts to conceal one's ignorance or incompetence or petty thefts of cash or merchandise to such things as major defalcations and untruthful financial statements issued to outsiders. Ledger keepers who are unable to agree a trial balance been known to "force" one; petty cashiers have forged vouchers to cover their thefts; they sometimes put wrong totals in various columns to tally the cross totalling, overstated inventory quantities and improperly classified assets/liabilities items have been used to improve the current position in balance sheet issued for credit purposes.

Intentional errors are most difficult to detect and auditors generally devote greater attention to this type because out of long and sometimes unfortunate experience, auditors have developed a point of view that if they direct their procedures of discovering the more difficult intentional errors, they are reasonably certain to locate the more simple and far more common unintentional errors on the way. The auditors have also learnt by experience that although most people are honest under different circumstances but they may be unable to resist temptations. When circumstances are such that the possibility of being caught is rather remote, most people are likely to respond to temptation. This is a well known aspect of human behaviour. Auditors while studying the possibility and nature of fraud, must keep this always in mind and should not make any exception for those who held high offices. Factors, like job satisfaction in terms of responsibility, trust and reward, personal habits, temporary requirements, etc., have great bearing on the matter of commission of fraud. These things generally starts in a non-consequential way — often a subordinate staff member first borrows small amounts from the cash box to meet his temporary difficulty and then gradually it becomes his habit to borrow in such manner whenever he is in difficulty; when he finds that nobody has even an inkling of the matter, he ventures with far larger amounts which on many occasions, he finds himself unable to replace. Fraud also takes place in forms other than cash defalcation, discussed above. It may be misappropriation of goods or manipulation of accounts with a view to presenting a false state of affairs.

Defalcation of cash has been found to be perpetrated generally in the following ways:

(*a*) By inflating cash payments.

(*b*) By suppressing cash receipts, and

(*c*) By casting wrong totals in the cash book.

Examples of inflation of payments:

1. Making payments against fictitious vouchers.
2. Making payments against vouchers, the amounts whereof have been inflated.
3. Manipulating totals of wage rolls either by including therein names of dummy workers or by inflating them in any other manner.
4. Casting a larger totals for petty cash expenditure and adjusting the excess in the totals of the detailed columns so that cross totals show agreement.

We may as well know a few techniques of how receipts are suppressed. There are:

(*a*) **Teeming and Lading:** Amount received from a customer being misappropriated; also to prevent its detection the money received from another customer subsequently being credited to the account of the customer who has paid earlier. Similarly, moneys received from the customer who has paid thereafter being credited to the account of the second customer and such a practice is continued so that no one account is outstanding for payment for any length of time, which may lead the management to either send out a statement of account to him or communicate with him.

(*b*) Adjusting unauthorised or fictitious, rebates, allowances, discounts, etc., customer' accounts and misappropriating amount paid by them.

(*c*) Writing off as debts in respect of such balances against which cash has already been received but has been misappropriated.

(*d*) Not accounting for cash sales fully.

(*e*) Not accounting for miscellaneous receipts, *e.g.*, sale of scrap, quarters allotted to the employees, etc.

(*f*) Writing down asset values in entirety selling them subsequently and misappropriating the proceeds.

Fraud in the form of *misappropriation of goods* is still more difficult to detect; for this management is to rely on various measures. Apart from the various requirements of record keeping about the physical quantities and their periodic checks, there must be rules and procedures for allowing persons inside the area where goods are kept. In addition, there should be external security arrangements to see that no goods are taken out without proper authority. Goods can be anything in the premises; it may be machinery. It may even be the daily necessities of the office like stationary. The goods may be removed by subordinate employees or even by persons quite higher up in the management. Auditors can detect this by undertaking a thorough and strenuous checking of records followed by physical verification process. Also, by resorting to intelligent ratio analysis, auditors may be able to form an idea whether such fraud exists. For example, the gross profit ratio adjusted for any recorded change during the year, reveals whether the value of stock is reasonable with reference to the amount of the sale. Similarly, the input-output ratio of production in terms of physical quantity may reveal whether output is normal with reference to the quantity consumed for production.

Detection of manipulation of accounts with a view to presenting a false state of affairs is a task requiring great tact and intelligence because generally management personnel in higher management cadre are associated with this type of fraud and this is perpetrated in methodical way. This type of fraud is generally committed:

(*a*) To avoid incidence of income-tax or other taxes;

(*b*) For declaring a dividend when there are insufficient profits;

(*c*) To withhold declaration of dividend even when there is adequate profit (this is often done to manipulate the value of shares in stock market to make it possible for selected persons to acquire shares at a lower cost); and

(*d*) For receiving higher remuneration where managerial remuneration is payable by reference to profits.

There are numerous ways of committing this type of fraud. Some of the methods are given below:

(*i*) Inflating or suppressing purchases and expenses;

(*ii*) Inflating or suppressing sales and other items of income,

(*iii*) Inflating or deflating the value of closing stock;

(*iv*) Failing to adjust outstanding liabilities or prepaid expenses; and

(*v*) Charging items of capital expenditure to revenue or by capitalising revenue expenses.

As a general rule, mistakes are unconcealed but frauds are deliberately concealed. This proposition does not need any elaboration; but exceptions are in both cases. Mistakes become concealed if compensated by another or more mistakes in the opposite direction; or it may even be greatly minimised by that chance happening. For example, by mistake one or more accounts were short debited by an aggregate figure of ₹ 30,000 and this short debit is compensated by chance error or say short casting or one or more credit accounts to the tune of say ₹ 30,200 the dimension of the error would apparently be ₹ 200 by which the trial balance would be thrown out of agreement and there may be a temptation to think, "the error is small, let us ignore it". This attitude towards apparently small errors is dangerous because its true dimensions remain concealed and that may render the statements of account totally unacceptable. Mistakes may as well be concealed for wrong arithmetical calculations or for a faulty process of verification. Depreciation and stocks are examples which immediately come to one's mind. Wrong calculation of depreciation or omission to include certain stocks in the inventory or wrong valuation of stocks are not apparent. Petty cash defalcation is often unconcealed because petty cash is an item which on many occasions is left out of checking.

Sometimes, we become so obsessed with the general ledger and its supporting records that we neglect other important features of the accounting system. An accounting system includes both records and procedure. Errors can appear in either or both. Whatever errors occur in the implementation of the procedures may be termed as procedural errors (which include frauds also). For example, the sales procedure of a company may include the following steps:

(*a*) Receipt of an order through salesman.

(*b*) Review of order by the credit department to determine whether the customer should be given credit as requested.

(*c*) Clearance with inventory department to be sure that the order can be executed.

(*d*) Preparation of forwarding note with copies' to obtain the customer's acknowledgement of the receipt of goods.

(*e*) Preparation of invoice and despatch of the same to the customer.

If the procedure requires that these steps should be taken in the order indicated and if, for any reason, the second step is omitted, or is not completed before subsequent steps have been taken an error in procedure has been made and this may lead the company into financial loss caused by non-recovery of the money. Procedures are established to maintain control over resources and over transactions; any failure to follow the established procedures lessens the control and may permit errors which do affect ledger accounts. Any breakdown in established procedures thus suggests not only the presence of a procedure type errors but also of other consequences.

Other errors of this type include the approving of transactions of documents by some one other than the person authorised to do so, failure to ensure that all preceding steps have been taken before approving a document and substitution of one person by another in a procedural function without proper authority. It is the normal procedure that goods, when received should be inspected for quality by the inspection department staff. If the storekeeper carried out this function it is indeed risky. Similarly, if the procedure requires that the timber godown should have been given periodical insecticide treatment and management has ignored that, a great loss may be caused to the timber by white ants. What is needed to be emphasised here is this that a procedural error, which is neither a defalcation nor misappropriation, may involve the company in a sizeable loss. This type of error or fraud cannot be located by any rigorous examination of the books of account.

All these errors discussed above may be grouped in the following categories in terms of their accounting incidence:

(*i*) Errors of omission — where a transaction has been omitted either wholly or partially.

(*ii*) Errors of commission — where a transaction has been misrecorded either wholly or partially.

(*iii*) Compensating errors — where there are two or more errors which exactly counter balance each other, so that the trial balance agrees inspite of them.

(*iv*) Errors of principle — these are errors arising as a result of transactions having been recorded in a fundamentally incorrect manner; for example, a distinction not being made between capital and revenue income or expenditure.

(*v*) Procedural errors.

Detection of Fraud and Error: Duty of an Auditor

SA-315 on Fraud and Error deals at length with the auditor's responsibilities for the detection of material misstatements resulting from fraud and error when carrying out an audit of financial information and to provide guidance as to the procedures that the auditor should perform when he encounters circumstances that cause him to suspect, or when he determines, that fraud or error has occurred. Broadly, the general principles laid down in the SAP may be noted as under:

(*i*) In planning and performing his examination, the auditor should take into consideration the risk of material misstatement of the financial information caused by fraud or error. He should inquire of management as to any fraud or significant error which has occurred in the reporting period and modify his audit procedures, if necessary.

(*ii*) If circumstances indicate the possible existence of fraud or error, the auditor should consider the potential effect of the suspected fraud or error on the financial information. If the auditor believes the suspected fraud or error could have a material effect on the financial information, he should perform such modified or additional procedures as he determines to be appropriate.

(*iii*) The auditor should satisfy himself that the effect of fraud is properly reflected in the financial information or the error is corrected in case the modified procedures performed by the auditor confirm the existence of the fraud. In case auditor is unable to obtain evidence to confirm or dispel a suspicious of fraud, the auditor should consider relevant laws and regulations and may wish to obtain legal advice before rendering any report on the financial information or before withdrawing from the engagement.

(*iv*) The reporting responsibilities would also include communicating with management. When those persons ultimately responsible for the overall direction of the entity are doubted, the auditor may seek legal advice to assist him in the determination of procedures to follow. The auditor should also consider the implications of the circumstances on the true and fair view which the financial statements ought to convey and frame his report appropriately. Where a significant fraud has occurred, the auditor should disclose the fraud in the financial statements.

1.4 FINANCIAL STATEMENT AUDIT

Objectives: The objective of an audit of financial statements (balance sheet, statement of profit and loss account, other statements and explanatory notes which form part thereof issued for the use of shareholders/members; creditors, employees and public at large) prepared by within a frame work of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements.

Auditor's opinion: The objectives of an audit of financial statements, prepared by within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an *opinion on such financial statements.* The author's opinion helps determination of the *true and fair view* of the *financial position* and operating results of an enterprise. The user, however, *should not assure* that the auditor's opinion is an *assurance as to the future viability of the enterprise* or the efficiency or effectiveness with which management has conducted the affairs of the enterprise.

Management Responsibility: While the auditor is responsible for forming and expressing his opinion on the financial statements, the *responsibility* for *their preparation* is that of the management of the enterprise. Management responsibilities include the maintenance of adequate accounting records and internal controls, the selection and application of accounting policies and the safeguarding of the assets of the enterprise. The audit of the financial statements does not relieve management of its responsibilities.

Audit Scope: The scope of an audit financial statements will be determined by the auditor having regards to the terms of the engagement, the requirements of relevant legislation and the pronouncements of the Institute of Chartered Accountants of India. The terms of engagement cannot, however, restrict the scope of an audit in relation to matters which are prescribed by legislation or by the institute.

The audit should be organised to cover adequately all aspects of the enterprise as far as they are relevant to the financial statements being audited. To form an opinion on the financial statements the author should be reasonably satisfied as to whether the information contained in the underlying accounting records and other source, data is reliable and sufficient as the basis for the preparation of the financial statements.

Informing his opinion, the auditor should also decide whether the relevant information is properly disclosed in the financial statements subject to statutory requirements, where applicable.

The auditor assesses the *reliability* and *sufficiency* of the *information* contained in the underlying accounting records and other source data by —

(*a*) Making a study and **evaluation of accounting systems** and internal controls on which he wishes to rely and testing those internal controls to determine the nature, extent and timing of other auditing procedures, and

(*b*) Carrying out such **other tests enquiries** and **other verification** procedures of accounting transactions and account balances, as he considers appropriate in the particular circumstance.

The auditor determines whether the relevant information is *properly disclosed* in the financial statements by —

(*i*) Comparing the financial statements with the underlying accounting records and other source data to see whether they **properly summarize** the **transactions** and events recorded therein, and

(*ii*) Considering the Judgments that management has made in preparing the financial statements accordingly, the auditor assesses the **selection** and **consistent application of accounting policies,** the manner in which the information has been classified and the adequacy of disclosure.

The auditor's work involves exercise of judgment, for example, in deciding the extent of audit procedures and in *assessing* the *reasonableness* of the judgments and estimates made by management in preparing the financial statements. Furthermore, much of the evidence available to the auditor can enable him to draw only reasonable conclusions there from. Because of these factors, *absolute certainly in auditing is rarely attainable.* In forming his opinion on the financial statements, the author follows procedures designed to satisfy himself that the financial statements *reflect a true and fair view* of the financial position and operating results of the enterprise. The auditor recognises that because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any system of internal control, there is an unavoidable risk that some material mis-statement may remain undiscovered. The audit cannot, therefore, be relied upon to ensure the discovery of all frauds or errors but where the auditor has any indication that some fraud or error may have occurred which could result in material misstatement the auditor should extend his procedures to conform or dispel his suspicious.

The auditor is primarily concerned with items which either **individually** or as a **group** are **material in relation** to the affairs of an enterprise. However, it is difficult to lay down any definite standard by which materiality can be judged. Material items are those which might influence the decisions of the user of the financial statements. It is the matter in which a decision is arrived at on the basis of the auditor's professional experience and judgment.

The auditor is **not expected** to **perform duties** which fall outside the scope of his competence. For example, the professional skill required of an auditor does not include that of a technical expert for **determining physical condition** of certain **assets**.

Constraints on the scope of the audit of financial statements that impair the auditor's ability to express an unqualified opinion on such financial statements should be set out in his report and a qualified opinion or disclaimer of opinion should be expressed as appropriate.

(c) External (Statutory) Audit: Auditing of banks, insurance, public sector undertaking, is required as per the requirements of the respective Acts, *viz.*, Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 and 1980, State Bank of India Act, 1955, RRBs Act, 1976 etc. to do statutory audit or audit by external auditor's appointed by RBI or authorities as per respective Acts.

1.4.1 Features of Bank's Audit

(*i*) Banks have custody of large volumes of monetary items, including cash and negotiable instruments (cheque, and bill of exchange or promissory notes) whose physical security has to be ensured. This applies to both the storage and the transfer of monetary items and makes banks vulnerable to misappropriation and fraud. They, therefore, need to establish formal operating procedures, well defined limits for individual discretion and rigorous systems of internal control.

(*ii*) They engage in a large volume and variety of transactions or interms of both number and value. This necessarily requires complex accounting and internal control systems.

(*iii*) Banks normally, operate through a wide network of branches and departments, which are geographically dispersed. This necessarily involves a greater decentralization of authority and dispersal of accounting and control functions, with consequent difficulties in maintaining uniform operating practices and accounting systems, particularly when the branch network transcends national boundaries

(*iv*) Banks assume significant commitments without any transfer of funds. These items, commonly called "OFF BALANCE SHEET" items, may not involve accounting entries and consequently, the failure to record such items may be difficult to detect.

(*v*) Banks are regulated by governmental authorities and the resultant regulatory requirements often influence accounting and auditing practices in the banking sector.

1.4.2 Appointment of Auditor

As per Banking Regulation Act, 1949, the auditor of a banking company is to be appointed at the AGM of the shareholders, where as, the auditor of a nationalized bank is to be appointed by the bank concerned acting through its Board of Directors, in either case, approval of the RBI is required, before the appointment is made. The auditor's of the State Bank of India, are to be appointed by the RBI, in consultation with the Central Government. The auditors of the subsidiaries of the SBI, are to be appointed by the SBI. The auditors of the RRBs Banks are to be appointed by the bank concerned with the approval of the Central Government. Nationalized banks and SBI generally appoint two or more firms as Joint-auditors.

Auditor's Report: (as per SA-700/706/720 effective from 01-04-2011) In the case of a nationalized bank, the auditor is required to make a report to the Central Government in which he has to state the following:

(*a*) Whether, in his opinion, the balance sheet is a full and fair balance sheet containing all the necessary particulars and is properly drawn up so as to exhibit a true and fair view of the affairs of the bank, and in case he had called for any explanation or information, whether it has been given and whether it is satisfactory.

(*b*) Whether or not the transactions of the bank, which have come to his notice, have been within the powers of that bank

(*c*) Whether or not the returns received from the offices and branches of the bank have been found adequate for the purpose of his audit.

(*d*) Whether the profit and loss account shows a true balance of profit or loss for the period covered by such account, and any other matter which he considers should be brought to the notice of the Central Government.

The report of auditors of State Bank of India, is also to be made to the Central Government and is almost identical to the auditor's report in the case of a nationalized bank. Besides the audit report, as per the **Statutory Requirements** the terms of appointment of auditors of public sector banks, private sector banks and foreign banks, as well as their branches, require the auditors to also furnish a **long form audit report** (LFAR).

Conducting an audit – the audit of banks or of their branches involves the following stages—

(*i*) Preliminary work

(*ii*) Evaluation of internal control system

(*iii*) Preparation of audit programme

(*iv*) Preparation and submission of audit report.

(i) Preliminary Work: The auditor should acquire Knowledge of the regulatory environment in which the bank operates. Thus, the auditor should familiarize himself with the relevant provisions of applicable laws and ascertain the scope of his duties and responsibilities. He should be well acquainted with the provisions of the Banking Regulation Act, 1949, as well as any other applicable laws *e.g.,* Companies Act, 2013, in the case of audit of a banking company, particularly in so far as they relate to preparation and presentation of financial statements and their audit.

