The origin of auditing can be traced to Italy. Around the year 1494, Luca Paciolo introduced the double entry system of bookkeeping and described the duties and responsibilities of an Auditor.

Auditing in India has been described in different ways −

“Auditing is a systematic and independent examination of data, statements, records, operations and performances (financial or otherwise) of an enterprise for a stated purpose. In any auditing situation, the Auditor perceives and recognizes the propositions before him for examination, collects evidence, evaluates the same and on this basis, formulates his judgment which is communicated through his audit report.”

- The Institute of Chartered Accountant of India

Another definition goes as such −

“Auditing is an intelligent and critical scrutiny of books of accounts of a business with the documents and vouchers from which they have been written up, for the purpose of ascertaining whether the working results of a particular period as shown by Profit and Loss Account and also the financial position as reflected in the Balance-sheet are truly and fairly determined and presented by those responsible for their compilation.”

- J. R. Batliboi

Auditing in India

Let us now understand the growth of auditing in India. The Indian Companies Act, 1913, prescribed for the first time the qualifications of an Auditor. The Government of Bombay was the first to conduct related courses of study such as the Government Diploma in Accountancy (GDA).

The Auditor’s Certificate Rule was passed in 1932 to maintain uniform standard in Accountancy and Auditing. The Chartered Accountant Act was enacted by the
Parliament of India in 1939. The Act regulates that a person can be authorized to audit only when he qualifies in the examinations conducted by The Institute of Chartered Accountants of India.

Following are a few other points related to Auditing in India –

- Members of Institute of Cost and Works Accountant of India are authorized to conduct cost audit according to Section 233-B of the Companies Act, 1956.
- Companies Act 1931 was replaced by Companies Act 1956.
- An Auditor can be appointed only by a special resolution as per section 224 The Companies (amendment) Act, 1974.

**Bookkeeping**

A Bookkeeper records day-to-day transaction in the books of accounts in a systematic manner. Bookkeeping includes –

- Journalizing
- Posting to ledger
- Totaling and balancing of ledger accounts

**Accountancy**

The job of Accountancy begins where bookkeeping ends and includes the following:

- Rectification of errors
- Preparation of Trial Balance
- Preparation of financial statements (Trading and Profit & Loss account and Balance Sheet, etc.)

**Auditing**

Preparation of accounts is not the duty of an Auditor. “Auditing begins, where accountancy ends”. Auditor is only concerned for checking and verification of records. Auditor is a qualified person appointed for the purpose of certification of work done by others.

**Investigation**

An investigation may be done with a specific purpose. It is usually conducted to know the financial position of a business, extent of fraud and misappropriation and the earning capacity of any business unit, etc. The time duration for investigation
may also extend beyond one year. Investigation may not be necessarily done by a qualified Chartered Accountant.

Qualities of an Auditor

An Auditor must have the following qualifications and qualities –

- He should be a qualified Chartered Accountant or he should be a qualified member of The Institute of Cost & Works Accountants of India to do cost audit.
- He must have adequate skills and qualities to conduct his work efficiently.
- An Auditor must be honest, impartial and unbiased. He should also be hard-working, have adequate common sense, capacity to hear arguments of others, systematic and methodical.
- An Auditor should ask for clarification on matter on which he is unable to understand the information provided to him.
- His audit report should be correct and clear.
- In case where any suspicious situation arises, he should assume that he is dealing with dishonest and fraudulent peoples.
- He must have thorough knowledge of accounting principles and practices.
- He must have the know how of all the domestic and international court case decisions.
- He must have thorough knowledge of financial management, industrial management and business organizations.
- He must have up-to-date knowledge of the Mercantile law and the Companies Act.

Scope of Auditing

In comparison with earlier days, where the main objective of auditing was to detect fraud, we now have enhanced ways to determine a true and fair view of financial statements. In recent times, almost every country of the world has introduced various legislations and framed rules and regulation of auditing. In India also legislations related to Tax Audit, Cost Audit, Management Audit and operation Audit, etc. are coming up.

The main purpose of auditing is to certify the correctness of financial statements and to detect errors and frauds.

Techniques of Auditing

Following are the common techniques of auditing –
• Checking of posting and casting.
• Physical verification of assets.
• Verification and examination of transactions with available evidences.
• Scrutiny of the books of accounts,
• Checking of various calculations.
• Checking of carried forward balances in next year.
• Checking of Bank reconciliation statements.
• Auditor can get information from inside and outside sources of organization.

Auditing - Detection and Prevention of Fraud

The main objective of auditing is to ensure the financial reliability of any organization; detection of fraud is just an incidental object.

Independent opinion and judgement form the objectives of auditing. The job of an Auditor is to ensure that the books of accounts are kept according to the rules stipulated in the Companies Act; an Auditor also needs to ensure whether the books of accounts show a true and fair view of the state of affairs of the company or not.