The auditor should also acquire knowledge of the economic environment in which the bank operates. Similarly the auditor needs to acquire good working knowledge of the services offered by the bank. In acquiring such knowledge, the auditor needs to be aware of the many variations in the basic deposit, loan and treasury services that are offered and continue to be developed by banks in response to market conditions. To do so, the auditor needs to understand the nature of services rendered through instruments such as *letters of credit,* acceptances, forward contracts, and other similar instruments.

The auditor should also obtain an understanding of the nature of books and records maintained and the terminology used by the bank to describe various types of transactions and operations. In the case of joint auditors, it would be preferable that the auditor also obtains a general understanding of the books and records, etc., relating to the work of other auditors. In addition to the above, the auditor should also undertake the following —

(*i*) Obtaining the internal audit reports, inspection reports and concurrent audit reports pertaining to the bank/branch.

(*ii*) Obtaining the latest report of the revenue or income and expenditure audits, where available and

(*iii*) In the case of branch auditors, obtaining the report given by the outgoing branch manager to the incoming branch manager in the case of change in incumbent at the branch during the year under audit, to the extent the same is relevant for the audit. RBI has introduced an off-site surveillance system for commercial banks on various aspects of operations including **solvency, liquidity, asset-quality,** earnings, performance, insider trading, etc., and has indicated that such reports shall be submitted at periodic intervals from the year commencing 1st April, 1995. It will be appropriate to be familiar with the reports submitted and to review them to the event that they are relevant for the purpose of audit.

In a computerized environment the audit procedures may have to be appropriately turned to the circumstances, particularly as the books are not authenticated as in manually maintained accounts and the auditor may not have his in house computer facility to test the software programmes. The emphasis would have to be laid on internals control procedures related to inputs, security in the matter of access to EDP system, use of codes, passwords, data inputs being prepared by persons independent of key operators and other built in procedures for data validation and system controls as to ensure completeness and correctness of the transactions keyed in system documentation of the software may be obtained and examined.

(ii) Evaluation of Internal Control System: Transactions in banks are voluminous and repetitive, and fall into limited categories/eopynet clear of account. It may, therefore, be more appropriate that the evaluation of the internal control is made for each class/category of transactions. If the exercise of internal control evaluation is properly carried out, it will assist the auditor to *determine* the *effectiveness* or otherwise of the control systems and accordingly enable him to strengthen his audit procedures, and lay appropriate emphasis on the risk prone areas. Internal control would include; *Accounting* controls and *administrative* controls.

Accounting Controls: Accounting controls cover areas directly concerned with recording of financial transactions and maintenance of such registers/records as to ensure their reliability. Internal accounting controls also envisage such procedures as would determine responsibility and fix accountability with regard to safeguarding of the assets of the bank. It would not be out of place of mention that there is a distinction between accounting systems and internal accounting controls. Accounting system envisages the processing of the transactions and events, their recognition, and appropriate recording. Internal controls are techniques, methods and procedures so designed and usually built into systems, as would enable prevention as well as detection of errors, omissions or irregularities in the process of execution and recording of transactions/events.

Administrative Controls: These are broadly concerned with the decision making process and laying down authority/delegation of powers by the management. It may be noted that in the normal course, the head office/regional offices do not conduct any banking business. They are responsible for administrative and policy decisions which are executed at the branch level.

(iii) Preparation of Audit Programme: Having familiarised the requirements of audit, the auditor should prepare an audit programmes for substantive testing which should adequately cover the scope of his work. In framing the audit programme, due weightage should be given by the auditor to areas where, in his view, there are weaknesses in the internal controls. The audit programme for the statutory auditors would be different from that of the branch auditor. At the branch level, basic banking operations are to be covered by the audit. On the other hand, the statutory auditors at the head office level have to deal with consolidation of branch returns (both audited and unaudited), verification of investments, items normally deal with at the head office (like provision for gratuity, interoffice accounts etc.). The scope of the work of the statutory auditors would also involve dealing with various accounting aspects and disclosure requirements arising out of the branch returns.

(iv) Preparation and Submission of Audit Report: The branch auditor forwards his report to the statutory auditors who have to deal with the same in such manner as they consider necessary. It is desirable that the branch auditors' reports are adequately detailed in unambiguous terms. As far as possible, the financial impact of all qualifications or adverse comments on the branch accounts should be clearly brought out in the branch audit report. It would assist the statutory auditors if a standard patterns of reporting, say head wise, commencing with assets, then liabilities and thereafter items related to income and expenditure, is followed. In preparing the audit report, the auditor should keep in mind the concept *of materiality*. Thus, items which do not materially affect the view presented by the financial statements may be ignored. However, if in the judgment of the auditor, an item though not material, is contrary to accounting principles or any pronouncements of the Institute of Chartered Accountant of India or is such as would require a review of the relevant procedure, it would be appropriate for him to draw the attention of the management to this aspect in his long form audit report. In all cases, matters covering the statutory responsibilities of the auditors should be dealt within the main report. The LFAR should be used to further elaborate matters contained in the main report and not as a substitute thereof. Similarly, while framing his main report, the auditor should consider wherever practicable, the significance of various comments in his LFAR, where any of the comments made by the auditor therein is adverse, he should consider whether a qualification in his main report is necessary by using his discretion on the facts and circumstances of each case. It may be emphasised that the main report should be self-contained document.

1.5 AUDIT PROCEDURE

Selection of the appropriate audit procedure is again a matter of experience and judgment. Take extreme example of contingent liability in respect of pending suits: no entry or other records for this would be available to the auditor; verification of the estimate of the liability would become difficult for lack of basis. In such cases it would be more reasonable for the auditor to get the estimate confirmed by the solicitors of the company. In addition, he should examine the correspondence pertaining to the case and should discuss the matter with the company's officials. If the company was involved in a similar suit in the past, by going through the records thereof; the auditor would be able to cull out relevant considerations for estimating the liability. In any case, the auditor is not precluded from making his own estimate on the basis of similar cases reported in the law journals.

The normal procedure for verification of cash balance is counting but this is not practicable in respect of the cash-in-transit. The auditor has to think in advance about the possibilities of departure from the normal procedure and the areas likely to be affected thereby. The procedure should provide for such situations in the programme.

It has been emphasised earlier that all available evidence should be used by the auditor but it is not intended to stretch it too far. Sometimes evidence collection becomes costly both in terms of money and time involved. If you are checking the cost of a building constructed by the client in addition to having recourse to all internal evidence, you may have the temptation of getting an independent valuation certificate by a professional valuer. This would be an unwise course in the absence of any suspicious circumstances — it would cost the company a lot of money for procuring that evidence for the satisfaction of the auditor; it may also give rise to an unwarranted feeling suspicion about the bonafide of the management, though there was no evidence available with the auditor to suggest it. The auditor must be cautious and reasonable in his attitude. If, however, the situation was otherwise, *i.e.*, the evidence normally made available to the auditor failed to provide him with satisfactory evidence about the cost incurred, it may be absolutely necessary for him to insist on an independent valuation.

While collecting audit evidence through an audit procedure, the auditor collects the same by employing different techniques. In order to verify a particular item in financial statements, say, cash, he may have to collect audit evidence from different sources. For instance, in case of cash at bank, reference may be made to bank column in cash book, reference to bank reconciliation statement followed by examination of bank statement/bank pass book. Further, the auditor may like to obtain confirmation from the client's asset. During all this process, the auditor would have to see that audit evidence obtained from different sources does not contradict each other and the cost of obtaining more and more audit evidence is justified by the benefit flowing from obtaining such evidence.

Possibility of fraud and error is ruled out while framing the audit programme. The auditor should prescribe procedures and techniques keeping this possibility in view. If he undertakes a review and testing of internal controls and checks before or while drawing up the programme, he would reasonably be in a position to focus his attention on the matters where this possibility is rather great. The consideration of the auditor should be specifically directed to provide for the discovery of serious errors and frauds, the potential of which is great. The possibility of other errors which are generally not of great consequence can be left open to be observed and discovered in the course of normal evidence collection process.

Coordination of the Procedures: Knowledge about accounting may be conveniently used in assembling the procedures in the most rational and natural manner. Fixed assets, like plant and machinery or buildings are directly linked with charges for repairs, maintenance and depreciation; purchase is linked with inward freight and sales with outward freight, sales tax and excise duty; earnings from investments bear a relationship with the investments. Hence, in assembling the procedures and methods, if the related items are grouped together, the programme becomes cohesive, comprehensive, purposeful and easy to coordinate; the work can also he conveniently distributed amongst assistants on the basis of the groupings so that, say the assistant assigned the work in connection with plant and machinery would be responsible for carrying out also the related work, *e.g.*, repairs and depreciation. This would help easy flow of work with the least possibility of any information gap to the assistant concerned.

1.5.1 Audit Planning

As per Statement on Standard Auditing Practices 1, "Basic Principles Governing an Audit", Audit planning is one of the basic principles. Accordingly, it states:

"The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client's business.

Plans should be made to cover, among other things:

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

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

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

(*d*) Coordinating the work to be performed.

Plans should be further developed and revised as necessary during the course of the audit."

SAP-8 further expounds this principle. According to it, planning should be continuous throughout the engagement and involves

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

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

Objectives of Planning: Adequate audit planning helps to

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

In planning his audit, the auditor will consider factors such as complexity of the audit, the environment in which the entity operates, his previous experience with the client and knowledge of the client's business.

The auditor may wish to discuss elements of his overall plan and certain audit procedures with the client to improve the efficiency of the audit and to coordinate audit procedures with work of the client's personnel. The overall audit plan and the audit programme, however, remain the auditor's responsibility.

Knowledge of the Client's Business

It is one of the important principles in developing an overall audit plan. In fact without adequate knowledge of client's business, a proper audit is not possible. SA-20 on "Knowledge of the Business" deals in detail about the significance of such knowledge on the part of the auditor.

The auditor needs to obtain a level of knowledge of the client's business that will enable him to identify the events, transactions and practices that, in his judgment, may have significant effect on the financial information. Among other things, the auditor can obtain such knowledge from:

- The client's annual reports to shareholders.
- Minutes of meetings of shareholders, board of directors and important committees.
- Internal financial management reports for current and previous periods, including budgets, if any.
- The previous year's audit working papers, and other relevant files.

- Firm personnel responsible for non-audit services to the client who may be able to provide information on matters that may affect the audit.
- Discussions with client.
- The client's policy and procedures manual.
- Relevant publications of the Institute of Chartered Accountants of India and other professional bodies, industry publications, trade journals, magazines, newspapers or text books.
- Consideration of the state of the economy and its effect on the client's business.
- Visits to the client's premises and plant facilities.

With respect to the previous year's audit working papers and other relevant files, the auditor should pay particular attention to matters that required special consideration and decide whether they might affect the work to be done in the current year.

Discussions with the client might include such subjects as:

- Changes in management, organisational structure, and activities of the client.
- Current Government legislation, rules, regulations and directives affecting the client.
- Current business developments affecting the client.
- Current or impending financial difficulties or accounting problems.
- Existence of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.
- New or closed premises and plant facilities.
- Recent or impending changes in technology, type of products or services and production or distribution methods.
- Significant matters arising from previous year's financial statements, audit report and management letters, if any.
- Changes in the accounting practices and procedures and in the system of internal control.
- Scope and timing of the examination.
- Assistance of client personnel in data preparation.
- Relevance of any work to be carried out by the client's internal auditors.

In addition to the importance of knowledge of the client's business in establishing the overall audit plan, such knowledge helps the auditor to identify areas of special audit consideration, to evaluate the reasonableness both of accounting estimates and management representations,

1.6 MANAGEMENT AUDIT

Management audit is an audit of the management. The management audit would concern itself with the whole field of activities of the concern, from top to bottom, starting, as always where management control is concerned, from the top, because we are primarily concerned with whether the general management is functioning smoothly and satisfactorily. If it is not, it may be due to the functional management being faulty and, therefore, we pass on to examine that in its turn, in order to find the missing or faulty link which is causing the trouble. It includes review of the adequacy and competence of the objectives, plans, policies and decisions of the top management. In a management audit, the auditor will look to see whether management is getting information relevant to the decisions and actions, which it must take. This will require a much more intensive analysis of information needs and the efficiency of the existing system in meeting them. The auditor will not have to decide whether management is making the right strategic and operative decisions but rather, whether management has always to it and is using the relevant information and techniques necessary to evaluate rationality the various alternatives that exist. Management audits are concerned with appraising management's accomplishment of organizational objectives, the management functions of planning, organising, directing and controlling and the adequacy of management's decisions and actions in moving towards its stated objectives. Hence, the accent is on evaluating manager's ability to manage.

Management audit is concerned with the wide spectrum of issues such as objectives, policies, strategies, effectiveness of the structure work systems, work culture and the organisational processes. In management audit, the auditor is to make his test to the level of top management, its formulation of objectives plans and policies and its decision making. It is not that he just verifies the operations of control and procedures and fulfillments of the plans in conformity with the prescribed policies. He is to reach the root *i.e.,* the *functions of top management* which lay down objectives and policies, provide means and procedures of implementations and control and which actually engage in direction and control on a continuous basis. In addition to what would normally be covered in an operational audit, management audit, management audit, would also encompass the relevance and effectiveness of the *aims, duties and decisions of management* at various levels. Every aspect of the functions of Board of Directors should be in *conformity with the objects* set out in the constituting document. Similarly the managing director, if any, *should act not only in accordance* with the *mandate,* he has received but he should ensure that the decisions he takes, *are in conformity* with the *objects of the company* and *the policies formulated* by the Board. The *effectiveness of management* under the control of managing director and the various members of the Board including those of incharge of finance, production, sales, publicity, personnel etc. should be subject to review of the management auditor. From the point of view of the *management auditor, knowledge* about the following is essential:

(i) ***Purpose of organization:*** The purpose of steel rolling mill in the public sector is:

(*a*) To reduce imports of steel

(*b*) Creation of employment opportunities

(*c*) Development of backward areas

(*d*) Providing staff welfare consistent with the needs

(*e*) Running of steel rolling for profit

(ii) ***Delegation*** of authority, planning and budgeting

(iii) ***Reports*** for a proper management and receipt of such reports.

(iv) ***Internal controls.***

(v) ***Knowledge of flow*** and content of work leading to production and their mutual relationships.

(vi) ***Production planning***

(vii) ***Factory layout,*** design and installed capacity.

(viii) ***Personnel policy*** and personnel management including training, welfare, incentives and punishments.

(ix) ***Materials management*** including sources of raw materials, receipt of materials of the quality and quantity needed, storage, supervision and safe custody, insurance and procedure for issue of materials.

(x) ***Sales management*** and sales planning including advertisement policy.

(xi) ***Decision making*** process.

(xii) ***Financial management*** of the organisation.

1.6.1 Desirability of Management Audit

It is a **tool to improve management performance** by recognizing facts and information about management presented after appropriate examination, verification and evaluation, by professionally qualified and competent people. Naturally, any organization of a reasonable size may be able to **derive benefit** from this form of audit which is distinctly different from annual statutory financial auditing and deeper and broader than the conventional internal auditing. Management audit focuses attention on a comprehensive and constructive examination of the organization structure, its components such as divisions, departments, ventures, plans, policies, its financial control system, its method of operation, its appropriate use of human physical and financial resources. The main reason for undertaking a management audit is the *need for detecting* and *overcoming current* managerial *deficiencies* in *ongoing operations.* Unlike the annual review by outside accountants which focuses on financial results of the past year and thus is backward looking, a management audit represents a more positive, forward looking approach that evaluates, how well management accomplishes its stated organisational objectives, how effective management is in planning, organising, directing and controlling the organisation's activities, and how appropriate management's decision are for reaching stated organisation objectives. The evaluation of management performance is achieved with the aid of a *management – audit questionnaire*. The important point is, that some group is charged with the responsibility to undertake this evaluation *process periodically.* One benefit of the management audit, then, is that managerial problems and related operational difficulties can be spotted before the fact rather than after the fact as with a financial audit. This *Forward Looking* approach is analogous to the preventive maintenance concept found in production, that is, periodic management audits can pin-point problems as they are developing from a small scale. In comparison detecting the same problem at a later time, when they have generally increased in scope, results in higher costs to the organisation.

A **second important** benefit of management auditing is that it *represents another management tool to assist* the organisation in accomplishing desired objectives. The capability of the management audit questionnaire to pin point important problem areas that are related to managing an organisation is a real plus factor for its use. *Business failures* are caused largely by poor management what better way can this important problem overcome than by employing management audit in an objective manner ? If certain mangers are ineffective in their present positions, appropriate corrective action should be taken. Management auditing would be clearly helpful in the case of ailing industries, to isolate the problems and account *for their ailments*. It is specially important if such industries are either to be *taken over* by the *government* or to be *heavily financed by financial institutions* with a view to bring *back vigour* in them. Given bad management, any amount of money pumped in may go waste, similarly, without proper knowledge of the causes of sickness, government takeover may not cure the ills. Even a sound entity may also benefit from the periodical management audit, further improvement in its operations can be effected the brewing or latent problems may be detected and analyzed and opportunities or difficulties created by changing circumstances can be known. By the time problems are known, considerable monetary and other losses take place. These losses can probably be minimized to a great extent by the introduction of management audit. Public sector companies have earned a reputation as *Repository* of enormous volume of stocks and stores which either would never be used or would take long time to use. This single phenomenon has inflicted loss of crores of rupees of the public sector industries.

The Audit by professional auditors and the audit of the C. and A.G. **is not aimed** to cover the entire area that can reasonably by covered by management audit.

Management audit Reports: Management audit reports, will inevitably cover a wide variety of subjects, reflecting as they do the many and cover increasing ramifications of management audit departments. Broadly, however, reports may be divided into **four main categories:**

(*i*) Reports after visits to a unit

(*ii*) Periodical reports summarizing the main audit findings and recommendations

(*iii*) Reports on the results of special investigations and inquiries

(*iv*) Annual audit report.

1.6.2. Types of Reports

The reporting of results covers a wide spectrum of types, such as :

1. Oral Report.
2. Interim Written Report
3. Regular Written Report
4. Summary Written Report.

(1) Oral Report: In many situations, the reporting of results will be an oral basis. To some extent, this is inevitable since a part of the actual audit effort is carried on in conjunction with company personnel. In other cases, it is a result of **emergency action needs.** It may also be a prelude to more formal written reports. Oral reporting serves a useful and legitimate purpose. It is recognized that it has a major limitation that there is **no permanent record**. **For example,** a management auditor if he has come across any embezzlement should immediately inform the concerned management orally, so that steps may be immediately taken to present further embezzlement.

(2) Interim Written Report: Where it is deemed advisable to inform management of significant developments during the course of the audit, or at least preceding the release of the regular report, there may be some kind of interim written report. This report may pertain to especially significant problems where there is a need for early consideration or the report may be of a progressive nature. Normally, interim reports are full, curved in the final regular reports unless certain matters included in the interim report have been cleared/rectified to the auditor's satisfaction. All in all, interim reports represent a type of reporting which, when used with judgments can be a good device to improve the total reporting process.

(3) Regular Written Report: In the particular audit assignment the preparation of formal report is included. The form and content of such written reports will vary widely, both as between individual audit assignments and individual companies. They may be short or long. They may be presented in many different ways, including the extent to which quantitive or financial data are re-included.

(4) Summary Written Report: These summary reports are also referred to as "flash" reports. In a number of companies the practice has developed of issuing an annual report summarizing the various individual reports issued, and describing the range of their content. These summary reports in some cases are *primarily for audit committees* of Boards of Directors, but in other cases for higher level management. They are especially useful to TOP LEVEL MANAGERS who do not actively review the individual reports.

1.6.3. Difficulties in Management Audit

One of the biggest difficulties involved during the course of management — audit is that people working in the government do not wish to accept any change. While at the of **conducting interviews** people working in the organization are amenable to change but at the *time of actual implementation,* they come up with stiff resistance to proposals on account of various *behavioural problems,* arising on this account. Another fear which haunts executives working in the organization is that the management – auditor's recommendations may lead to their removal or reshuffling in the process.

Financial auditors deal mainly with *figures,* while management auditors deal mainly with people. Therefore, management auditors must develop and maintain good relations with audites to gain information's and do ensure corrective action on audit findings. Yet, the general image that the auditor seemed to create is that he is a *critic, fault finder* or *private spy* of the top management. It is an *occupational risk* of management auditors to come across very often ruffled feelings, hostile relationship and unwelcome atmosphere. Suggestions made by management audit either may not be accepted or if forcibly implemented attempts are like to be made to make them a failure. The staff/line relationship is in herently prone to conflict. Management auditors are staff and the people in the sense all members of other departments of the organisation are likely to regard the management auditor, the same ways as they regard other staff people. Management Auditors being specialists in their field may think that their approach amd solutions are the only answers. They tend to discount the difficulty, people may face if called on to act on their ideas. Line personnel will almost regard staff with antagonism.

Fear of adverse opinion: As the management auditor is expected to evaluate the effectiveness of controls, there is an instinctive reaction from the auditee to have certain amount of fear that his actions when reported are likely to CAUSE adverse effect on those who receive the auditor's report, *viz., top management.* There is a certain amount of justified fear that top management's opinion of their performance or implementation of control procedures is likely to be effected by the auditor's report. Therefore, the management auditor being the part of control system and through evaluation of controls, lead to breeding of antagonism on the part of auditees. The causes of antagonism are:

- Fear of criticism stemming from adverse audit findings
- Fear of changes in day to day working habits because of changes resulting audit recommendations.
- Punitive action by superiors prompted by reported deficiencies.
- Insensitive audit practices reports which are overly critical reports which focus on deficiencies only, the air of mystery clocking some audits, and the perception that auditors gain personality from reporting deficiencies.
- *Hostile Audit Style:* A cold and distinct aspect is a lack of understanding of the auditee's problems, an absence of empathy, an air of smugness or superiority, an excessive concentration on insignificant errors, a prosecutional tone when asking questions, and a greater concern with parading defects than helping constructively to improve conditions.

The other significant cause is that auditor's study of existing systems and procedures may give room for recommendations for *changes of such systems*. There is a certain built-in resistance to change. When a change is recommended by the auditor the **resistance to change is transferred** to the auditor's recommendations and the auditor. The auditor is looked upon as a likely instrument for recommending changes and auditees do not welcome the visits of auditors and much less their studies and their reports thereafter.

Solution to behavioural problems : Relations between the auditor and the auditee may improve if the auditor acts and is perceived as a professional advisor and consultant. In event, there is a need to demonstrate to the extent if possible that

1. the audit is a part of an overall programme mandated by higher-level authority to meet higher level organisational needs for both *protection* and *maximum constructive benefit.*
2. the objective of the review is to *provide maximum service* in all feasible managerial dimensions
3. the review will be conducted with *minimum interference with regular operations* of the operating personnel.
4. the responsible officers will be kept fully informed and have an *opportunity* to *review findings* and recommendations before any audit report is formally released.
5. it is essential to create an atmosphere of trust and friendliness so that audit reports will be understood in their proper prospective.

Constructive Criticism by Auditors: It is essential that the auditor should concentrate only on constructive criticism. Once the auditor is able to convince the auditees that his approach is one of mutual problem solving rather than one of fault finding, them it would produce positive results and the chances of auditor's recommendations being considered in an objective fashion would be better. If the auditors were to adopt a *fault-finding role*, the auditee would be constrained to become defensive and would bend backwards to justify their position.

CASES OF BEHAVIOURAL PROBLEMS

Case 1 — Auditor objective and Auditee offensive

In Aptec Computers Ltd., the management auditor as a part of his duty was expected to perform the audit function of the consultancy division of the organisation. The auditor is the normal functioning discovered *lack of control* and a further study revealed suppression of information regarding illegal procedures being followed by the department. His further in-depth examination of the books revealed that the division has been overstating profits, to justify its existence. These facts which had been in existence with the knowledge of incharge of sales-division had been left undetected. The auditor was totally professional. His attitude was not one of *policing*. He had discussed the contents of the proposed report with the auditee. The auditee had to be offensive. Management had to face the predicament of appreciating the good job done by the management audit department without openly decrying the sales manager. There was open cold war of hatred and hostility declared by the sales manager. The behavioural problems arose in spite of auditor's professional role. The *auditee's reaction* was *instinctive* as a corollary to being self-defensive. The management had a tough time. The problem was sorted out and the atmosphere of ill-feeling and hatred generated by the auditee could be smoothened.

Case II — Auditee Progressive and Auditor Cantankerous, Management Indifferent

In a large organization, High Value Ideas Ltd., there was a long-standing problem of lack of coordination between marketing and production. The pressures of day to day problem, made the situation worse. Production and marketing manager were happy to have the services of the management, auditor to streamline procedures and monitor the implementation. It would have been ideal for the auditor to evolve a good system after a detailed study of the problems, have the key personnel of production and marketing departments participate in the discussion and to have introduced the proposed system with their cooperation. Instead the auditor took on his duty as a mission for fault finding and started submitting secret reports on the malfunctioning of the production and marketing departments. Management, having already the heavy load of coordination would seek explanations from production and marketing departments. The auditor's cantankerous behaviour and management's indifferent attitude inspite of auditee's very cooperative approach gave room for a series of behavioural problems. A participative approach, with the total curtailment of **policing** reports with the correct guidance from the management would have avoided all behavioural problems.

1.7 SOCIAL AUDIT/ENVIRONMENT AUDIT/ENERGY AUDIT

(a) Social Audit

Social obligations may be imposed by law, contract or be undertaken voluntarily. In practice, there may be little difference between the behaviour expected from the private sector and the public sector undertakings. However, there is usually an expectations that the Government Business Enterprises (GBEs) will act in accordance with the highest standards.

The challenges which faces countries, is how to get an acceptable balance between commercial concerns and social responsibilities of GBEs. The general worldwide trend of improving the financial performance of PSUs is likely to impose limits on the extent to which these organisations can undertake uneconomic social responsibilities. This emphasis on the **Rate of Return**, from the Government investment in these organizations may lead them to give a lower priority to their social obligations at a time when there is growing public concern over the organization responsibilities to the environment clients and employees.

The accounting rate of return is the rate used for discounting social profits. In determining the accounting rate of return the following considerations should be borne in mine

- The future social profit for all the projects (enterprises) must be discounted.
- The rate of return should be such that all mutually compatible projects with positive present social value can be undertaken.
- The accounting rate of return (interest) should maintain some kind of balance between investment and investible resources, *too low* on accounting rate of interest would lead to *over investment* with inflationary effect and *too high* an accounting rate of interest would leave savings under utilised and result in exeessive unemployment.
- The rate of return currently being earned is a good guide to the accounting rate of interest when the following conditions are reasonably satisfied
  (*i*) indirect taxes are fairly uniform with little discrimination between imported and exported commodities.
  (*ii*) the social wage rate is close to the actual wage rate.
- Experience is the best guide to the choice of accounting rate of interest. If the *investment requirement* of acceptable projects *exceeds* the availability of investible funds, increases the accounting rate of interest. If the investment *requirement of acceptable* projects *is less* than the availability of investible funds, decrease the accounting rate of interest.

(b) Environmental Audit

Environmental audit is a term commonly used to describe the disclosure by an entity of environmentally sealed verified (audited) or not regarding environmental *risks, impacts, policies, strategies, targets, costs, liabilities or performance,* to those who have an interest in such information as an aid to enabling enriching their relationship, via either —

(*i*) The annual report and accounts package

(*ii*) A stand-alone Corporate Environmental Performance Report (CEPR).

(*iii*) A site centered environmental statement, or

(*iv*) Some other medium (*e.g.*, staff news letter, video CD ROM, Internet site).

Environmental audits are becoming increasingly common in certain industries. Audit can be performed by *external* or *internal experts* (sometimes including internal auditors). Often the work is performed by a multi disciplinary team and is performed at the *request of management* and are for *internal use*.

In our country, the Regulatory Authorities like Ministry of Environment and Forest, State Pollution Control Board, State Development of Environment etc. have come into play to clear the projects from environment view point before its commissioning. The Environmental Impact Assessment (EAI) is a pre-requisite to start an industry. The EAI tries to forecast the expected damage to be caused by the development of the industries to the environmental and the means required to mitigate that damage, in corporating the same in the Project Report for compliance in due course, keeping in view the serious threat to all the living beings in the universe by the repaid industrialisation, which is polluting the environmental on an irreparable extent. The Government of India Notification by GSR No. 329 E dated 13/02/1992 has asked that "Every person carrying on an industry; operation or process requiring consent under section 25 of the Water (Prevention and Control of Pollution) Act, 1974 or under section 21 of the AIR (Prevention and Control of Pollution Act 1981 or both or authorization under the Hazardous Waste (Management and Handling) Rules 1989, issued under Environment Protection Act 1986, shall submit an Environment Audit Report for the financial year ending 31st March in form V to the concerned State Pollution Control Board on or before the 15th day of May, every year beginning 1993.

With a view to define the *Environmental Audit, it may be stressed that it is a critical analysis of (i) policies (ii) principles (iii) systems (iv) procedures (v) practices and (vi) performances* of the aspect which relates to the environment. It is a management tool comprising a systematic, documented, periodic and objective evaluation of how well environmental organization, management and equipment are performing with the aim of helping to safeguard the environment by —

(*i*) Facilitating management control of environmental process.

(*ii*) Assessing compliance with company policies, which would include meeting regulatory requirements.

The Objective of Environment: Audit are to evaluate the efficacy of the utilisation of resources of man, machines and materials, and to identify the areas of environmental risks and liabilities and weaknesses of management system and problems in compliance of the directives of the regulatory agencies and control the generation of pollutants and/or waste.

The environment audit is in its infancy and information what is usually required meant for the compliance of the statutory requirements *i.e.*, to obtain clearance before establishing an industry.

Aspects to be considered for environmental audit

(i) ***Layout and Design:*** The layout to be sketched in the style which will allow adequate provisions for installing pollution control devices, as well as provision for upgradation of pollution control measures and the meeting of the requirements of the regulations framed by the Government. In the course of the audit, the areas which requires attention but not attended by the industry to be pinpointed. Further, future requirements of environmental measures with the proposed future course of working plan are to be identified.

(ii) ***Management of Resources:*** Management resources include air, water, land, energy; raw materials and human resources besides others. The waste of resources to the minimum possible extents is good for the health of the industry as well as the environment.

(iii) ***Pollution Control System:*** An effective pollution control system should be in existence. One aspect should be whether all required pollution control measures are in vogue or not. Next aspect should be whether the same is effective or not. Further, it is to be investigated whether more measures are required.

(iv) ***Emergent Safety Arrangement:*** The chemical, gas etc. industry which are *prone to sudden* requirements of *safety* arrangements, must *remain alert* all the while. The emergency plans are to be reviewed periodically sufficient staff along with other required safety amenities should be kept ready.

(v) ***Medical and Health Care:*** The medical services should be maintained. The health of the workers should be a big consideration for the management.

(vi) ***Industrial Hygiene:*** Proper system should be in vogue to eliminate industrial unhygienic state.

(vii) ***Occupational Health:*** As the occupational health *hazards varies* from industry to industry due to the differences in the nature of working atmosphere and the pollutants present in it, the concerned industry must pay proper weightage to those diseases which are prone to that particular type of industry.

(viii) ***Assimilation and Reporting:*** The information system should be strengthened to generate and its reporting system should be proper, keeping in view, the authorities, responsibilities and subsequent delegations. A report of compliance of all statutory environmental laws alongwith other preventive and precautionary measures should be put to Board at regular intervals.

(ix) ***EIA Methodology:*** Environment Impact Assessment (EIA) is usually are pre requisites to start an industry. This is done considering the known spheres of activities on the existing environment conditions. But the predictions necessarily deviate from the actual happenings when the industry starts working.

(x) ***Compliance to regulatory mechanism:*** The persons who are directly working with the system, should be trained and instructed on regular basis, to avoid making the Board/ owner vulnerable to prosecution and penalty.

(xi) ***Concern for the society:*** The audit should look into gaseous, dustful, clumsy state of surroundings so that the displaced persons should not feel alienated with industrialization and make a balance between its own development and the society's concern.

(c) Energy Audit

In addition to general points of audit, there are special points which arise in energy audit (or electricity companies)

(i) The auditor should study the provisions of the Electricity Supply Act, 1948 and the Indian Electricity Act, 1910 relating to the accounts of the company.

(ii) Should examine the internal control system specially in regard to the methods of billing consumers, recording payment of wages to worker and the collection of debts.

(iii) Compare the consumer's tabular ledger with the original records.

(iv) Test check the receipt of cash/cheque from the consumers with reference to the bills and the entries in the machine for receipt.

(v) Should ensure the arrears for properly accounting for and recovered from the consumers.

1.8 AUDITING IN A COMPUTERIZED ENVIRONMENT (EDP)

EDP Audit is the process of auditing in a computerized environment. The prime objectives of EDP Audit are to determine whether computer systems safeguard assets, maintain data integrity, achieve organisational goals effectively and consume resources efficiently. The use of a computer changes the processing and storage of financial information and may affect the organization and procedures employed by the entity to achieve adequate internal control.

The impact on auditing is as follows:

1. Widespread end-user computing could sometimes result in *unintentional errors* into systems owing to inexperienced persons being involved. Also, coordinated program modifications etc. may not be possible.
2. Improper use of Decision Support Systems (DSS) can have *serious repercussions*. Their underlying assumptions must be clearly documented.
3. Auditor's participation to a *limited extent* in systems development may become in evitable to ensure that *adequate controls* are built in
4. *Usage of sophisticated* audit software would become a necessity, since *contenventional methods* of auditing would no longer be sufficient.
5. *Data communications* and networking would *introduce new risks,* which an auditor must be aware of . He must have sufficient knowledge in this area to recommend the necessary *data security* and *control measures.*
6. The move towards paperless electronics data inter change *(EDI)* would *eliminate* much of the traditional *audit trail,* radically changing the nature of audit evidence.

1.8.1. Types of EDP Accounting

Many types of computer systems are currently in use. These systems are distinguished by the methods they use for processing transactions, by the type of filling systems used for storing and retrieving data, and by the hardware configuration comprising the system. This section briefly describe the more common systems to be found under each of these headings:

(*a*) Processing System

(*b*) Time sharing and service bureaus.

(*c*) File systems.

(*d*) Hardware Configurations.

(a) Processing Systems: It has got two systems:

(i) Batch Processing: *Transactions* are *accumulated* and *processed* in *group* sales orders for the day, invoices to be recorded, and daily each receipts might each be viewed as a batch of transactions, to be processed as a group. Control totals, consisting of adding – machine tapes, summing the rupee account of transactions in a group, are usually developed and compared with output in order to assure complete and accurate processing. *Batch processing* systems are distinguished by their relative simplicity and realiability. They *do not process* transactions as *quickly* as the more advanced systems, nor do they process the potential for providing *timely information* concerning the files updated by transactions — processing. The use of networked PCs terminals has become wide spread, even among small entities. In today's system it is rarely found.

(ii) Real Time Processing Systems: In an online real time (OLRT) processing system, transactions are entered as they occur and are processed as they are entered. Here the continuous updating of the database is there as the transactions are entered. Although powerful in terms of information capacity, OLRT are more complex than batch processing systems.

(b) Time Sharing and Service Bureau

(i) Time sharing occurs when a computer serves more than one user. In transaction processing, time sharing occurs when a computer processes transactions for more than one entity. A Thrift institutions, for example, may rent time on its computer to a investment company that uses the computer to process loan payments.

(ii) Service Bureau: is an entity that processes transaction for other entities. A service bureau, may handle the complete payroll processing for small companies that singly, do not have a *sufficient number* of *transactions* to justify acquisition of a computer.