The following are the three distinct types of fraud –

• Misappropriation of Cash
• Misappropriation of Goods
• Manipulation of Accounts

Misappropriation of Cash

Misappropriation of cash is the easiest way of fraud especially in large business houses where there is limited or no communication between the owner of an organization and the cashier. Following are some of the ways through which embezzlement or misappropriation can be done –

• Theft of cash receipts and petty cash and showing fictitious payment to workers, creditors, purchases, etc.
• Showing false payments or excess payments in cash book.
By using the **Teeming** and **Lading** method, the money received from any customer can be pocketed and the money received from another customer can be shown as money received from the former.

Cash sale can be shown as credit sale.

Strict internal control system should be followed in receipts and payments of cash so that the work done by one person should be automatically checked by another person.

**Misappropriation of Goods**

Misappropriation of goods can be done in the following ways –

- Goods may be stolen by employees or with the help of employees.
- By issuing false credit notes to customer on account of goods return.

Detection of misappropriation of goods is more difficult rather than detecting misappropriation of money, especially where management is not much vigilant and sound system of book-keeping, internal control and adequate system of securities are not available. To keep control on the physical verification of goods, reconciliation of physical stock with books and careful checking of sale and purchase is must.

**Manipulation of Accounts**

Two types of manipulation of accounts are mainly done by top management to mislead some parties for some specific purpose.

- **Showing higher profits** – Following are the reasons behind showing higher profit than actual –
  - To obtain credit or to enhance existing credit from financial institutions and also to show credit worthies to suppliers of the company.
  - To maintain confidence of shareholders.
  - To hike the market price of shares of the company and enable the sale of those at higher price, it may be done by declaring higher dividends on shares.
  - To get more commission where commission is calculated on the basis of profit earned.
  - To declare dividend at higher rate.

- **Showing low profits** – Following are the reasons behind showing lower profit than actual –
To avoid or to reduce Direct Taxes of the company (Income Tax, Wealth Tax).

To purchase shares at lower price.

To give wrong impression to the other competitors of the business.

**Manner of Manipulation of Accounts**

Manipulation of accounts may be done in the following ways –

- **Window dressing** is a manipulation or miss-representation of financial data in such a way that it seems better than what it actually is. Some of the method of window dressing is given as hereunder.
  - Over valuation of closing stock
  - Under valuation of Liabilities or Over-valuation of assets
  - Purchases and expenses of current year may be deferred to next financial year
  - Charging revenue expenses as capital expenditure
  - Sale and other incomes of preceding year may be shown as income or sale of the current year.

- Secret reserves of previous years may be used in the current financial year to inflate the profit or secret reserves may be created to suppress the profit of the current financial year.

- Stock may be under or overvalued. Income and sales may be suppressed or inflated. Expenses and purchases may be suppressed or inflated.

**Auditing - Detection and Prevention of Errors**

Auditors should be very careful about the detection of errors because manipulation in accounting may also appear as error or it may be a result of carelessness on part of a bookkeeper.

Errors may be broadly classified as follows –

- Error of Principle
- Errors of Omission
- Errors of Duplication
- Errors of Commission
- Compensating Errors
Error of Principle

Where the recording of the items of transactions are not done according to the Principle of Accounting, it is known to be an error of principle. These errors are not traceable from trail balance; these errors may be committed unintentionally or for the purpose of manipulation of accounts to inflate or deflate profit.

Following are the examples of such type of errors –

- Providing excessive or inadequate depreciation
- Where the provision for outstanding expenses or prepaid expenses is wrong
- Where revenue expenses may be treated as capital expenditure or vice versa
- Where valuation of Plant & Machinery, Stock, investment and other assets are not done according to the Principle of Accounting.
- Where income received is credited to personal account of the person who is making the payment; for example, commission received from Mr. A credited to Mr. A’s account instead of the commission account, it will increase creditors in the Balance Sheet and reduce profit in the Profit & Loss account.
- Where the payment of expenses is posted to the personal account of a person who receives payment; for example, the rent paid to Mr. A wrongly debited to Mr. A’s account, it will increase profit and also increase debtors in the Balance sheet.

Errors of Omission

There may be two types of omission of entry while recording the transactions in the books of accounts;

- Where transaction is totally omitted from the books of accounts, it will not affect the trial balance and the detection of such error is difficult. Following are the examples of such errors;
  - Omission of purchase or sale from the purchase day book or the sale day book respectively.
  - Omission of outstanding or unpaid expenses.
- Examples of the transactions which are partially omitted from the books of accounts are
  - Where total of purchase day book or sale day book omitted to be posted in purchase or sale account respectively.
Where payment or receipt transaction omitted to be recorded in ledger account from cash book.

Errors of Duplication

The detection of error of duplication is very difficult. It might be detected with proper and minute observation of accounts; for example, purchase may be recorded twice with original and duplicate copy of purchase invoice, etc. It is also possible to post the total of any ledger account twice in the trial balance.