(c) File Systems

(i) Flat file system: Under it users own their own data that is, the *user has exclusive access* to and use of his or her set of data. Flat file systems produce redundancy in that several users may require the same set of data. Many data sets may need to be updated for a single transaction or group of transaction. The data processing and storage cost associated with flat file systems can be quite expensive, given heavy data volume.

(ii) Integrated Database System: As alternative to flat file systems, many firms have adopted a data base approach whereby *data is entered only once* and *shared* by a multitude of users. It contains a set of interrelated master files that are integrated in order to reduce data redundancy. The software used to control input and output is referred to as database management system (DBMS) handles storage, retrieval, updating and maintenance of data in the data base. Integrated files are associated most often with real time systems and pose the greatest challenge for auditors controls within these systems are harder to test and assess due to the danger of file destruction and the internal storage of data in random, rather than sequential order increases the difficulty involved in performing substantive tests.

Data Warehousing: A form of integral system collected in one database immense volume of data detailing every aspect of a company's operations and cross indexes it. The system then uses clusters of parallel computers together with *warehousing software* that extracts data from main frames, cross indexes it for rapid searching, and analyses and presents the results. The system can also search masses of data to locate unanticipated patterns and relationships.

(d) Hardware Configurations

(i) ***Online Systems*** are unique in that each transaction is entered by way of a communication device (such as terminal) connected directly to the computer. Online systems store data and files on disks. Online systems may or may not be real time systems, depending on whether transactions is processed and files updated immediately as transactions are entered.

(ii) Electronic Data Interchange (EDI) currently being adopted by an increasing number of companies, is the computer exchange of inter company business documents in a public standard format MORE SPECIFICALLY, it is a technique by which a company's computer system is linked to those of its suppliers and customers and transactions such as purchases, sales and cash receipts and payments, may be initiated automatically by the system. EDI eliminates the need to re-enter data into the accounting system. This results in fewer errors and more timely information.

(iii) Distributed Data Processing: Many large companies use PCs extensively, for both data processing and analysis. Companies with branches or divisions, for example, frequently use area networks for processing branch or division transactions and for transmitting them to the have office main frame via communication links. At the same time, the PC can be used by the managers for various kinds of analysis, such as analysis of inventory status, customer inventory and aging of accounts receivable.

Distributed data processing systems are connected to a mainframe computer located at the entity's head office. Additional, they may be linked to one another through a system of *Networking*. Networking includes Local Area Networks (LAN), Wide Area Networks (WAN) and Value Added Networks Services (VANS). A division faced with an unusually large number of transactions to share work loads.

1.8.2. Specific Problems of EDP relating to Internal Control

In an EDP system, the following problems arise in the implementation of internal control:

(1) No separation of duties: In a manual system, separate individuals are responsible for initiating transactions recording transactions , and custody of assets. In a computer system, however, the traditional notion of separation of duties does not always apply.

(2) Delegation of authority an unclear responsibility: A clear line of authority and responsibility is an essential control in *both manual* and *computer systems.* In a computer system, however, delegating authority and responsibility in an UNAMBIGUOUS way may be difficult because some resources are shared among multiple users. When multiple-users have access to the same data and integrity of the data is sometimes violated, it is not always easy to trace the responsibility for corrupting the data and correcting the error.

(3) Need for competent and trustworthy personnel: The data processing is exceedingly complex and highly skilled personnel and required to develop, modify, maintain and operate computer systems. There is always a shortage of well trained and experienced data processing personnel due to constraint of total emoluments offered to them. As such, organisations, sometime have been forced to compromise in their choice of staff. High turnover in the data processing industry has been the norm and the rapid evolution of technology inhibits management's ability to evaluate an employee's skill.

(4) System of authorisations: Management issues two types of authorisations to execute transactions, General authorisations and specific authorisations. When evaluating the adequacy of authorisations procedures, auditors have to examine not only the work of employees but also the veracity of program – processing.

(5) Adequate documents and records: In computer systems, documents may not be used to support the initiation, execution and recording of some transactions. Thus, no visible audit or management trail may be available to trace the transaction. The absence of a visible audit trail is not a problem for the auditor provided that systems have been designed to maintain a record of all events and there is a means of accessing these records. Unfortunately, not all computer systems are well designed and cause serious control problems.

(6) Physical control over assets and records: In computer there is concentration of data processing assets and records of an organization. The perpetrator does not have to got to physically distance locations to execute the fraud. This concentration of data processing assets and records also increases the loss that can arise from computer abuse or a disaster. For example, a fire that destroys a computer room may result in the loss of all major master files in an organisation. If the organization does not have suitable back-up, it may be unable to continue operations.

(7) Adequate management supervision: In computer systems, however, data communications may be used to enable employees to be closer to the customers they service. Thus, the supervision of employees may have to be carried out remotely.

(8) Comparing recorded accountability with assets: In a computer system, programs are used to prepare periodically. Data and assets should be compared to determine whether incompleteness or inaccuracies in the data exist or shortages or shortages in the assets have occurred.

1.8.3 Special Audit Techniques

Computer-Assisted Audit Techniques (CAATs) — International standard on auditing describes two of the more common types of CATTs, *audit software* and *Test-data* for audit purposes.

(i) Audit Software:

Audit Software consist of computer programs used by the auditor, as part of his auditing procedures, to process data of audit significance from the entity's accounting system. It may consist of *package programs, purpose-written* programs, and *utility programs.* Prior to the use of audit programs, the auditor should substantiate their validity.

- **Package Programs —** are generalized computer programs designed to perform data processing functions which include reading computer files, selecting information, performing calculations, created data files and printing reports in a format specified by the auditor.
- **Purpose-written** programs are designed to perform audit tasks in specific circumstances.
- **Utility Programs** — are used by, the entity to perform common data processing functions, such as sorting, creating and printing files.

(ii) Test Data:

Test data techniques are used in conducting audit procedures by entering data into an entity's computer system, and comparing the results obtained with predetermined results. Test data is used to test specific controls in computer programs, such as *online password* and data access controls. Example of such uses are:

- Test transactions selected from previously processed transactions or created by the auditor to test specific processing characteristics of an entity's computer system.
- Test transactions used in an integrated test facility where a *"dummy"* unit is established and to which test transactions are posted during the normal processing cycle.

After processing of *test-data,* the auditor should ensure that the *test transactions* are subsequently *eliminated* from the entity's accounting records.

1.8.4 Uses of CAATs:

CAATs may be used in performing various auditing procedures including

(*i*) Tests of details of transactions and balances

(*ii*) Analytical review procedures. For example, the use of audit software to identify unusual fluctuations or items.

(*iii*) Compliance tests of *General IT Controls, e.g.,* the use of test data to test access procedures to the program librasies.

(*iv*) Compliance test of *IT application controls, e.g.,* the use of test data to test the functioning of a programmed procedure.

Considerations in the use of CAATs

When planning the audit, the auditor should consider an appropriate combination of manual and computer assited audit techniques. In determining whether to use CAATs, the factors to be considered include —

(*i*) Computer knowledge expertise and experience of the auditor

(*ii*) Availability of CAATs and suitable computer facilities

(*iii*) Impracticability of manual tests.

(*iv*) Effectiveness and efficiency.

(i) Computer knowledge and expertise: The auditor should have sufficient knowledge to plan, execute and use the results of the particular, CAAT adopted. The auditor should be aware that the use of CAATs in certain circumstances may require significantly more computer knowledge and expertise than in others.

(ii) Availability of CAATs : The auditor should consider the availability of CAATs, suitable computer facilities and the necessary computer-based accounting systems and files. The auditor should have a reasonable expectation that the computer facilities will be controlled as under:

The cooperation of the entity's personnel may be required to provide processing facilities at a convenient time, and to provide copies of data files in the format required.

(iii) Impracticability of Manual tests: Many computerized accounting systems perform tasks for which no visible evidence is available and in these circumstances, it may be imperative for the auditor to perform tests manually. The lack of visible evidence may occur at different stages in the accounting process *e.g.,*

(*a*) input documents may be non-existent where sales orders are entered online .

(*b*) the system may not produce a visible audit trail of transactions processed through the computer.

(*c*) output reports may not be produced by the systems. In addition a printed report may only contain summary totals while supporting details are retained in computer files.

(iv) Effectiveness and efficiency improvement: The effectiveness and efficiency of auditing procedures may be improved through the use of CAATs in obtaining and evaluating audit evidence. *e.g.*,

(*a*) some transactions may be tested *more effectively* for a similar *level of cost*.

(*b*) balance details may be reviewed reports printed of *unusual items* more efficiently.

(*c*) the use of CAATs may make additional substantive procedures more efficient than reliance on controls and related compliance procedures.

1.8.5 Major steps in application of CAATs

The major steps to be undertaken by the auditor in the application of a CAAT are to:

(*a*) Set the objective of CAAT application.

(*b*) Content and accessibility of the entity's files.

(*c*) Transaction types to be tested.

(*d*) Procedures to be performed on the data.

(*e*) Output requirements

(*f*) Identify the audit and computer personnel.

(*g*) Refine the estimates of cost and benefits.

(*h*) Use of CAAT is properly controlled and documented.

(*i*) Arrange the administrative activities.

(*j*) Execute the CAAT application.

(*k*) Evaluate the results.

The presence of the auditor is not necessarily required at the computer facility during running of a CAAT to ensure appropriate control procedures. However, it may provide practical advantages, such as being able to control distribution of the output and ensuring the timely correction of errors.

1.8.6 Requirements for Effective Computer Audit System

Prior to selecting a computer audit package, a review should be made of the generalized computer audit program. System that have been developed by other organisations. No single software package may satisfy all the requirements of every audit group or assignment. The following are some characteristics of an effective systems:

(1) Simplicity: The system should be simple to use and eliminate the needs for remembering countless details normally required in writing or revising computer programs.

(2) Understandability: The system should be readily understandable by members of the audit staff, even those with little computer expertise. The capabilities of the system should be known and it should be easy to use. Coding forms provided should not be difficult to understand.

(3) Adaptability: The system should be capable of writing computer audit programs for the various types of computers used in the company or expected to be acquired. Thus the package will be usable in the equipment is changed in the future.

(4) Vendor Technical Support: This includes assisting in the initial installation and providing adequate documentations. In addition, training provided for the audit – staff is important, and provisions be made for future revisions in the programs.

(5) Statistical Sampling Capability: This should include the selection of items on a random basis, determination of sample size and evaluation of results at different confidence levels.

(6) Acceptability: It should be acceptable to both the auditors and the computer-centres. For auditors, it should be easily carried to the site and practical use. For the computer centre the programs should be compatible with the system and be capable of minimum interference with normal routines.

(7) Processing Capabilities: The package should be able to process many different types of applications. It should have ability to operate under *multi-programming* situations. It should have powerful generalized audit commands.

(8) Report Writing: The package should have a strong report writing function. This should include the ability to prepare multiple reports in a single program run to generate flexible output report formats.

1.8.7 Basic Principles Governing an Audit

SA 220 (*w.e.f.* 01-04-2010) describes the basic principles which govern the auditor's professional responsibilities regarding quality control procedures for an audit and which should be complied with whenever an audit is carried out. Compliance with the basic principles requires the application of auditing procedures and reporting practices appropriate to the particular circumstances. The basic principles as stated in this guideline are:

1. Integrity, objectivity and independence: The auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity.

2. Confidentiality: The auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose.

3. Skills and competence: The audit should be performed and the report prepared with due professional care by persons who have adequate training, experience and competence in auditing. The auditor requires specialised skills and competence which are acquired through a combination of general education, knowledge obtained through study and formal courses concluded by qualifying examination recognised for this purpose and practical experience under proper supervision. In addition, the auditor requires a continuing awareness of developments including pronouncements of the ICAI on accounting and auditing matters, and relevant regulations and statutory requirements.

4. Work performed by others: When the auditor delegates work to assistants or uses work performed by other auditors and experts he continues to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. In the case of any independent statutory appointment to perform the work on which the auditor has to rely in forming his opinion, as in the case of the work of branch auditors appointed under the Companies Act, 1956 the auditor's report should expressly state the fact of such reliance. The auditor should carefully direct, supervise and review work delegated to assistants. The auditor should obtain reasonable assurance that work performed by other auditor or experts is adequate for his purpose.

5. Documentation: The auditor should document matter which are important in providing evidence that the audit was carried out in accordance with the basic principles.

6. Planning: The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on a knowledge of the client's business. Plans should be made to cover, among other things:

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

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

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

(*d*) Coordinating the work to be performed.

Plans should be further developed and revised as necessary during the course of the audit.

7. Audit evidence: The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information. Compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect. Substantive procedures are designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system.

They are of two types:

(*i*) Test of details of transactions and balances; and

(*ii*) Analysis of significant ratios and trends including the resulting enquiry of unusual fluctuations and items.

8. Accounting system and internal control: Management is responsible for maintaining an adequate accounting system incorporating various internal controls to the extent appropriate to the size and nature of the business. The auditor should reasonably assure himself that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal controls normally contribute to such assurance.

The auditor should gain an understanding of the accounting system and related controls and should study and evaluate the operation of those internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures. Where the auditor concludes that he can rely on certain internal controls, his substantive procedures would normally be less extensive than would otherwise be required and may also differ as to their nature and timing.

9. Audit conclusions and reporting: The auditor should review and assess the conclusions drawn from the audit evidence obtained and from his knowledge of business of the entity as the basis for the expression of his opinion on the financial information. This review and assessment involves forming an overall conclusion as to whether

(*a*) the financial information has been prepared using acceptable accounting policies, which have been consistently applied;

(*b*) the financial information complies with relevant regulations and statutory requirements;

(*c*) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements;

(*c*) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.

The audit report should contain a clear written opinion on the financial information and if the form or content of the report is laid down in or prescribed under any agreement or statute or regulation, the audit report should comply with such requirements. An unqualified opinion indicates the auditor's satisfaction in all material respects with the matters stated above or as may be laid down or prescribed under the agreement of statute or regulation as the case may be.

When a qualified opinion, adverse opinion or a disclaimer of opinion is to be given or reservation of opinion on any matter is to be made, the audit report should state the reasons therefor.

VOUCHING AND VERIFICATION OF ASSETS AND LIABILITIES

1.8.8 Capital and Revenue Expenditure

A capital expenditure is that which is incurred for the undermentioned purposes:

(*a*) Acquiring fixed assets, *i.e.*, assets of a permanent or a semi-permanent nature, which are held not for resale but for use with a view to earning profits.

(*b*) Making additions to the existing fixed assets.

(*c*) Increasing earning capacity of the business.

(*d*) Reducing the cost of production.

(*e*) Acquiring a benefit of enduring nature of a valuable right.

An expenditure, the benefits of which is immediately (within one year) expended or exhausted in the process of earning revenue, *e.g.*, on purchase of goods for sale, on their movement from one place to another, on maintaining assets, on keeping a business organisation going, etc. is a revenue expenditure.

The different forms that capital expenditure takes are: (*i*) land; (*ii*) building; (*iii*) plant and machinery; (*iv*) electric installations; (*v*) premium paid for the lease of a building; (*vi*) development expenditure on land; and (*vii*) goodwill; etc.

Examples of revenue expenditure are: (*i*) cost of raw material and stores consumed in the process of manufacture; (*ii*) salaries and wages of employees engaged directly or indirectly in production; (*iii*) repairs and renewals of fixed assets; (*iv*) advertisement; (*v*) postage; (*vi*) stationery; (*vii*) rent; (*viii*) insurance; (*ix*) interest on borrowings, etc.

Expenses which are essentially of a revenue nature, if incurred for creating an assets or adding to its value or achieving higher productivity, are also regarded as expenditure of a capital nature.

Examples: (*i*) *Material and wages* — capital expenditure when expended on the construction of a building or erection of machinery.

(*ii*) *Legal expenses* — capital expenditure when incurred in connection with the purchase of land or building.

(*iii*) *Freight* — capital expenditure when incurred in respect of purchase of plant and machinery.

Whenever, therefore, a part of the expenditure, ostensibly of a revenue nature, is capitalised it is the duty of the auditor not only to examine the precise particulars of the expenditure but also the considerations on which it has been capitalised.

Deferred Revenue Expenditure

Deferred revenue expenditure is an expenditure which is primarily of revenue nature but the benefit whereof is not exhausted in the year in which it is incurred. Such an expenditure should be written off over the period during which the benefit from it will accrue. Examples of deferred revenue expenditure:

(*i*) Expenditure on an advertisement campaign to introduce a product in the market.

(*ii*) Discount allowed on subscriptions to debentures.

(*iii*) Development expense in the case of mines and plantations.

Exceptional losses suffered due to a natural calamity, some political or other social disturbance, are also sometimes carried forward in whole or in part to be written off against future profit. But these must not be confused with the deferred revenue expenditure which is considered as an asset on account of the benefit that is expected to arise from it in the future. On this account the Balance Sheet of every company must clearly distinguish the nature of deferred expenditure which being carried over from that of a loss suffered which has not been written off. Examples of an exceptional losses not connected with the business will be the cost of assets left by a concern in Pakistan on its migration to India, loss suffered by a foreign investor on his investment in India as a result of devaluation of the rupee, etc. Whenever it is proposed to carry forward either an expense or a loss, the auditor should inquire into the facts of the case and unless he is satisfied that circumstances justify the proposed action he must not agree to the amount being carried forward.

Distinction between Capital and Revenue Expenditure

The distinction between these two forms of expenditure is of fundamental importance for the following reasons:

(1) If any expenditure of a revenue nature is treated as capital, it would have the effect of inflating the profit of the year. On the other hand, if the expenditure of a capital nature is charged to a revenue head, the amount of profit would be reduced. In either case, the Balance Sheet and the Profit and Loss Account in the preparation of which, such a mistake has been made, would show an incorrect state of affairs.

(2) If any item of expenditure has the effect of enhancing the life of an asset or improving its earning capacity, it is necessary that the cost of the relatively permanent benefit should be segregated from the expenditure on the maintenance or repairs of the asset, and be written off over the period of benefit in order that a true and fair profit for each year can be ascertained.

(3) For the proper capitalisation of a business, its capital must be sufficient to fully cover the cost of fixed assets and a part of floating assets. It is, therefore, essential that the fixed capital expenditure should be correctly disclosed in a Balance Sheet so that the adequacy or otherwise of the amount of capital invested in the business can be readily ascertained.

DEPRECIATION OF ASSETS

Definition

"Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time, obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose usefulness is predetermined".

The term "depreciable amount" of a depreciable asset as per the standard is its historical cost, or other amount substituted for historical cost in the financial statements less the estimated residual value.

The accounting standard recommends that the depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset.

Purposes of Providing Depreciation

(a) To keep capital intact: It will be evident that one of the effects of providing for depreciation on an asset is to retain in the business out of the profits in each year, an amount equal to the proportion of the cost of the asset employed in the business that has run off, estimated on the basis of the period of its working life and its scrap value. Thus, the original capital of the entity, assuming that all profits have been withdrawn and losses, if any, made good, will be intact. If, on the contrary, depreciation had not been charged, the net income would have been overstated over the years of the life of the asset, and if the same was withdrawn or distributed as dividends, the business would have no funds for the replacement of the asset.

(b) To ascertain cost accurately: Unless a proper charge on account of depreciation is included in the Profit and Loss Account, the true cost of manufacture of different products will not be ascertained. This is because depreciation is as much a charge against revenue as any other expenditure and must be included in accounts irrespective of the fact whether the final result of a working is profit or loss.

(c) To charge initial costs against earnings: The cost of a machine less its scrap value can, in effect, be regarded as the price for use of the machine paid in advance for the period it will be rendering service. According to this view unless an appropriate part of this price is charged to the profits of the business each year, the profit earned on its working will not be correctly ascertained.

The object of depreciation accounting thus is to determine on a scientific basis, the proportion of the cost of a machine which must be charged in the accounts of each year during which the machine will be used. Depreciation is an expense incurred for earning profit, which is similar to the hire of an asset, the only difference being that in one case the amount is paid to an outsider while, in the other, it is kept in the entity itself. Therefore, each accounting period must be charged a fair proportion of the cost of fixed assets as the price for their use, and the charge should not be contingent on profits being earned. Accordingly, depreciation is a charge against profits and not an appropriation out of profits.

(d) To prepare true and fair statements: Unless depreciation is provided, the assets will be shown at an amount higher than their true value and the profit shown will be more than the real profit. In other words, the Balance Sheet and the Profit and Loss Account will not be true and fair.

Depreciation should not be confused with any fluctuation in the value of fixed assets. The market price of an asset at the end of a year may be either more or less than its book value. It would be the result of a rise or a fall in the price level, a factor over which the business has no control. Such fluctuation in the value of assets may or may not be taken into account, for fixing the sale price of the articles manufactured, but these must be totally ignored for computing the amount of depreciation chargeable to the Profit and Loss Account.

Depreciation on Wasting Assets

In terms of the decision in the case *Lee v. Neuchatel Asphalte Co. Ltd. (1889)*, there does not appear any necessity to provide depreciation on wasting assets like mines, quarries, etc. In the present-day context, however, it is highly doubtful whether the principle propounded in the above case would hold good. Wasting assets exhaust by working and necessarily that involves depletion of the capital employed on such assets. It is, therefore, necessary with a view to maintain the capital employed, a charge for such depletion for ascertaining a true and fair view of the accounts. By this process, the cost inherent in depletion would be accounted for and the fair value of the asset would be disclosed in the Balance Sheet. The term depletion stands for depreciation in case of a wasting asset, because here depreciation is really represented by the quantum of diminution of the deposits of materials in the wasting asset.

The legal position governing depreciation in case of a company is contained in the Companies Act, 1956. However, it is enough to know at this stage that in the opinion of the Company Law Board, depreciation on wasting assets is a necessary charge for arriving at the true and fair picture of the Profit and Loss Account and Balance Sheet.

Methods of Depreciation

There are several methods of allocating depreciation over the useful life of the assets. Those most commonly employed in industrial and commercial enterprises are the straightline method and the reducing balance method.

Under the Straight Line Method, an equal amount is written off each year during the life of the asset. *Under the Reducing Balance Method,* the annual charge for depreciation decreases from year to year with the result that earlier years suffer to the benefit of later years. Also under this method, the value of an asset can never be completely written off. The rate of depreciation to be applied in the case of the Reducing Balance Method is substantially higher than that which must be applied under the Straight Line Method if an asset is to be written off within a certain period. For example, if an asset to the written off to 5% of its original cost over 13 years, under the Straight Line Method the rate of depreciation will be 7.3% but the equivalent rate under Reducing Balance Method will be 20%.

The main advantage of the Reducing Balance Method is that during the first few years, when the charge on account of depreciation is heavier, the cost of repairs is usually small and thus, the total charge for each asset is distributed almost equal annually throughout its life, taking cost of repairs also into account. What is claimed as an advantage for the Reducing Balance Method is a drawback in the case of the Straight Line Method. This can be overcome by building up a reserve for repairs and renewals. This is done by an equal amount determined on estimating the average cost of repairs and renewals being annually charged to the Profit and Loss Account and credited to the provision for repairs account. Against this provision for the expenditure on repairs and renewals is charged as and when incurred, with the result that the annual charge for depreciation and repairs is equalised.

The various important factors which the management should take into account while selecting a particular method are

(*i*) type of asset;

(*ii*) the nature of the use of the asset;

(*iii*) circumstances prevailing in the business; and

(*iv*) state of the economy-whether stable or inflationary.

For example, in a stable economic condition, a going concern ,with steady operations may select the straight line method. Further certain assets like patents and trade marks should also be depreciated on a straight line basis because of their nature conditioned by a legally prescribed life. A company with uneven asset acquisition over the years may go for written down value method.

The method of depreciation is applied consistently to provide comparability of the results of the operation of the enterprises from period to period. A change from one method of providing depreciation to another is made only if adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statement of the enterprise. When such a change in the method of depreciation is made, depreciation is recalculated in accordance with the new method from the date of the assets coming into use. The deficiency or surplus arising from recomputation of depreciation in accordance with the new method is adjusted in the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of the past years, the deficiency is charged in the statement of Profit & Loss. In case the change in method results in surplus, the surplus is credited to the Profit & Loss Account in the year in which such change is made. Such a change in method is a change in the accounting policy and its effect is quantified and disclosed.

Determining the Amount of Depreciation

The assessment of depreciation and the amount to be charged in respect thereof in an accounting period are usually based on the following three factors:

(*i*) Historical cost or other amount substituted for the historical cost of the depreciable asset when the asset has been revalued;

(*ii*) Expected useful life of the depreciable asset; and

(*iii*) Estimated residual value of the depreciable asset.

The useful life of a depreciable asset is shorter than its physical life and is

(*i*) predetermined by legal or contractual limits, such as the expiry dates of related leases;

(*ii*) directly governed by extraction or consumption;

(*iii*) dependent on the extent of use and physical deterioration on account of wear and tear which again depends on operational factors, such as, the number of shifts for which the asset is to be used, repair and maintenance policy of the enterprise, etc.; and

(*iv*) reduced by obsolescence arising from such factors as

(*a*) technological changes;

(*b*) improvement in production methods;

(*c*) change in market demand for the product or service output of the asset; or

(*d*) legal or other restrictions.

Determination of the useful life of a depreciable asset is a matter of estimation and is normally based on various factors including experience with similar types of assets. Such estimation is more difficult for an asset using new technology or used in the production of a new product or in the provision of a new service but is nevertheless required on some reasonable basis.

Determination of residual value of an asset is normally a difficult matter. If such value is considered as insignificant, it is normally regarded as nil. On the contrary, if the residual value is likely to be significant, it is estimated at the time of acquisition/installation, or at the time of subsequent revaluation of the asset. One of the bases for determining the residual value would be the realisable value of similar assets which have reached the end of their useful lives and have operated under conditions similar to those in which the asset will be used.

The quantum of depreciation to be provided in an accounting period involves the exercise of judgement by management in the light of technical, commercial, accounting and legal requirements and accordingly may need periodical review. If it is considered that the original estimate of useful life of an asset requires any revision, the unamortised depreciable amount of the asset is charged to revenue over the revised remaining useful life.

The useful lives of major depreciable assets or class of depreciable assets may be reviewed periodically. Where there is revision of estimated useful life of an asset, the unamortised depreciation amount should be charged over the remaining useful life too.

An entity may adopt different types of methods of depreciation for different types of assets provided the same are adopted on a consistent basis. Even a company having plants at different locations may adopt different method of depreciation in the same accounting year. Further, it may be noted that the depreciation would be charged on pro-rata basis in respect of assets acquired during the financial year.

Depreciation on Low Value Items

The Department of Company Affairs, Ministry of Law, Justice & Company Affairs, Government of India, issued a notification during December 1993, which has been inserted in Schedule II to the Companies Act, 2013. Notwithstanding anything mentioned in Schedule, depreciation on assets, whose actual costs does not exceed Rs. 5,000 shall be provided @ 100%. According to the above note, the individual items of fixed assets whose actual cost does not exceed ₹ 5,000, shall be charged depreciation @ 100%. However, in respect of the fixed assets acquired prior to December, 1993 alternative basis of computing the depreciation charge are permitted.

It is to be noted that Note requires *inter alia* where during any financial year any addition has been made to any assets, the depreciation on such as should be calculated on a pro rata basis from the date of such addition. Since Note has prescribed the rate of depreciation of 100%, prorata depreciation should be charged on addition of the said low value items of fixed assets also. However, the company can write off fully low value items on the consideration of materiality. Where such an accounting policy is followed by a company, the same should be properly disclosed in the accounts.

Disclosure in the Profit and Loss Account and Balance Sheet of a Company

As per Schedule III to Companies Act, 2013 provides that the Profit and Loss Account must disclose the amount of depreciation, renewals or diminution in value of the fixed assets. If such a provision is not made by means of a depreciation charge, the method adopted for making such a provision should be disclosed. If no provision has been made for depreciation in respect of a particular asset, the fact that no provision has been made should be stated and the quantum of arrears of depreciation computed in accordance with section 123 should be disclosed by way of a note.

The form of the Balance Sheet prescribed under the Part I of Schedule III to Companies Act, 2013, further requires that total depreciation written off or provided in respect of each asset should be disclosed.

Accounting Standard 6 requires following information to be disclosed in the financial statements;

(*i*) the historical cost or other amount substituted for historical cost of each class of depreciable assets;

(*ii*) total depreciation for the period for each class of assets; and

(*iii*) the related accumulated depreciation.

It also requires following disclosure of information in the financial statements alongwith the disclosure of other accounting policies;

(*i*) depreciation method used; and

(*ii*) depreciation rates or the useful lives of the assets, if they are different from the principal rates specified in the statute governing the enterprise.

Legal Necessity of Provision for Depreciation

On account of the provision under section 123 that, no dividend shall be declared except out of profits arrived at after providing for depreciation in accordance with the provisions of the Act, it has become obligatory for every company distributing dividend to make a provision for depreciation.

Section 123 prescribes different methods that may be adopted for computing the amount of depreciation. There are summarised below:

(1) The charge on account of depreciation may be calculated in the manner required by section 198. As per the Companies (Amendment Act), 1988, the amount of depreciation was calculated with reference to: the written-down value of the assets as shown by the books of the company at the end of the financial year expiring at the commencement of this Act or immediately thereafter and at the end of each subsequent financial year, at the rate specified in schedule XIV. Thus, depreciation is now required to be calculated in accordance with the rates specified in the Schedule II to the Act and thereby, delinking in the Companies Act, 2013 from that under the Income Tax Act, 1961.

As per Schedule II amended "the amount of depreciation assets". Therefore depreciation in future would be with reference to amount as per books of account.

(2) However, it may be noted that Schedule II to the Companies Act, 2013 provides rates as per straight line method as well.

(3) The provision for depreciation may be made on any other basis approved by the Central Government which has the effect of writing off by way of depreciation 95% of the original cost to the company of each depreciable asset at the expiry of the specified period.

It is provided further that if an asset is sold, discarded, demolished or destroyed, for any reason before depreciation if such asset has been provided in full, the excess of its written value, if any, at the end of the financial year in which it is sold, discarded, etc., over its sale proceeds of scrap value, also must be written off in that year, in which the asset is sold, discarded, demolished or destroyed.

(4) If a company possesses a depreciable asset for which no rate of depreciation has been prescribed by the Companies Act, 2013 or the Rules framed thereunder, the amount of depreciation

should be computed on such basis as the Central Government may approve, either by any general order published in the Official Gazette or any special order in a particular case.

Provision of Depreciation for Past Years

Section 123 prescribes that if a company has not provided for depreciation for any previous financial year it shall, before declaring, or paying dividend, provide for such depreciation:

(a) either out of the profits of that financial year, or

(*b*) out of the profits of any other previous financial year or years.

The implication of this rule is that if, for example, the profits of a company for the year ending 31st March, 2014 are proposed to be distributed, and it is found that due to inadequacy of profits no provision depreciation had been made for the year ended 31st March, 2013, it would be necessary to make provisions in respect of the depreciation, for the year ended 31st March, 2013 as well as 2014 and only the balance of the profits for the year 31st March, 2014 would be available for distribution as a dividend.

There are, however, two exceptions to this rule:

A company may be permitted by the Central Government, if it is thought necessary, to pay dividend for any financial year, without first providing for depreciation for that year or for any earlier year. The Central Government would, however, exempt a company only if it finds that such a distribution is necessary in the public interest [Clause(c) of the first provision to subsection (I) of section 123.

Ascertainment of depreciation for computing net profits for the purpose of managerial remuneration: Under section 197 of the Companies Act, 2013 depreciation calculated in the manner specified in section 198 must be deducted for arriving at the amount of net profits, on which remuneration payable to managerial personnel is to be calculated.

Auditor's Duty as Regards Depreciation

Apart from fixed assets in respect of which depreciation must be provided in the manner aforementioned, it also has to be provided on semi-permanent assets, *e.g.*, patents, trade marks, blocks and dies, etc. Since the auditor is not in a position to estimate the working life of a majority of them, for this he has to rely on the opinion of persons who have a technical knowledge of the assets. He must, however satisfy himself that an honest attempt has been made to estimate the working life of each asset, that the total provision for depreciation is adequate and that the method adopted for determining that amount to be written off appears to be fair and reasonable. If he is of the opinion that the provision for depreciation is not adequate, he should report to the appropriate authority. He must also see that depreciation written off is properly disclosed in the Profit and Loss Account and the Balance Sheet.

Revaluation of Fixed Assets

In recent years, due to an abnormal rise in the price level, it has been suggested in many quarters that accountants should modify the practice that so far prevailed of calculating the provision for depreciation on historical cost (*i.e.*, original cost of fixed assets) and may, for the purpose adopt the replacement cost basis. In support of such a view, it has been argued that, as a result of the rise in the price level, replacement costs of assets have gone up to such an extent that the depreciation provision, based on the original costs, does not leave in the business sufficient funds enabling it to replace its fixed assets. Thus when financial statements are prepared on a basis other than historical cost basis, it is necessary that depreciation should also be computed accordingly on the revised book value of the assets. The revalued amounts of fixed assets are presented in financial statements either by restating both the gross book value and accumulated depreciation so as to give a net book value equal to the net revalued amount or by restating the net book value by adding therein the net increase on account of revaluation. An upward revaluation does not provide a basis for crediting to the profit and loss statement the accumulated depreciation existing at the date of revaluation. Further an Increase in net book value arising on revaluation of fixed assets is normally credited directly to owner's interests under the heading of revaluation reserves and is regarded as not available for distribution. a decrease in net book book value arising on revaluation of fixed assets is charged to profit and loss statement except that, to the extent that such a decrease is considered to be related to a previous increase on revaluation that is included in revaluation reserve, it is sometimes charged against that earlier increase. It sometimes happens that an increase to be recorded is a reversal of a previous decrease arising on revaluation which has been charged to profit and loss statement in which case the increase is credited to profit and loss statement to the extent that it offsets the previously recorded decrease. On disposal of a previously revalued item of fixed asset, the difference between net disposal proceeds and the net book value is normally charged or credited to the profit and loss statement except that, to the extent such a loss is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilised, it is charged directly to that account. The amount standing in revaluation reserve following the retirement or disposal of an asset which relates to that asset may be transferred to general reserve. AS-6 on "Depreciation Accounting, requires where the depreciable assets are revalued, the provision for depreciation should be based on the revalued amount and on the estimate of the remaining useful lives of such assets. In case the revaluation has a material effect on the amount of depreciation, the same should be disclosed separately in the year in which revaluation is carried out.

RESERVES

Reserves v. Provision

Reserves are amounts appropriated out of profits which are not intended to meet any liability, contingency, commitment or diminution in the value of assets known to exist at the date of the Balance Sheet. In contradistinction, provisions are amounts charged against revenue to provide for

(*i*) depreciation, renewal or diminution in the value of assets; or

(*ii*) a known liability, the amount whereof cannot be determined with substantial accuracy; or

(*iii*) a claim which is disputed.

Amounts contributed or transferred from profits to make good the diminution in assets values due to the fact that some of them have been lost or destroyed, as a result of some natural calamity or debts have proved to be irrecoverable are also described as provisions. Provisions are normally charged to the Profit and Loss Account before arriving at the amount of profit. Reserves are appropriations out of profits.

The difference between the two is that provisions are amounts set apart to meet specific liabilities of diminution in assets value. These must be provided for regardless of the fact whether or not any profit has been earned by the concern. If a provision is in excess of the amount considered necessary, the same must be written back or credited to a Reserve Account. On this consideration, Schedule III to the Companies Act, 2013, it is provided that a provision in excess of the amount which, in the opinion of the directors, is reasonably necessary for the purpose should be treated as a reserve.