Errors of Commission

Error of commission occurs the entry made in the books of the original entry or the ledger account is wrong. Let us see the following examples –

- Purchase of goods for Rs. 25,000 wrongly entered as Rs. 2,500 in purchase book.
- Credit purchase from AB Company wrongly credited to BA Company’s account.
- Wrong totaling – total of purchase day book is totaled as Rs. 1,12,500 instead of 1,21,500.
- Purchase from AB Company wrongly debited to AB company account instead of crediting AB company account and debiting purchase account.

Compensating Errors

When the effect of an error compensates with another error; it is known to be a compensating error. Such errors do not affect the trial balance; for example, total of a debit account as well as credit account totaled short by Rs. 7,500. This type of error will compensate both.

Prevention of Errors and Fraud

After the completion of audit, the Auditor can suggest his client to make changes in the accounting systems and also to improve his internal control system as an Auditor cannot do anything directly to prevent errors and frauds.

Auditors are expected to conduct audit as per professional standards expected from him. He cannot guarantee that no fraud exists. An Auditor should ensure and follow these standards –

- Internal control system

- While recording the business transaction whether accounting principle are being followed or not

- Policies of management are being followed or not
• Whether provisions laid in the Companies Act are being followed while preparing books of accounts
• Whether Balance-sheet and Profit & Loss account show true and fair view of state of affairs of concern

Following factors decide whether an Auditor is responsible for non-detection of errors and frauds –

• An Auditor should audit as per the principles laid out for auditing.
• He should fulfil his duty as per the prevailing standards of his profession.
• Error should be rectified during his audit and fraud is to be reflected in his audit report.
• Even a simple hint that reflects that there is something wrong should not be overlooked.
• He should believe on substantial accuracy in statement of accounts.

Auditing - Basic Principles

Planning
An Auditor should plan his work to complete his work efficiently and well within time. To plan work accordingly, an Auditor handles the following –

• Accounting system and policies.
• Internal control system of organization.
• Determination of audit procedures and coordinating audit work.

Honesty
An Auditor must have impartial attitude and should be free from any interest. He should be honest and sincere to his work and he should do his work without any bias and prejudice.

Secrecy
An Auditor should keep confidential all the information acquired by him during his audit. He should not share the information with anyone without the permission of the client and that too the information can be shared with the client’s permission only when it is bound to be so.

Audit Evidence
An Auditor should adhere to substantive and compliance procedure for collecting audit evidences before conducting an audit. Through substantive procedures, an
Auditor may collect evidences regarding accuracy, completeness and validity of data; and through compliance procedure, he may collect evidences regarding internal control system as used in the client’s organization.

**Internal Control System**

It is the primary responsibility of a company to keep adequate internal control system in his organization. On the basis of such internal control system, an Auditor can determine the nature, timing and audit procedure to be applied to conduct his audit.

**Skill and Competence**

Audit should be done by trained, experienced and competent persons and audit staff should be updated with all the developments in accounting, auditing and legal rules and regulations as amended from time to time.

**Work Done by Others**

An Auditor is permitted to rely on work done by others but he should exercise due diligence when referring to it. He should mention the source of reference thereof in his report.

**Working Papers**

An Auditor should prepare and preserve all the necessary documents as obtained during his audit. These documents can be used by him as audit evidences.

**Legal Framework**

All business activities should be run adhering to the rules and regulations stipulated in the legal framework. This is to safeguard the interests and rights of the interested parties.

**Audit Report**

On the basis of the review and assessment of the audit evidences, Auditor should express his opinion regarding financial statements of an organization –

- Financial statements are prepared using acceptable accounting principles.
- Financial statements comply all relevant statutory requirements.
- All material matters are disclosed and proper presentation of financial statements are done subject to statutory requirements.

**Auditing - Advantages**
Following are the main advantages of auditing for different stakeholders –

For the Owner and Shareholders
- Sole proprietor of a business and partners of firm can rely and depend on audited financial statements.
- Auditing is helpful for valuation and business settlement at the time of admission of new partner, retirement or death of a partner. This avoids the risk of any dispute in a firm.
- Audited financial statement is the only way out for shareholders to judge the performance of the management of the company.

For the Management
- Auditing is helpful in detecting frauds and prevention of errors.
- It helps to keep the staff vigilant; as eventually the work done by them goes for an audit.
- Insurance claim can be easily estimated from audited accounts.
- Management can take advantage of expert advice of Auditor in financial matters.
- Comparison of financial statements of different years becomes easier.
- Assessment of Tax Liabilities is easy.

For the Government
Taxation authorities and all other Government authorities rely on audited financial statements; even the courts accept these as evidence when the situations call for.

For the Creditors
Creditors of an organization also rely on audited financial statements and accordingly grant credit limit to business entities.

For Others
- Audited accounts are easily accepted by insurance companies for settlement of claims.
- Audited financial statements are acceptable by bank and financial institutions and helpful in getting loans and credit facilities.

Auditing - Limitations
Following are a few limitations of auditing –

- **Rely on Experts** - An Auditor has to rely on experts like engineers, valuers and lawyers for estimation and valuation of fixed assets and estimation of contingent liabilities.
• **Efficiency of Management** – An Auditor does not comment on the efficiency of management working in client organization; no comments on future performance of an organization can be made through audited financial statements.

• **Checking of All Transactions** – It is not possible for an Auditor to check all business transactions especially in big organizations where the number of transactions is very high. An Auditor has to rely on sampling and test checking.

• **Additional Financial burden** – An organization has to bear additional financial burden on account of any fees and other such expenses for conducting an audit.

• **Not Easy to Detect Some Frauds** – It is not easy for an Auditor to detect deeply laid frauds like forgery, misstatements and non-recording of transactions.

### Auditing - Classifications

In this chapter, we will learn the various types/classes of Audit and their basis. The following table lists out the different types of audit.

<table>
<thead>
<tr>
<th>Basis</th>
<th>Types</th>
</tr>
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</table>
| Scope          | • **Specific Audit** - Cash audit, Cost audit, Standard audit, Tax audit, Interim audit, Audit in depth, Management audit, Operational audit, Secretarial audit, Partial audit, Post & vouch audit, etc. are common types of specific audit.  
• **General Audit** - It can be an internal or an independent Audit.  |
| Activities     | • Commercial  
• Non-Commercial                                                                 |
| Organization   | • Government  
• Private                                                                 |
| Legal          | • **Statutory** - Insurance Company, Electricity Company, Banking Companies, Trust, Company, Corporations, Co-operative societies.  
• **Non-statutory** - Individual, Firm, Sole trader, etc.  |
Let us now understand the important classifications of audit.

### Audit of Individuals

Sources of income of any individual may be from his investments, property, shares, commission as agent, interest income, etc.

Following are the purposes and benefits if anyone opts for an audit −

- To know the correct income from all of his sources.
- Assurance of accuracy.
- Prevention and detection of any fraud or misappropriation
- Helpful and useful in Income Tax Assessment.
- To keep moral check on accountant and agent.

### Audit of Sole-Trader’s Books of Accounts

The scope of audit will depend on the instructions and agreement between Auditor and sole proprietor, the latter being an individual owner of the business; the sole proprietor decides himself the scope of audit.

The purpose and benefit of audit in a sole trader’s business are almost the same as for an individual. Following are some additional benefits −

- Assurance about proper vouchers of his expenditure and preparation of his accounts with accuracy and correctness.
- Assurance about true and fair picture of his business income and expenditure.
- His accounts can be compared with the previous years’.

### Audit of Partnership Firm

An Auditor for a partnership firm may be appointed by the partners with mutual consent. Mutual agreement between partners and Auditor is based on the latter’s rights, liabilities & the scope of his audit. Reference to the partnership deed is must for an Auditor and he should refer to the Partnership Act, 1932 in case where
partnership deed is silent. Certificate of an Auditor will contain points related to the following –

- Reliability of accounts depending upon the nature of business.
- If any restrictions and limitations imposed by the partners on his audit scope.
- Whether the auditor got all the required information and explanations or not.

**Important provision of Partnership Act**

An Auditor should refer to following provisions of the Partnership Act, 1932, where partnership deed is silent.

- A minor can be admitted to a firm as a partner only for profits, he will not be liable for any loss.
- Property of the firm can be exclusively used by the partners for business purpose.
- Partners will share profit & loss equally.
- There is no entitlement of any remuneration or salary to any of the partner.
- 6% interest on capital will be paid to partner in case of any addition to capital made by any partner in excess of agreed amount.
- Interest on capital will be payable out of profits only.
- Goodwill of the firm will be treated as assets of the firm at the time of dissolution of the firm.
- At the time of dissolution of the firm, the settlement of account will be done in the following order –
  - Out of profit
  - Out of capital
  - By the partners individually in their profit sharing ratio

**Government Audit**

Government of India maintains a separate department known as the Account and Audit Department and this department is headed by the Comptroller and Auditor General of India, which works only for government offices.

Important Features of the Government Audit –

- In almost every government department, prior sanction is must before any payment of expenditure.
Before making any payment, a preliminary examination of bills is done by the Treasury officer.

Nature of Government audit is always continuous due to large number of transactions and huge amount of expenditure.

Major portion of the accounts is prepared by the Accounts and Audit department which work independently.

**Objectives**

The following are the main objectives of Government audit –

- To check and ensure that prescribed rules and regulations have been followed while making payments.
- To ensure that expenditure should not be excessive.
- To check and verify physical stock, stores and spares along with their proper valuation. Stock-taking should be done at regular intervals and the recording of stock in the stock register should be done correctly and up-to-date.
- To check whether every payment is sanctioned by proper authority or not.
- To ensure that expenditure should be done in public interest only by the right person and should be paid to the right person.
- To ensure that no expenditure should be incurred for any personal benefit of any authority.
- To give suggestion for any kind of improvement in efficiency and economy.
- To verify that the amount due from others are properly recorded in the books and also to verify that such amount is regularly recovered.