Reserves are made up of amounts appropriated out of profits, held for equalising the dividends of the company from one period to another or for financing the expansion of the company or for generally strengthening the company financially.

If we examine the Balance Sheet of a company, at a given time, and deduct the total liabilities to outside creditors from the value of assets shown therein, the difference between the two figures will represent the net worth of the company based on the book values of assets as on that date. It will consist of the capital contributed by the shareholders as well as total undistributed profit held either to the credit of the Profit and Loss Account or to reserves; the reserves again will be segregated as revenue or capital reserves. It may be noted that the amount of a reserve is affected by the values placed on assets. If these are excessive, the real reserve might not exist at all or be smaller than the figure at which it is shown in the balance sheet.

Revenue reserves represent profits that are available for distribution to shareholders held for the time being or anyone or more purpose, *e.g.*, to supplement divisible profits in lean years, to finance an extension of business, to augment the working capital of the business or to generally strengthen the company's financial position.

A capital reserve on the other hand represents surplus or profit earned in respect of certain types of transactions; for example, on sale of fixed assets at a price in excess of cost, realisation of profits on issue of forfeited shares or balances which because of their origin or the purposes for which these are held, are not regarded by the directors as free for distribution as a dividend through the Profit and Loss Account.

According to the definition of capital reserve, contained in Schedule III to the Companies Act, 2013, it is a reserve which does not include any amount regarded as free for distribution through the Profit and Loss Account. In its narrowest sense, therefore the description would include only share premium, capital redemption reserve, development rebate reserve and profit on reissue of forfeited shares. Capital profits representing surpluses realised on the sale of assets, profit on redemptio of debentures and the like, in certai circumstances, are capable of being distributed as dividends. Thus, strictly, these do not form a part of acpital reserves in all cases or at all time since circumstances may change from one year to another. It may further be noted that if a company appropriates revenue profit for being credited to the asset replacement reserve with the objective that these are to be used for a cpital purpose, such a reserve also would be a capital reserve.

A capital reserve, generally, can be utilised for writing down fictitious assets or losses or (subject to provisions in the Articles) for issuing bonus shares if it is realised. But thge amount of share premium or capital redemption reserve account can be utilised only for the purpose specified in sections 52 and 55 respectively of the Companies Act, 2013.

Students may further note that according to the form prescribed for the Balance Sheet in Schedule III, the amount of capital and revenue reserves must be shown separately. Also capital redemption reserve and share premium account must be segregated. Further, if there are more than one kind of revenue reserves, their nature and amounts must be disclosed; also the balance of the Profit and Loss Account, if in debit, should be deducted from the revenue reserve.

Schedule III further provides that the aggregate of amount are set aside or proposed to be set aside to reserves, if material, should be disclosed in the Profit and Loss account. Similarly, aggregate of amounts, if material, withdrawn from reserves should be disclosed.

Reserves either may be retained in the business as a part of the working capital or invested outside the business in marketable securities. To the extent additional capital can be usefully and profitably employed in the business, undistributed profits should be left in the business. For these when so employed, would earn a higher return than what they would if they were invested outside in the shares or debentures of another company. So much of the profits as cannot be usefully employed in the business as well as the part of the profits earned which necessarily must be invested outside the business, under some legal obligation *i.e.,* for the redemption of debentures, reserves should be invested in such securities which are easily realisable and the prices whereof are not liable to wide fluctuations. The term 'Reserves Fund' should be employed to describe a reserve only when the amount of reserve is invested outside the business and it is represented by the readily realised assets.

Reserves which are not disclosed in the Balance Sheet are known as secret or hidden reserves. Secret reserves can be created in the following ways:

(*i*) By writing down fixed asset more than what is necessary.

(*ii*) By writing off capital expenditure as though it were revenue.

(*iii*) Undervaluation of stock-in-trade.

(*iv*) By making an excessive provision for bad debts.

(*v*) By making an excessive provision for contingencies or by continuing to carry forward provision even when they are not required.

In the light of the provisions contained in Schedule III to the Companies Act, 2013 requiring that a provision for depreciation, renewal or diminution in the values of assets and that in respect of a known liability which, in the opinion of directors, is in excess of the amount which is reasonably necessary for the purpose, should be credited to a Reserve, it is not any more possible for a company to create a secret reserve.

Note: Students may read the decision in the case *Rex vs. Kylsant and Moreland* to acquaint themselves with the circumstances which led to the introduction of restrictions on the creation of secret reserves.

Specific Reserves

A specific reserve is created for some definite purpose out of the profits of the company. The purpose may be any thing connected with the business which the Article of Association or the directors want to be provided for, such as dividend equalisation, replacement of fixed assets, expansion of the organisation, income-tax liability of the future, etc. Though the concerned amounts are carried under earmarked heads, these are available for distribution as dividend on the recommendation of the directors but subject to the approval of shareholders, since these are created by appropriation of profits.

There may be slight confusion since some of the objects for which specified reserves are created, may also appear to be covered by a charge against revenue, for example, provision for bad and doubtful debts as well as reserve for bad and doubtful debts or a provision for repairs and renewals running along with a reserve for an identical purpose. The only distinction between the two is based on whether it is a charge against revenue or an appropriation of profits. To create any specific reserve existence of profit is essential. Any amount which the directors desire to retain or the Articles require the company to retain over and above provision, necessary for a true and fair disclosure of profit, is specific reserve unless the same is retained for a general purpose, when it would become a general reserve.

Normally, specific reserves are created to comply with the terms of the Articles of Association or in accordance with a decision of the Board to meet a particular situation which may arise in the future. Also some of the specific reserves may be required under contractual obligations or legal compulsion. An example of the former would be the fund for redemption of debentures; that of the latter would be the development rebate reserve which is compulsory if the advantage of the development rebate is to be enjoyed in respect of income-tax. Such specific reserves take on the character of capital reserves.

VERIFICATION OF ASSETS

General Principles

Verification of assets is an important audit process: by convention its scope has been limited to inspection of assets, where it is practicable, and collection of information about them on an examination of documentary and other evidence so as to confirm

(*a*) that the assets were in existence on the date of the balance sheet;

(*b*) that the assets had been acquired for the purpose of the business and under a proper authority;

(*c*) that the right of ownership of the assets vested in or belonged to the undertaking;

(*d*) that they were free from any lien or charge not disclosed in the balance sheet;

(*e*) that they had been correctly valued having regard to their physical condition; and

(*f*) that their values are correctly disclosed in the balance sheet.

Verification of assets is primarily the responsibility of the management since the proprietor or the officials of the entity are expected to have a much greater intimate knowledge of the assets of the business as regards location, condition, etc. than that which an outsider might be able to acquire on their inspection. They alone, thus, are competent to determine the values at which these should be included in the Balance Sheet. The auditor's function in the circumstances is limited only to an appraisal of the evidence, their inspection and reporting on matters affecting their valuation, existence and title, observed in the course of such an examination. Principally, the auditor is required to verify the original cost of assets and to confirm, as far as practicable, that such a valuation is fair and reasonable. As regards the manner in which the original cost should be ascertained, there are well defined modes of valuation which he is expected to follow.

Assets are valued either on a 'going concern' or a 'break-up value' basis. The first mentioned basis considered appropriate when the concern is working and the second, when it has closed down and is being wound-up. AS-1 mentions that "Going Concern" is one of the fundamental accounting assumptions to be followed in preparation and presentation of financial statements. In case of non-observance, the fact that "Going Concern" assumption has not been followed is to be specified. If considered necessary, the auditor can also obtain the assistance of expert valuer. He must further ensure that the Balance Sheet discloses the basis on which different assets have been valued.

Valuation of Assets

Fixed assets are acquired for purpose of business with the object of earning revenue in the ordinary course of business; these are intended to be used and not sold, *e.g.*, land, building, machinery, etc. Almost all fixed assets (except land and goodwill) suffer depletion or exhaustion due to afflux of time and their use or exploitation. Mines and quarries are notable examples of the class of assets that are described as wasting assets, denoting that their value diminishes on exploitation, in contradistinction to the loss of value through use or obsolescence that takes place in the case of other assets. Floating assets are acquired for resale with a view to earning profits or are those that come into existence during the processes of trade or manufacture. All those, in the normal course of business, are quickly convertible into cash, *e.g.*, stock-in-trade, book debts, bills receivable, etc.

Fixed Assets: Fixed assets are included in the Balance Sheet at their cost less depreciation. Cost includes all expenditure necessary to bring the assets into existence and to put them in working condition. It would be incorrect to value them at their sale price since these are not intended to be sold. For the very same reason, the fluctuation in the market values are ignored even when these are permanent. If these were taken into account, it would result in either under or over allocation of their cost.

Wasting Assets: More as a result of custom than financial expediency, no specific provision to reduce the value of wasting assets exists in the Companies Act, 1956. For the first time, this matter was considered by the Court in the case *Lee v. Neuchatel Asphalt Company Limited* and it was held that it was not necessary for a company to provide depreciation on wasting assets to arrive at the amount of profits which it could distribute. It cannot, however, be contended that the value of wasting assets remains unaltered despite their exploitation year after year. On a consideration of this position, the Institute of Chartered Accountants in England and Wales, as early as 1944, recommended that provision for depreciation or depletion should be made in respect of every wasting assets, such as mine, on the basis of the estimated physical exhaustion that takes place. The amount that must be provided can be determined on ascertaining the proportion that the quantity of the output during the year bears to the total quantity that the mine is expected to yield during its normal working life. The unit for such a computation should be the unit of the refined produce and not that of the raw one. In terms of the clarification issued by the Company Law Board, it seems that even wasting assets need to be depreciated for the purpose of section 123 of Companies Act. Section 123 of the Act covers cases in respect of which no rate of depreciation is provided by the .Companies Act. On the very same consideration, if a mine has been acquired on a lease, the total amount paid for the lease should preferably be amortised over the period of the lease in proportion to the output in each year. This may sometimes appear impracticable; under such a situation, amortisation on a time basis may be considered.

Floating assets: In the case of these assets the attempt is to include them in the Balance-sheet at their realisable value. These, therefore, are valued either at cost or market value whichever is less. The term ‘cost’ refers to purchase price including duties and taxes, freight inwards and other expenditure directly attributable to acquisition less trade discount, rebates, duties drawbacks and subsidies, in the year in which they are accounted, whether immediate or deferred in respect of such purchase. The term ‘market value’ may either refer to “Net realisable value” or the replacement cost.

1. Net Realisable Value is the estimated selling price in the ordinary course of business less estimated costs of completion and the estimated costs necessarily to be incurred in order to make the sale.

2. Replacement Cost refers to the price which would have to be paid for acquiring the same assets at the current market rate on the date of the Balance-sheet. The replacement cost is determined by taking into account the price that would have to be paid for purchasing the assets from normal sources of supply. In case free market for the assets does not exist it may not be possible to determine the replacement cost.

It may be noted here that in case of valuation of inventories, only net realisable value as a variant of market value has to be considered. This is in accordance with the Accounting Standard 2 on ‘Valuation of Inventories’.

Stock-in-Trade is a current asset held for sale in the ordinary course of business or in the process of production for such sale or for consumption in the production of goods or service for sale. The normally accepted accounting principle of valuation of stock-in-trade is at cost or net realisable value whichever is lower. This principle is in accordance with the AS-2 (since revised) on 'Valuation of Inventories'. This general principle applies to valuation of all inventories including stock-in-trade except inventories of the following to which special considerations apply.

(*a*) Work-in-progress arising under construction contracts, including directly related service contracts (see Accounting Standard (AS)7, Accounting for Construction Contracts);

(*b*) Work-in-progress arising in the ordinary course of business of service providers;

(*c*) Shares, debentures and other financial instruments held as stock-in-trade; and

(*d*) Producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries.

The inventories referred to in (*d*) above are measured at net realisable value at certain stages of production. This occurs, for example, when agricultural crops have been harvested or mineral oils, ores and gases have been extracted and sale is assured under a forward contract or a Government guarantee, or when a homogenous market exists and there is a negligible risk of failure to sell. These inventories are excluded from the scope of this statement.

For instance, in the case of stock of tea, coffee and rubber, held by the plantations which have produced them, with a view to showing in their annual accounts the true profits in respect of each crop, it is valued at the date of the Balance Sheet at the price at which it has been sold subsequently, reduced either by actual or estimated selling expenses pertaining thereto. And where stocks are held for maturing (*e.g.,* rice, timber and wine), though their value increases substantially with the passage of time, these are usually valued at an amount which is equal to their cost plus storage charges. Where during storage the weight shrinks, an allowance for this factor is also made. In no case, however, the price applied is allowed to exceed the current market (selling) price of similar goods less costs necessarily to be incurred in order to make the sale.

Following the fundamental accounting assumption of consistency, whatever basis of valuation is adopted, it should be consistent from one period to another to prevent distortion of trading results disclosed by the annual accounts. Therefore, any change in the accounting policy relating to inventories (including the basis of comparison of historical cost with net realisable value and the cost formulae used) which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed. In the case of a change in accounting policy which has a material effect in the current period the amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.

Different Connotations of 'Cost': The significance of this term varies in different circumstances on account of the nature of goods and the methods by which cost has been computed. Essentially, it refers to an appropriate combination of the cost of purchase, cost of conversion and other costs incurred in the normal course of business in bringing the inventories up to the present location and condition.

In determining the cost of inventories in accordance with paragraph 6, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are (*a*) abnormal amounts of wasted materials, labour, or other production costs;

(*b*) storage costs, unless those costs are necessary in the production process prior to a further production stage;

(*c*) administrative overheads that do not contribute to bringing the inventories to their present location and condition; and

(*d*) selling and distribution costs.

The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects should be assigned by specific identification of their individual costs.

The cost of inventories, other than those dealt with in paragraph 14, should be assigned by using the first-in, first-out (FIFO), or weighted average cost formula. The formula used should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.

Valuation of Inventories below Historical Cost: The historical cost of inventories may at times not be realised, *e.g.,* if their selling prices have significantly declined, or if they become wholly or partially obsolete, or if the quantity of inventories is so large that it is unlikely to be sold/utilised within the normal turnover period and there exists a genuine risk of physical deterioration, obsolescence or loss on disposal. In such circumstances, it becomes necessary to write down the inventory to 'net realisable value,' in accordance with the principle of conservatism which requires that current assets should not be carried in the financial statements in excess of amounts expected to be realised in the ordinarily course of business.

Disclosure: The financial statements should disclose

(*a*) the accounting policies adopted in measuring inventories, including the cost formula used; and

(*b*) the total carrying amount of inventories and its classification appropriate to the enterprise.

Investments: Fundamentally, the basis of valuation of investments depends on the purpose for which these are held. If investments constitute a floating asset, .these are valued at cost or at fair value whichever is lower. Where, however these are treated as a fixed asset *i.e.,* an asset held to earn permanent income, these are valued at cost.

The Companies Act, 1956 has introduced a new concept — that of trade investments. These are investments made by a company in the shares and in debentures of another, not sufficiently large as to make the other a subsidiary. Such investments are always valued at cost since the basic consideration in making the investment associates in trade.

The market value of shares or debentures of a company which are not quoted on the Stock Exchanges in ascertained on a consideration of the financial position of the company as disclosed by its last Balance Sheet and Profit and Loss Account. For this purpose, the dividend policy and the price at which shares have changed hands in the previous months also are taken into account. It may, however, be noted that listing of all public issues have been made. compulsory with the recognised stock exchange by the Companies Act.

Where shares or debentures have been acquired by a concern in lieu of services rendered in the promotion of a company (*e.g.,* in pursuance of an underwriting contract) or in the part payment of purchase consideration, these are included in the Balance Sheet at cost, determined on a reference to the relative agreement in pursuance whereof the allotment has been made. For example, where shares have been allotted in consideration of subscription obtained to loans or debentures, these are valued at the amount paid for them, reduced by the amount of underwriting commission earned; the shares allotted in pursuance to a vendor's agreement are valued at the price specified in the agreement. As per AS-13, the cost of an investment should include acquisition charges such as brokerage, fees and duties. If an investment is acquired, or partly acquired, by the issue of shares or other securities, the acquisition cost should be the fair value of the securities issued (which in appropriate cases may be indicated by the issue price as determined by statutory authorities). The fair value may not necessarily be equal to the nominal or par value of the securities issued. If an investment is acquired in exchange for another asset, the acquisition cost of the investment should be determined by reference to the fair value of the asset given up. Alternatively, the acquisition cost of the investment may be determined with reference to the fair value of the investment acquired if it is more clearly evident.

When an investment is sold for determining the amount of profit or loss resulting on its sales, it is necessary to first ascertain its cost. While doing so, a distinction is made between capital and revenue expenses and receipts. For instance the amount of brokerage paid on purchasing investment (Government Securities or debentures) is added to their cost. Costs such as transfer fees, stamp duty, etc. should be capitalised. But the amount, if any, paid on account of interest which had accrued due till the date of transaction is not taken into account for it is recoverable. Likewise, the value of bonus shares allotted subsequent to the purchase of the shares is not added to their cost. Then the cost of the original requisition would represent the cost for the total holding including bonus shares. However, the amount received on sale of 'right' in respect of new shares offered by the company may be deducted from the value of shares held, it being a capital receipt. On the very same consideration, any dividend received on shares for a period which had closed before the date of acquisition is treated as a capital receipt. As per AS-13, interest, dividend and rentals receivables in connection with an investment are generally regarded as income, being the return on the investment. However, in some circumstances, such inflows represent a recovery of cost and do not form part of income. For example, when unpaid interest has accrued before the acquisition of an interest-bearing investment and is therefore included in the price paid for the investment, the subsequent receipt of interest is allocated between pre-acquisition and post-acquisition periods; the pre-acquisition portion is deducted from cost. When dividends on equity are declared from pre-acquisition profits, a similar treatment may apply. If it is difficult to make such an allocation except on an arbitrary basis, the cost of investment is normally reduced by dividends receivable only if they clearly represent a recovery of a part of the cost.