**Statutory Audit**

Where the appointment of a qualified Auditor is compulsory as per the law is called as a statutory audit. The following are the essential characteristics of statutory audit –

- An Auditor must be a qualified accountant.
- Norms of the appointment of Auditor are provided by the law. Rights, duties and liabilities of an Auditor are as defined by the statute; management cannot make any changes in it.
- Organization cannot restrict the scope of statutory audit.
• Statutory audit provides true and fair view of financial position to shareholders and members of an organization. It helps the shareholders to keep themselves protected from any fraud and misrepresentation.

• Statutory audit is a compulsory audit. Auditor is an independent person and management doesn’t have any control over his work.

Following stakeholders are covered under the statutory or compulsory audit.

**Audit of Companies**

First time in India, the Indian Companies Act, 1913 made it compulsory for joint stock companies to get their accounts audited by a qualified person (chartered accountant). Appointments, duties, qualifications, powers and liabilities are amended through the Companies Act, 1956 and 2013.

**Audit of Trust**

The Public Trust Act provides compulsory audit of accounts by a qualified Auditor. Conditions and terms as laid down in Trust deed are the basis on which accounts of trusts are maintained. Any Beneficiary of trust does not have control or access over accounts of trust, therefore, there are more chances of fraud and misappropriations.

**Audit of Co-operative Societies**

The Companies Act is not applicable to societies; co-operative societies are established under the Co-operative Societies Act, 1912. It is a must for a qualified accountant to have the required expertise and he should be updated with various amendment of the Act. An Auditor should also have knowledge of the by-laws of this act.

**Audit of other Institutions**

Banks, Insurance companies and Electricity companies are audited as per the provisions of special Act of the Parliament.

**Cost Audit**

“Cost audit would apparently mean an examination of Cost books, Cost Accounts, Cost Statements and Subsidiary and prime documents with a view to satisfy the Auditor that these represent a fair and true view of the cost of production. This will naturally mean an examination of appropriateness of the cost accounting system adopted by business and effectiveness of its implementation.”

- J.G. Tickhe

Services of qualified cost accountants are necessary to have full control on the records of costs and cost variations. Big business houses and manufacturing units
do understand the importance of cost accounting. Cost Auditors check the work done by Cost Accountants to ensure correctness of the accounting.

**Objectives of Cost Audit**

- To verify arithmetical accuracy of cost accounting.
- To help management to take decision about production and cost variations.
- To detect error and frauds.
- To have control over cost accounting department.
- To give suggestions about efficiency of material, labour and machine.

**Tax Audit**

Under the provision of section 44AB of the Income Tax Act, 1961, every person carrying a business/Profession is required to get his accounts audited, if the total turnover or gross receipts during the previous year exceed Rs. 100 lacs in case of business and Rs. 25 lacs in case of profession.

Profit and Loss account of a business or profession is adjusted according to the provision of the Income Tax Act, therefore accounting profit and tax profit differ. The reason behind the difference in profit or loss may be because of the following –

- Amount of depreciation
- Under the Income Tax Act, certain expenses are allowed only on the basis of actual payment and those should be within the prescribed time as provided by law, like the payment of Provident Fund, ESI, Interest to financial institutions, VAT/Central Sales Tax, Employees related payments, etc.

**Balance Sheet Audit**

Balance sheet audit is very popular in the United States of America. Balance sheet audit is an annual audit and it covers each and every item of nominal accounts as appeared in profit and loss account, assets, liabilities, reserves, provisions, stocks and surplus. Balance sheet audit is also done by highly-skilled accountants.

**Continuous Audit**

Under continuous audit each and every transaction of the business is checked by the Auditor regularly. Continuous audit is required in large organizations where number of transactions is very high, internal control system is not effective, periodicals statements are required and final accounts are prepared immediately after the close of financial years like banks.
Advantages – Complete checking of records, up-to-date accounts, moral-check on staff and early finalization of financial statements are the main advantages of continuous audit.

Disadvantages – High cost of continuous audit, mechanical work of Auditor, chances of unhealthy relations with staff due to frequent visits, etc., are main disadvantages of continuous audit.

Annual Audit

In an organization where the number of transactions is not large, an Auditor usually comes after the close of financial year and completes his audit work in continuous session. In case of small business houses, annual audit gives satisfactory results.

Advantages – The work that is done by an Auditor in Annual Auditing does not affect the everyday routine of the organization and its people; the Auditor has full control over financial statements and records. Among other advantages, Annual Audit is cost-effective.

Disadvantages – There might come instances where the unavailability of Auditor may cause unnecessary delay in audit work; due to complete audit in one sitting, chances of undetected errors and frauds are high. This is not recommended for big business houses and the delay in annual general meeting is sometimes due to delay in audit which turns out to be a major disadvantage of annual audit.

Partial Audit

Partial audit is done only for a specific purpose; for example, to check the receipt side or the payment side of the cash book, to check cash sale, to check purchases or expenses only. The reason for calling out for a Partial Audit largely depends on the Management of the organization.

Internal Audit

Internal audit may be done by an independent person or by the employees of the company; internal Auditor may or may not be qualified person for audit. Internal audit is continuous in nature. As per section 144 of the Companies Act, an internal Auditor cannot render his services as Statutory Auditor for the same company.

As per the new section 138 of the Companies Act, internal audit has been made compulsory for certain categories of companies;

- Certain class of companies or may be prescribed shall be required to appoint an internal Auditor, who shall either be a chartered accountant or cost accountant or such other
professional as may be decided by the Board to conduct internal audit of the functions and activities of the company.

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

The following classes of companies are required to appoint an internal Auditor –

- Listed companies.
- Unlisted companies and Private companies meeting any of the following criteria.

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Private Company</th>
<th>Unlisted Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Turnover</td>
<td>Rs. 200 crore or more during the preceding financial year</td>
<td>Rs. 200 crore or more during the preceding financial year</td>
</tr>
<tr>
<td>Paid up share capital</td>
<td>No such criteria is applicable to private company</td>
<td>Rs. 50 crore or more during the preceding financial year</td>
</tr>
<tr>
<td>Outstanding deposits</td>
<td>No such criteria is applicable to private company</td>
<td>Rs. 25 crore or more at any point of time during the preceding financial year</td>
</tr>
<tr>
<td>Outstanding Loans or borrowings from banks or public financial institutions</td>
<td>Exceeding Rs. 100 crore at any point of time during the preceding financial year</td>
<td>Exceeding Rs. 100 crore at any point of time during the preceding financial year</td>
</tr>
</tbody>
</table>

Management Audit

Efforts are done to bring out an overall improvement in management efficiency through review of all the objectives, policies, procedures and functions of management. Only a person having good knowledge and experience of management techniques may be appointed as Management Auditor.

**Objectives of Management Audit**

Following are the main objectives of management audit –

- To help management in setting sound objectives.
• To ensure the fulfilment of objectives.
• To give recommendation about change in policies and procedure for better results.
• To help management in elaborating duties, rights and liabilities of the employees.
• To help management in establishing good and sound relation with outsiders.

Post & Vouch Audit

Under this audit system, we have checking of every single original entry and their posting in ledger along with, balancing and totaling. This audit system is only advisable in small business units; in big business houses internal Auditor do this job and Auditor just check the effectiveness of internal control system of that organization.

Audit in Depth

Audit in depth means detailed stepwise verification of some specific transactions; this helps an Auditor to understand the complete procedure of transaction as adopted by the organization to carry out any transaction. For example, to check the purchase transaction, an Auditor will check the quotations, purchase orders (P.O.), material receipt note (M.R.N), goods/material inspection note, bin card and stock ledger.

Interim Audit

Interim audit is done between two annual audits of an organization for a part of year. It enables the Board of Directors to declare interim dividend and also to determine interim figures of sales.

Auditing - Preparation before an Audit

In this chapter, we will focus on the important aspects that have to be taken care of, before commencing a new audit.

Scope of Duties

Auditor should know the scope of duties as per the Companies Act in case of company audit and in any other case, he should discuss with the person who is going to engage him for audit.

Letter of Engagement

To avoid any misunderstanding with the client, an Auditor should procure an engagement letter. It is a contract between an Auditor and a client. This letter is a
standard letter accordance with the established accounting practice and special assignment or task, if, any should be added to it.

**Knowledge about Business, Accounting System, and Technical Detail**

Complete understanding about the business of the client is desirable. An Auditor may gain knowledge through the following –

- He may visit a factory site to know the process of production and to understand the nature of material, labor and machine.
- He should read the available document there like Memorandum of Association or the partnership deed as the case may be.
- He should obtain a list of officers and staff along with their job profiles.
- He should study the complete accounting system of the client, the scope and effectiveness of internal control system and the list of books maintained by the client.
- To understand the nature of transaction, knowledge of technical aspects of business is must.

**List of documents/schedule require from client**

After doing all above preparation, an Auditor should give a list of documents or schedule required for audit purpose along with instructions. Following documents or schedule may be required to get auditing started –

- Stock statement with value and method of valuation.
- Schedule of debtors and creditors.
- Schedule of fixed assets.
- Schedule of prepaid outstanding expenses, expenditure and income.
- List of deferred revenue expenses.
- List of capital expenditure incurred during the relevant financial year.
- Investment schedule with cost of acquisition.