As per AS-13 on Accounting for Investments, "an enterprise should disclose current investments and long term investments distinctly in its financial statements". Regarding valuation, it states as under:

"Investments classified as current investments should be carried in the financial statements at the lower of cost and fair value determined either on an individual investment basis or by category of investment, but not on an overall (or global) basis.

Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually.

Any reduction in the carrying amount and any reversals of such reductions should be charged or credited to the profit and loss statement.

On disposal of an investment, the difference between the carrying amount and net disposal proceeds should be charged or credited to the profit and loss statement.”

General Principles Regarding Verification of Assets

1. Where a company or a partnership has taken over the assets of a going concern, the agreement of sale should be inspected and that amount paid for them ascertained. It should be further verified that the allocation of the total cost among the various assets is fair and reasonable.
2. The cost of assets acquired piecemeal should be verified with their invoices, purchase agreements or ownership rights and the receipt of the sellers in respect of the price paid. It should be verified that expenditure on assets newly acquired and that on the renewal and replacement of old assets has been correctly recorded, consistent with the method that has been generally followed in the past.
3. When an asset is sold, its sale-proceeds should be vouched by reference to the agreement, containing the terms and conditions of sale, counterfoil of the receipt issued to the purchaser or any other evidence which may be available. If the sale of a fixed asset has resulted in capital profit, it should be transferred to capital reserve. However, the profit limited to the original cost or a loss should be transferred to the Profit & Loss Account.
4. It is obligatory for a company to provide for depreciation out of the profits in accordance with the provisions under sub-section (1) of section 123, before any profits can be distributed as dividend. The law requires that depreciation should be provided in one of the ways specified in the section 123 of the Companies Act, 2013.
5. The existence of fixed assets, where practicable, should be verified by a physical inspection and, or by comparing the particulars of assets as are entered in the Schedule attached to the Balance Sheet, with the Plant or Property Register and reconciling their total value with the General Ledger balances.
6. Wherever possible, all the securities and documents of title, cash, negotiable instruments, etc. representing the assets, should be inspected at the close of the last day of the accounting period. If this be not practicable and the examination is undertaken at the later date, a careful scrutiny of transactions subsequent to the date of the balance sheet’ must be made to ensure that the changes in their balance that have subsequently taken place are bona fide and are supported by adequate evidence.
7. It should be ascertained that no unauthorised charge has been created against an asset and all the charges are duly registered and disclosed. Where shares or securities are lodged with a bank to secure a loan or an overdraft, a certificate should be obtained from the bank showing the nature of the charge, if any.
8. Where assets, *e.g.*, government securities, share scrips and debenture bonds are in the custody of a third party other than a bank, these must be inspected.
9. Where depreciable assets are disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material, should be disclosed separately.
10. According to the provisions contained in Schedule III to the Companies Act, 2013, the expenditure on fixed assets is required to be segregated under the following heads:
    (*a*) Goodwill
    (*b*) Land

(*c*) Buildings
(*d*) Leaseholds
(*e*) Railway sidings, locomotives, Rolling stocks, tramways.
(*f*) Plant and machinery (and Special Plant and Machinery)
(*g*) Furniture and fittings
(*h*) Development of property
(*i*) Patents, trade marks and designs
(*j*) Livestock
(*k*) Motor vehicles, lorries, motor cycles, etc.
(*l*) Ships
(*m*) Aircraft or Helicopters
(*n*) Ropency structures
(*o*) Hydraulic works, pipelines and sluices.

It is the duty of the management to ensure that the fixed assets of the company are in existence and for this purpose, it is important that physical examination of plant and machinery and other fixed assets should be carried out periodically depending upon the size of the company. The order issued under section 143 of the Act requires the auditor to report on the physical verification of the fixed assets by he management, and the treatment of the discrepancies, if any.

Audit of Fixed Assets

The Guidance Note on Audit of Fixed Assets issued by the ICAI recommends that the verification of fixed assets consists of examination of related records and physical verification. The auditor should normally verify the records with reference to the documentary evidence and by evaluation of internal controls.

The verification of records would include verifying the opening balances of the existing fixed assets from records such as the Schedule of fixed assets, ledger or register balances to acquisition of new fixed assets should be verified with reference to supporting documents such as orders, invoices, receiving reports and title deeds. Self-constructed fixed assets and capital work-in-progress should be verified with reference to the supporting documents such as contractors' bills, work orders and independent confirmation of the work performed from other parties. When fixed assets have been written off or fully depreciated in the year of acquisition, the auditor should examine whether these were recorded in the fixed assets register before being written off or depreciated. In respect of retirement of fixed assets, the auditor should examine whether retirements were properly authorised, whether depreciation accounts have been properly adjusted, whether the sale proceeds, if any, have been accounted for and the resulting gains or losses, if material, have been properly adjusted and disclosed in the profit and loss account.

The ownership of assets like land and buildings should be verified by examining title deeds. In case the title deeds are held by other persons such as bankers or solicitors, independent confirmation should be obtained directly by the auditor through a request signed by the client.

Physical verification of fixed assets is primarily a responsibility of the management. The management is required to carry out physical verification of fixed assets at appropriate intervals in order to ensure that they are in existence. However, the auditor should satisfy himself that such verification was done by the management wherever possible and by examining the relevant working papers. The auditor should also examine whether the method of verification was reasonable in the circumstances relating to each asset. The reasonableness of the frequency of verification should also be examined by the auditor in the circumstances of each case. The auditor should test check the book records of fixed assets with the physical verification reports. He should examine whether discrepancies noticed on physical verification have been properly dealt with.

The auditor should see that the fixed assets have been valued and disclosed as per the requirements of law and generally accepted accounting principles. The auditor should test check the calculations of depreciation and the total depreciation arrived at should be compared with that of the preceding years to identify reasons for variations. He should particularly examine whether the depreciation charge is adequate keeping in view the generally accepted basis of accounting for depreciation. The Institute has also recommended that the company should provide depreciation so as to write off the asset over its normal working life. The company may provide depreciation at higher rate than the rates prescribed under Schedule XIV to the Companies Act, 2013, if it feels that the normal working life of the asset is low. However, if the company feels that the normal working life of the assets is much higher, it cannot provide depreciation at the rates lower than the rate prescribed by the Schedule II to the Companies Act, 2013. In such a case the rates given in Schedules II should be followed.

Re-valuation of fixed assets implies re-statement of their book values on the basis of systematic scientific appraisal which would include ascertainment of working condition of each unit of fixed assets. It would also include making technical estimates of future working life and the possibility of obsolescence. Such an appraisal is usually made by independent and qualified persons such as engineers, architects, etc. To the extent possible, the auditor should examine these appraisals. As long as the appraisal appears reasonable and based on adequate facts, he is entitled to accept the revaluation made by the experts.

VERIFICATION OF SPECIFIC ASSETS

Land and Buildings

Sometimes the two assets are shown together in the Balance Sheet. Nevertheless, their ledger accounts should always be separated particularly in view of the fact that buildings are subject to depreciation while land in general is not.

The land holdings should be verified by an inspection of the original title deed to ensure that the land described therein covers all the lands the cost of which is debited in the books of the concern. The auditor however, not being competent to verify the regularity of the title of the concern to the land, is not responsible for doing so. Therefore, generally, a certificate should be obtained from the legal adviser of the client confirming the validity of his title to the land. The auditor should, however, verify that the conveyance deed has been duly registered as required by section 17(1) of the Registration Act, 1908 also that particulars required to be endorsed thereon according to section 58 of the same Act have been duly made and verified. He should, in addition, generally ascertain that *prima facie* the title of the client does not appear to be defective.

If the property is mortgaged, the title deed would be in the possession of the mortgagee or his solicitors. A certificate to this effect should be obtained from them. It should also be ascertained whether there is any second or subsequent mortgage. If ground rents, outstanding for recovery, are included in the Balance Sheet as an asset, the auditor must examine the counter parts of leases granted and also verify that the ground rents which were outstanding for recovery on the date of the Balance Sheet have since been recovered. If there has been any sale of land or building, it should be verified that he amount of profit or loss resulting on sale has been correctly adjusted in the accounts.

The cost of buildings, as is entered in the books, should be depreciated at appropriate rates, depending upon the quality of their structure and the use which is being made of them. The cost of fittings and fixtures to the building should be adjusted separately in the account from the cost of buildings, since these suffer higher rate of wear and tear than the brick and mortar structure and therefore, have to be depreciated at a higher rate.

If the values of land and buildings are not separately recorded in the books of account, the same should be separated for purposes of calculating the amount of deprecation. This should be done with the assistance of a valuer, unless the same can be achieved on the basis of some documentary evidence available in the record.

Since buildings are continually repaired and there is only a thin margin of differentiation between the expenditure of their improvement and that on repairs, it is necessary for the auditor to scrutinise closely the expenditure on repairs so as to exclude from its expenditure that could legitimately be considered to have added either to the life or the utility of the asset. Such an expenditure should be added to their cost while the amount incurred on current repairs is written off.

It is not customary to write-up the book values of land and buildings even though their market values have increased but, where this has been done it will be necessary for the auditor to verify that the appreciation adjusted has been disclosed as required by the law. On the same consideration, no notice need be taken of any fall in the market value of such an asset until the same has crystallized by the asset being sold.

The landholding in the case of real estate dealer will be a current asset and not a fixed asset. The same should, therefore, be valued at cost or market value whichever is less. The amount of profit or loss arising on sale of plots of land by such a dealer should be verified as follows:

(*i*) Each property account should be examined from the beginning of the development with special reference to the nature of charges so as to find out that only the appropriate cost and charges have been debited to the account and the total cost of the property has been set off against the price realised for it.

(*ii*) This basis of distribution of the common charges between different plots of land developed during the period, and basis for allocation of cost to individual properties comprised in a particular piece of land should be scrutinised.

(*iii*) If land price lists are available, these should be compared with actual selling prices obtained and it should be verified that contracts entered into in respect of sale have been duly sanctioned by appropriate authorities.

(*iv*) Where part of the sale price is intended to reimburse taxes or expenses, suitable provisions should be maintained for the purpose.

(*v*) The prices obtained for various Plots of land sold should be checked with the plan map of the entire tract and any discrepancy or unreasonable price variations should be inquired into. The sale price of different plots of land should be verified on a reference to certified copies of sale deeds executed.

(*vi*) Out of the sale proceeds, provision should be made for the expenditure incurred on improvement of land, which so far has been accounted for.

Leasehold Property

Various steps involved in the verification of leasehold rights are stated below:

(*a*) Inspect the lease or assignment thereof to ascertain the amount of premium, if any, for securing the lease, and its terms and conditions; and that the lease has been duly registered. A lease exceeding one year is not valid unless it has been granted by a registered instrument (Section 107 of the Transfer of Property Act, 1882).

(*b*) Ascertain that all the conditions, the failure to comply with which might result in the forfeiture or cancellation of the lease, *e.g.*, payment of ground rent on the due-dates, insurance of property, its maintenance in a satisfactory state of repairs, etc. prescribed by the lease, are being duly complied with.

(*c*) Examine the counterpart of the tenants' agreements, if part of the leasehold property has been sublet.

(*d*) Make certain that due provisions for any claim that might arise under the dilapidation clause on the expiry of the lease has been made, and, if no such provision has been made, draw the client's attention to the matter.

(*e*) Ensure that the outlay as well as any legal expenses incurred to acquire the lease which are shown as an asset in the Balance Sheet are being written off at a rate which could completely wipe off the asset over the unexpired term of the lease.

A leasehold property, even where no premium has been paid for its acquisition, may some time come to have a considerable value. In such a case, it may not be advisable to continue to show the asset as if it has no value. Nevertheless, where the leasehold rights have been revalued that fact should be clearly shown on the Balance Sheet till the account has been completely written off.

Buildings (RCC Structure or Non-RCC Structures) Factory Buildiing, Fences, wells, tubewells

If the building has been built or is in the course of construction, under a contract the auditor should verify the debit balance of the account by reference to the architect's certificate, as well as the contractor's receipts for amounts paid.

If the building has been constructed by the client's own organisation, it will be necessary for the auditor to verify that the basis upon which cost of materials, wages and the supervision charged have been allocated to the account, is reasonable. The expenses charged should include all the expenditure necessary to bring the building into existence and to make it habitable. As a safeguard against any mistake arising in the expenses chargeable to the asset, the auditor should obtain a certificate from a responsible official in respect of total expenditure incurred on the construction of the building up to the date of the Balance Sheet. The amount of expenditure, where possible, should also be compared with the estimated cost of construction which may have been prepared by an architect or received with the tenders, if any, invited for construction. If there is a material discrepancy in the amount of actual and estimated expenditure, causes thereof should be reviewed.

Goodwill (Intangible Asset)

According to Accounting Standard-10 on Accounting for Fixed Assets, goodwill should be recorded in the books only when some consideration in money or money's worth has been paid for it. Whenever a business is acquired for a price (payable either in cash or in shares or otherwise) which is in excess of the value of the net assets of the business taken over, the excess is termed as goodwill. Goodwill arises from business connections, trade name or reputation of an enterprise or from other intangible benefits enjoyed by an enterprise. Thus the verification of the amount of goodwill would require reference to the vendor's agreement on the basis of which assets of the running business have been acquired by the company at a price existing in the books of the assets or where a specific sum has been paid for the goodwill. In such a case the auditor should see that only the amount paid to the vendors not represented by tangible assets has been debited to the goodwill account. Therefore, it is not prudent that goodwill should be shown in the company's accounts by way of writing-up the value of its assets on revaluation or writing back the amount of goodwill earlier written off by the company. As a matter of financial prudence goodwill is written off over a period. However, many enterprises do not write-off goodwill and retain it as an asset. AS-14 on "Accounting for Amalgamations" requires that goodwill should be written off over a period of five years .

Know-how (To be included in others category)

Know-how in general is recorded in the books only when some consideration in money or money's worth has been paid for it. Know-how is generally of two types: (*i*) relating to manufacturing process; and (*ii*) relating to plans, designs and drawings of buildings or plant and machinery.

Know-how related to plans, design and drawings of buildings or plant and machinery is capitalised under the relevant asset heads. In such a case depreciation is calculated on the total cost of those assets, including the cost of the know-how capitalised. Know-how related to manufacturing processes is usually expensed in the year in which it is incurred. Where the amount paid for know-how is a complete sum in respect of both manufacturing process and related to plans, designs etc. such amount should be apportioned amongst them on a reasonable basis.

Where the consideration for the supply of know-how is a series of recurring annual payments as royalties, technical assistance fees, contribution to research, engineering, etc., are charged to the profit and loss account each year.

Plant and Machinery

In the absence of a Plant Register containing detailed particulars of various articles of machinery and equipment, showing separately original cost, addition to and sales from it from time to time. It is not normally practicable for the auditor to verify the existence of such assets. The auditors should therefore insist on a Plant Register being maintained where the value and variety of machinery and plant are substantial in comparison with the total assets of the business.

Where such a register is kept, it is customary to prepare at the end of each year a statement from the Plant Register showing opening balance, sale and addition thereto during the year in respect of various items of machinery and plant. Its total is then reconciled with the balance in the General Ledger.

The cost of addition, if any, is verified with the invoice of machinery supplied together with evidence in respect of other incidental expenses chargeable to the account, including installation expenses. If any of the addition represents the cost of machinery manufactured by the concern with its own material and by its own labour, the basis on which the expenditure has been allocated should be verified. In addition, a certificate is obtained from the engineer responsible for the manufacture of the plant confirming the total cost of manufacture.

In case any item or machinery has been scrapped, destroyed or sold the auditor should ascertain that the profit or loss arising thereon has been correctly determined which has either been disclosed in the Profit and Loss Account or credited to the Capital Reserve. In appropriate circumstances, a certificate should be obtained from a senior official that this has been done.

Though it is the duty of the management to ensure that fixed assets are in existence, the auditor also should, periodically, physically examine various items of plant and machinery and other fixed assets, say, once in every three or five years, depending upon the size of the concern.

Certain companies, for convenience of inspection attach to each unit of plant and machinery a metallic disc bearing the number at which it is shown in the Plant Register.

When an asset has been revalued, depreciation should be provided on the revised value and not on the historical value.

Patterns, Dies, Loose Tools, etc.

Several entities have large investments in such assets which have a relatively short useful life and low unit cost. Evidently, it is a difficult matter, under the circumstances, to prepare a separate account for each such assets although a careful control over such property is necessary.

On these considerations, some entities charge off small tools and other similar items to Production Account as and when they are purchased and do not place any value on the unused stock on the Balance Sheet. Nevertheless, a record of issues and receipts of tools to workmen is kept, as a check on the same being pilfered and a memorandum stock account of dies and patterns is also maintained. In other concerns, the cost of tools, dies, etc., purchased is debited to appropriate assets account, and an inventory of the unused items at the end of the year is prepared and valued; the sum total of opening balance and purchase reduced by the value of closing stock, as disclosed by the inventory, is charged off to Production Account in respect of such assets. On the other hand, some concerns carry such assets at their book values at the end of the first year and charge off the cost of all the purchases in the subsequent year to the Production Account on the plea that they represent cost of replacement.

The most satisfactory method, however, is that of preparing an inventory of serviceable articles, at the close of each year, and revaluing the assets on this basis, the various articles included in the inventory being valued at cost. Care, however, should be taken to see that the inventory does not include any worn out or defective articles the life of which has already run out.

Furniture, Fittings and Fixtures

The cost of these assets should be verified by reference to the invoices of suppliers. All the expenditure incidental to their purchase also should be debited to the appropriate asset account. Further, the auditor should carefully scrutinise the details of the cost of additions debited to these accounts so as to ascertain that only the cost of genuine additions has been debited to such accounts. In the case of assets in regard to which there is a danger of loss through pilferage, there should be a satisfactory system of stock control over them. It requires that each article of furniture is entered in a Stock Register before its price is paid and the stock number under which it is entered is painted over it also that at the end of each period, an inventory is prepared and reconciled with the Stock Register and cost of all the articles which becomes unserviceable or have been lost is written off under proper authority.