**Auditing - Audit Planning**

Audit planning is required for an Auditor to conduct an effective and efficient audit. Target of audit planning should be about the following –

- Time budgets
• Recruitment of audit staff
• Schedule about date of audit procedure

Base of Audit Planning
Audit planning should be based on the following –

• Complete accounting knowledge of client’s business
• Reliability of internal control system
• Programming of audit procedures and
• Co-ordination of staff

Development of Audit Plan
The following points need to be considered at the time of preparation of an audit plan –

• Auditor Engagement terms
• Statutory responsibility of Auditor
• Co-ordination with other Auditors
• Internal control system of branches and subsidiaries
• Reliability of internal control system of an organization
• To mark important audit areas
• Impact of legal rules
• Nature and timing of reports

Standard on Auditing 300 (SA 300)
The Standard on Auditing (SA) came into effect from 1st April, 2008; this deals with the auditor’s responsibility to plan an audit of financial statements.

<table>
<thead>
<tr>
<th>Scope</th>
<th>SA 300 deals with the Auditors responsibility to plan an audit of financial statements.</th>
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<tbody>
<tr>
<td>Objective</td>
<td>To plan the audit to perform it in an effective manner.</td>
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<tr>
<td>Effective</td>
<td>SA 300 is effective on financial statements for the period starts from 1st April, 2008</td>
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Preliminary Engagement Activities

Auditor shall communicate with predecessor Auditor, in case of change in Auditor. Auditor shall undertake performing procedures as per SA 220, evaluating compliance of ethical requirement as per SA 220 and establishing terms as engagement as per SA 210.

Planning Activities

To set the scope, directions and timing of audit which guide the development of audit program, the Auditor shall establish an overall audit strategy.

- Identify the characteristics of the engagement that defines scope.
- To Plan the timing of audit and the nature of communication, ascertainment of the reporting objectives of the engagement plan is required.
- Consideration of significant factors in directing the engagement team’s effort.

Documentation

- Overall audit strategy.
- The Audit Plan.
- In case of any significant changes made the overall strategy or audit plan and reasons for such changes.

Auditing - Audit Program

The success of audit plan depends on sound and solid audit Program. An audit plan is the Auditor’s plan of action. The audit Program is specially designed for each audit is a plan of the work of examination and a set of audit procedures. A written audit Program begins with the recognition of specific objectives followed by specification of procedure design to produce sufficient competent evidential matter.

An audit Program acts as a guide to arrange and distribute the work and also to check work against the possibility of omissions. Auditor should first prepare the preliminary audit Program for compliance testing of internal accounting control systems and substantive testing of accounting balance.

Compliance Test

There are two types of compliance tests to evaluate internal control system of an organization.
• Auditor observes control procedures that leave no trail of documentation.

• The second step involves the examination of documentation; this indicates the performance of control procedures.

Evaluation
Each major class of transaction and related assets perform the following steps to evaluate internal control system –

• Determination of the accounting control system that can prevent or detect errors and irregularities.

• To determine whether necessary procedures are prescribed and are being followed at satisfactory level.

• Evaluation of weakness about the nature and timing of other audit procedures and the necessary suggestion to the client in this regard is to be made by the Auditor.

• To consider the types of errors and irregularities that can occur.

Types of Audit Program
Following are the two types of audit Program –

• Fixed

• Flexible

**Fixed Audit Program **– Audit staff has to follow the instructions mentioned in the Audit Program as laid down in it without any change. Even all are not applicable to that particular organization in a particular situation. Fixed audit Program is very rigid in nature and any modification or change is Program is not easily possible.

**Flexible Audit Program **– Flexible Audit Program gives only the outline of the scope and the procedures to be followed instead of any fixed audit instructions. Therefore an Auditor has a choice to develop, adopt and modify an Audit Program as per the needs and requirements depending on the internal control system and other situations of that particular organization.

Advantages of Audit Program
The following are the advantages of audit Program –

• Audit Program gives complete coverage of audit work that can be performed by the audit staff.
Audit Program works as a road map for the upcoming years and the audit staff can refer to this and understand the future course of action.

Audit Program enhances the efficiency of the audit assistants as they are very clear about their duties.

Audit is more systematic through audit Program.

Disadvantages of Audit Program
The following are the disadvantages of audit Program –

- It is not of great help to small business units.
- Audit becomes mechanical and inefficient audit assistant may also take shelter behind the audit Program.
- Audit Program cannot be applied in uniformity to all business units as audit work of all organization cannot be the same.

Auditing - Examples of Audit Program
Audit Program for Sale/Sale Return
The Audit Program for Sale/Sale Return involves the review and check of the following –

- Complete accounting system right from the receiving of sale orders from customers to the receiving of payment from customers against the generated sale invoice.
- Indirect Taxation entries like VAT/CST/Excise and Service Tax as applicable.
- Stock valuation.
- Generation and approval of credit notes.
- Provision for doubtful and bad debts.
- Accounting entries for installment received, interest elements and unrealized profit in case of sale made on hire-purchase system.