Motor Vehicles (lorries, vans, motor cycles, scooters, buses, cars, taxies tractors)

The cost of these assets should be verified by reference to the invoices of suppliers and their ownership confirmed from permit and Registration Books. The auditor should also verify that the vehicles are covered by a comprehensive policy of insurance and adequate depreciation has been provided in respect of each of them. In case the number of vehicles is large, there should be a Vehicle Register similar to the Plant Register.

Livestock

A schedule of livestock at the close of the year should be obtained and entries in the same should be verified with the Register of Animals if it has been maintained. The entire stock of animals should be revalued on a uniform basis, from year to year, the cost of animals which have either been sold or have died during the year being excluded, and that of newly born or purchased during the year being added. There should be adjustment in the value of dry cattle on appropriate basis.

Ships

The cost of ships, if purchased outright, should be verified on a reference to the Bill of Sale and, if built to order, from the agreements with the shipbuilders. The ownership of the title should be verified from the certified copy of the entry in the port of registration unless the same is endorsed on the back of the Bill of Sale. Any mortgage or charge created on the ship is disclosed in the copy of 'entry' in case any exists, the same should be disclosed. In addition, it should be ascertained that the vessel is fully insured against all risks.

Assets Acquired under Hire Purchase System

The hire purchase agreement should be examined to ascertain that only the capital portion of the instalments paid up to date of the Balance Sheet has been debited to the asset account and that the interest included in each instalment as well as penal interest, if any, has been charged off to revenue. If the full capital value of the assets has been adjusted at the outset, it should be verified that the total instalments outstanding under the agreement have been reduced from the value of the asset. In either case, it should be confirmed that adequate depreciation has been provided on the full cash purchase price of the asset.

Investments

Investments are assets held by an entity for accretion of wealth by way of interest, royalties, dividends and rentals, for capital appreciation or for other benefits to the investing entity. It constitutes a significant portion of the total assets. An investment may be represented by Government securities, shares, debentures etc. The following procedure should be adopted for verifying the investments:

(*a*) Obtain schedule of securities and share in hand at the beginning of the audit period containing description, date of purchase, face value, book value (also the amount paid up if it differs from the book value), market value, rate of interest, date of payment of interest, date around which dividend is normally declared etc. In separate columns enter the amounts of interest and dividend received during the period, interest or dividend accrued or outstanding at the close of the period, tax deducted out of the first mentioned amount and deductible out of the second.

(*b*) Add to the above list, securities and shares purchased and sold during the year, giving the same description in regard to both.

(*c*) Balance this schedule and compare the closing balance with the control account in the General Ledger.

(*d*) The auditor should ascertain whether the investments made by entity are within its authority.

(*e*) The auditor himself should also be satisfied that the transaction for the purchase/sale of investments are supported by due authority and documentation.

(*f*) The acquisition/disposal of investments should be verified with reference to the brokers' contract note, bill of costs, etc. special attention should be paid to investments purchased or sold cum-dividend, ex-dividend, cum-interest/ex-interest, cum rights/ex-rights or cum bonus/ex-bonus.

(*g*) Where the amount of purchases or sales of investments are substantial, the auditor should check the prices paid/received with reference to stock exchange quotations.

(*h*) The auditor should also physically inspect investments. The investments should be physically verified at the last date of the accounting year. In case investments are not held by the entity in its own custody — then certificate should be obtained from the relevant authority to the effect of holding of investments.

(*i*) In case investments are held otherwise than in the name of the entity, *e.g.*, in the name of nominees/trustees, the auditor should ascertain the reasons for the same and examine relevant documentary evidence.

(*j*) The auditor should also examine the relevant provisions of section 143 and see that a company not doing an investment or banking company whether so much of the assets of the company as represented by shares and debentures have been sold at a price less than that at which they were purchased by the company.

(*k*) The auditor should also examine the relevant provisions of the MAOCARO, 1988 in this regard.

(*l*) The auditor should see title deeds of immovable properties.

(*m*) The auditor should also see that the immovable properties have been properly classified.

(*n*) In case immovable properties are held by an entity through purchase of shares in co-operative societies, the auditor should verify that cost of share is also included in the cost of the property.

(*o*) To judge the overall reasonableness of the amounts invested, the auditor may relate the amount with the preceding years and calculate relevant ratios.

(*p*) The auditor should satisfy that the investments have been valued and disclosed in the financial statements in accordance with the recognised accounting policies and parties and relevant statutory requirements. Reference to principles laid down in AS-13 on "Accounting for Investments" relating to valuation of investments will be necessary.

(*q*) The auditor should examine whether in computing the cost of investments, the expenditure incurred on account of transfer fees, stamp duty etc. is included in the cost of investments.

(*r*) The auditor may ascertain that the market value of the investments is in accordance with the authentic market reports. In the case of unquoted investments, the auditor should ascertain the basis from the entity adopted by it for the purpose of disclosure in the balance sheet.

(*s*) The auditor may also see that any money raised through share issue to the extent remains unutilised has been shown under the head "Investments" and the manner in which the same has been invested should also be indicated.

Note: About accounting of dividend income by companies, the Company Law Board has prescribed a procedure. In terms of the procedure, dividend declared during the accounting year even though not received should be accounted for in the same year. If dividend is declared after the year is over, but before the annual accounts are finalised and if the dividend relates to the accounting year, the same also should be accounted for in the year itself.

Section 187 of the Companies Act, 2013 requires that all investments made by a company on its own behalf shall be made and held by it in its own name except in cases which are specifically exempt. Section 56 states that every instrument of transfer, before it is signed by or for the transferor should be presented, in a prescribed form, to a prescribed authority. The instruments should be stamped or the date of presentation or otherwise endorsed thereon by the prescribed authority. Such an instrument should be delivered for registration to the company:

(*a*) In the case of shares which are dealt in or quoted on a recognised Stock Exchange at any time before the date on which the Register of Members is closed for the first time after the date of such presentation or within twelve months of such presentation whichever is later; and

(*b*) in any other case, within two months from the date of such presentation.

Its effects on the validity of the title to the shares held under bank transfer should be examined. Further, section 56 should also be referred to.

Investment in the shares or debentures of a subsidiary: The auditor should obtain a complete schedule of all such investments held, showing particulars as regards the name of the subsidiary company, class of shares or debenture, date of purchase, number of units and denoting numbers, book value, dividend received etc. All the particulars entered in the schedule should be verified with the relevant account in the General Ledger. He should, at the same time, examine all the investments by inspection of the securities, share scrips or certificates, debenture bonds, etc. If any of the securities are held by bankers, he should verify them with their certificate which should disclose the charge, if they are subject to any such charge.

The provisions contained in I, Schedule II to the Companies Act, 2013. require that shares held in a subsidiary should be shown separately. The shares or debentures of a subsidiary are valued at cost. If the subsidiary has suffered a loss a provision for the proportionate part of the loss should be made in the accounts of the holding company.

Investment in the Capital of a Partnership Firm

This has now got to be disclosed separately. To establish the authenticity of this item the auditor should go through the partnership deed, noting the capital contributed by the company, and the latest Balance Sheet and the Profit and Loss Account, duly audited. The amount of the loss, if any, falling to the share of the company should be debited to the profit and loss account; the share of profit should be similarly credited to the Profit and Loss Account. The auditor should see whether the firm has been duly registered and he will do well to note the particulars sent for registration.

Patent Rights

The ownership of a patent is verified by inspection of the certificate issued in respect of grant of the patent. It has been purchased, the agreement surrendering it in favour of the client should be examined. It must also be observed that the rights are 'alive' and legally enforceable and renewal fees have been paid on due dates by being charged to revenue and to the Patent Account. The last renewal receipt should be examined to ascertain that the patent has not lapsed. If a number of patents are held, a schedule thereof should be obtained. Since the amount paid in respect of each patent should be amortised over its life or a lesser period if its commercial life is shorter, it should be seen that the rate at which the value of each patent is being written off is adequate; its value would be completely written off by the time it would cease to have a commercial value. If the patent has been created by the client by research, experiments and laboratory work, the auditor should ascertain that only the actual cost incurred in the process has been capitalized. However, in all cases the registration cost should be capitalised.

Trademarks and Copyright

The existence of a trademark is verified by an inspection of the certificate as regards grant of the trademark. Where it has been purchased, the agreement surrendering it in favour of the client should be examined. It must also be observed that the rights are alive and legally enforceable. Copyrights are also acquired by surrender of rights and they also should be verified similarly. The auditor should obtain a schedule of trademarks and copyrights and verified that renewal fees have been paid and charged to revenue. The last renewal receipt should, in each case, be examined to ascertain that the trade mark has not lapsed. fopyrights and trademarks are generally revalued at the cost of each financial period. The auditor should see that revaluation has been made on a fair and reasonable basis. Where he finds that any publication has ceased to command sale, he should have the amount of its copyright written off to revenue.

Endowment Policies

Endowment policies taken out for the redemption of leases, or sinking fund policies for the redemption of debentures and policies for other similar purposes, being in the nature of quasi-fixed assets, should be verified by inspection of the policies and the auditor should ascertain that the last premium on them has been duly paid.

Assets Abroad

Where documents of title relating to assets held abroad are not available for inspection, ‘a certificate should be obtained from the agent or any other party holding the document. Such a certificate must disclose unequivocally that they are free from any charge or encumbrance. The auditor should state in his report whatever evidence has been produced for this verification.

Development of Property

Expenses when incurred for the development of any property and which cannot be conveniently added to the value of such property should be capitalized under this head and written off over the period during which the benefit from such development will accrue to the business. Examples may be expenses incurred in grading and preparing the soil for plantations, overhead removal cost for collieries and mines, etc. These expenses should be verified with reference to the budgets, sanction of the appropriate authority, technical report, if any, and the bills for actual expenditure incurred. It should also be ensured that appropriate write off has been made against these assets, keeping in view the period of benefit or the exploitation, as the case may be.

Railway Siding etc.

For verification of this item it would be essential to refer to agreement with Railway for availing of the facility. All expenses connected with the laying of the rails and making individual agreements, the amount paid to the Railway, if any should make up the cost. The cost of the railway siding should also be appropriately depreciated keeping in view the terms of agreement with the Railway, the permit or lease, if any, for the land used in providing the siding, etc.

CURRENT ASSETS

STOCK-IN-TRADE

The valuation of stock is frequently the main factor in determining the result shown by the accounts. Apart from the effect on the Balance Sheet, incorrect treatment of stock would affect the profits of the year that has closed as well as that of the next following. The valuation of the closing stock, therefore, is an important step essential for the determination of the profits of the year and also for truly disclosing the financial position of the concern at the close of the year. An auditor being intimately concerned with these aspects of financial statements, it is his duty to verify the existence of the stock-in-trade possessed by the concern at the end of the year and to ascertain that the same has been valued correctly on a consistent basis.

The precise duties in regard to verification of stock-in-trade are nowhere defined. Under the circumstances, these have to be deduced from an interpretation of the general responsibility of auditors in regard to the statements of accounts verified by them, especially in regard to stock-in-trade. These have been considered in a few English decisions.

The provisions in the Companies Act, 2013 have also considerably advanced the responsibilities of auditors in this regard. Section 128 of the Act requires a company to maintain proper books of account. Such books of account must, it is believed, include books kept to record transactions in stock-in-trade. The Act empowers the Central Government to require companies engaged in production processing, manufacturing or mining to maintain books as would furnish particulars in relation to utilisation of materials or labour or other items of cost as may be prescribed. Furthermore, by section 338 'proper books of account' have been defined to include statements of annual stocktaking and (except in case of goods sold by way of ordinary retail trade) of all goods sold and purchased.

Schedule III prescribes that the figures of opening and closing balances, of stock and work-in-progress be disclosed in the Profit and Loss account. Part I of the same Schedule requires that the mode of valuation of stock be shown on the Balance Sheet. Schedule III requiring particulars or quantities of materials purchased, opening and closing stock and turnover is also of particular significance in this respect.

Verification of Inventories

The responsibility for properly determining the quantity and value of inventories rests with the management of the entity. It is therefore the responsibility of the management of the entity to ensure that the inventories included in the financial information are physically in existence and represent all inventories owned by the entity. The management satisfies this responsibility by carrying out appropriate procedures which will include verification of all items of inventory at least oncein every financial year. This responsibility is not reduced even where the auditor attends any physical count of inventories in order to obtain audit evidence. Verification of inventories may be carried out by employing the following procedures

(*a*) examination of records;

(*b*) attendance at stock-taking;

(*c*) obtaining confirmations from third parties;

(*d*) examination of valuation and disclosure; and

(*e*) analytical review procedures.

The nature, timing and extent of audit procedures to be performed is, however, a matter of professional judgment of the auditor.

Attendance at Stock-taking

Physical verification of Inventories is the responsibility of the management of the entity. However, where the inventories are material and the auditor is placing reliance upon the physical count by the management, it may be appropriate for the auditor to attend the stock-taking. The extent of auditor's attendance at stock-taking would depend upon his assessment of the efficacy of relevant internal control procedures, and the results of his examination of the stock records maintained by the entity and of the analytical review procedures. The procedures concerning the auditor's attendance at stock-taking depend upon the method of stock-taking followed by the entity. There are two principal methods of stock-taking: periodic stock-taking and continuous stock-taking. Under the first method, physical verification of inventories is carried out at a single point of time, usually at the year-end. Under the second method, physical verification is carried out throughout the year, with different items of inventory being physically verified at different points of time. However, the verification programme is normally so designed that each material item is physically verified at least once in a year and more often in appropriate cases. The continuous stock-taking method is effective when a perpetual inventory system of record-keeping is also in existence. Some entities use continuous stock-taking methods for certain stocks and carry out a full count of other stocks at a selected date. The auditor is expected to examine the adequacy of the methods and procedures of physical verification followed by the entity. Before commencement of verification, the management should issue appropriate instructions to stock-taking personnel. Such instructions should cover all phases of physical verification and preferably be in writing. It would be useful if the instructions are formulated by the entity in consultation with the auditor. The auditor should examine these instructions to assess their efficacy. Where the auditor is present at the time of stock-taking, he should observe the procedure of physical verification adopted by the stock-taking personnel to ensure that the instructions issued in this behalf are being actually followed. The auditor should also perform test-counts to satisfy himself about the effectiveness of the count procedures. In carrying out the test counts, the auditor should give particular consideration to those stocks which have a high value either individually or as a category of stocks. Proper attention should also be paid to the physical condition of inventories. Ideally, there should be no movement of stocks when the physical verification is being carried out. On occasions, however, it may be necessary for the entity to continue the production, receiving, or despatch operations during physical verification. In such circumstances, it is essential that the entity has the procedures to identify and record such movement. The auditor should review the procedures adopted by the entity to account for the movement of inventories from one location to another within the entity during stock-taking (*e.g.*, issues from stores to production departments). The auditor should also examine whether the entity has instituted appropriate 'cut-off procedures' to ensure that —

(*a*) Goods purchased but not received have been included in the inventories and the liability has been provided for;

(*b*) Goods sold but not despatched have been excluded from the inventories and credit has been taken for the sales.

The auditor may examine a sample of documents evidencing the movement of stocks into and out of stores, including documents pertaining to period shortly before and shortly after the cut-off date, and check whether the stocks represented by those documents were included or excluded, as appropriate, during the stock-taking. The auditor should review the original physical verification sheets and trace selected items — including the more valuable ones — into the final inventories. He should also compare the final inventories with stock records and other corroborative evidence, *e.g.*, stock statements submitted to banks. The auditor should examine whether the discrepancies noticed on physical verification have been investigated and properly accounted for. Where continuous stock-taking methods are being used by the entity, the auditor should pay greater attention to ascertaining whether the management

(*a*) maintains adequate stock records that are kept up to date;

(*b*) has satisfactory procedures for physical verifications of inventories, so that in the normal circumstances the programme of physical verification will cover all material items of inventories at least once during the year; and

(*c*) investigates and corrects all material differences between the book records and the physical counts.

1.11 TERMINAL QUESTIONS

1. Define types of audit. Are there any compulsions in laws for audit of accounts of the organization? If yes, which are those organizations?
2. Cost Audit means whether audit of cost of production or cost incurred in running the organisation? Discuss the types of cost audit.
3. Explain internal audit and what are its objectives?
4. Define the essential feature of internal audit.
5. Discuss the objective of financial statement audit. What are the relevant informations required to be disclosed in the financial statement audit?
6. Statutory audit should be defined. How does it differentiate from internal audit?
7. While conducting an audit of bank what is the procedure adopted by auditors till submission of audit-report?
8. Due diligence audit is audit for individual partnership or for corporate world. Is it correct? Discuss its sub-classification.
9. Explain the specific aspects in due diligence.
10. Define management audit. What points are essentially to be known by management auditor?
11. Why management audit is desirable? Discuss in detail.
12. Are there any difficulties in management audit, discuss them? Give examples in support of your answer.
13. Propriety audit is most common in organisations of public interest and customs, do you agree? Define the areas of propriety audit. Do you foresee any problems in propriety audit?
14. What is environmental audit? What aspects are considered under it?
15. Social audit is audit for social obligations imposed by law or otherwise. Discuss.
16. Discuss EDP Audit and its impact.
17. What are the types of EDP Accounting?
18. Define the problems of EDP Audit.
19. What is C.A.A.T.? Discuss its uses.
20. Discuss the requirements of effective computer audit.
21. Basic principles governing an audit are described in which Standard of Auditing. Discuss.
22. Verification of capital and revenue expenditure is done for which purpose?
23. Define depreciation and purposes of providing for depreciation in the financial statements.
24. What is the legal necessity of providing for depreciation in financial statement? Discuss.
25. Discuss the general principles for verification of assets.

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