Audit Program for Purchase/Purchase Return
The Audit Program for Purchase/Purchase Return involves the review and check of the following –

- Complete accounting system right from the issuance of purchase orders to suppliers till the payment to suppliers/creditors against the purchase invoice.
- Checking of department-wise material requisition slips.
- Authorization of requisition slips and purchase orders.
- Comparison of quantity and rate of purchase bills with purchase order.
- Material inward record with purchase bills.
- Checking of Stock register.
- Checking of purchase return note with purchase bills.
- Impact of Indirect Taxation entries on the Cost of Purchase or Input Tax Credit account, CENVAT Account for VAT/CST/Excise and service Tax as applicable.

**Audit Program for Cash/Bank**

The Audit Program for Cash/Bank involves the review and check of the following –

- Check posting and balancing of Cash book.
- Check petty cash book if maintained.
- Check cash receipt with cash book.
- Check cash payment voucher with relevant support bills.
- Authorization of cash payments.
- Check accounting for cheques/demand draft received.
- Check cash withdrawal entries with Bank statements and entries in cash book.
- Checking of direct deposit into bank by parties.
- Checking of bank reconciliation.
- Physical verification of cash.

**Audit Program for Salary/Wages**

The Audit Program for Salary/Wages involves the review and check of the following –

- Collect organization chart and list of officers.
- Authorization of above list of employees with salary.
- Review employment contracts of the employees.
- Compare authorized salary with expense account.
- Collection of information about stock option, bonus plan or other incentives as applicable to employees.
- Scanning of stock register and stock issue record about issuance or reservation of shares to employees.
• Review Salaries, incentives, bonus and compensation etc. with basic evidence.

• Check and review legal formalities as applicable to organization such as E.S.I/ provident fund/TDS etc.

Auditing - Modification of Audit Program

The Audit Program for last year acts as guide to next year’s Audit Program and changes in this Program in the current year is called modification in audit Program. There is no difficulty to make changes in flexible audit Program but modification in fixed audit Program is very difficult.

Audit Note Book

A diary or register maintained by the audit staff to note difficulties, queries, errors or other important points with their clarifications is known to be audit note book. Following are the main contents of an audit note book.

• Date of commencement and completion of audit.

• List of books of accounts as maintained by the company.

• Organization chart with responsibilities of principal officers.

• Quarries calling for clarification and explanation and import points on which attention of Auditor require.

• Any other point Auditor’s staff feels important for discussion with management or Auditor.

Audit Working Papers

Working papers are supporting documents prepared by Auditors in course of their audit. Working papers may be in form of data on papers, electronic media, film or other media and designate the files of summaries, comments, correspondence and analysis. Other working papers are Trial Balance, accounts analysis, schedule of fixed assets, depreciation chart, schedule for debtors and creditors, schedule for liabilities, advances, bank reconciliation, stock valuation, previous audit reports, audit Program, audit evidence and important quarries with their explanation etc.

Working papers can also be used by Auditor in his defense if require in any court case of negligent audit.

Audit Evidence Papers
Audit evidence papers must be well indexed, clear, complete and informative as these papers highlight the quality of audit. Audit evidence obtained during audit and the decisions made on it form the main content of audit evidence papers.

**Purpose of Audit Working Papers**
Audit working papers serve the following purposes –

- These papers contain basic material from which audit report is prepared.
- Evidence papers assist in planning and performance of the audit work.
- They are permanent records of objectives and the scope of audit.
- Working papers contain backup material in support of audit observations.
- To assist and coordinate with the Auditor in organizing work of the Auditing staff.
- With the help of working papers, the Auditor gets to know the weaknesses of the accounting operations and internal control of an organization.

**Classification of Working Papers**
There are two categories of working papers – Permanent Papers and Administrative Papers.

**Permanent Papers**
There are files that contain papers of the same client; these papers can be made use of over the years and normally include –

- Partnership deed or memorandum and articles of association or other statutory papers like copy of PAN, VAT/Central Sales Tax/Excise/Service Tax registration papers.
- Documents having continuing importance.
- Policy documents like inventory valuation and charge of depreciation.
- Copies of Balance Sheet and audit reports for earlier years.

**Administrative Papers**
It may contain the following audit working papers –

- Appointment letter
- Internal control, Management control and EDP control questionnaire
- Flow charts
- Audit Program
- Trial Balance, etc
Auditing - Methods of Audit

There is no hard and fast rule or method that can be laid down for auditing. It all depends on the training and experience of the Auditor and also depends on the circumstances. The following points need to be considered by an Auditor.

Special Ticks

An Auditor should use special ticks for different classes of transactions like posting, casting, carry forward, bank statement and vouching.

An Auditor makes use of the following precautions for ticking –

- Different ticks should be used for the same class of transactions in different firms.
- The staff of the client should not be aware of the meaning of these ticks.
- Same color should not be used for different period.
- Work should be completed up to a certain level to avoid mistakes.
- The Auditor should note down all the important totals, balances and other important points in his note book.
- If the Auditor is asked to do balancing of accounts especially in small concerns, he should act like an Accountant instead of an Auditor.
- Auditor should not accept any figures written with pencils.
- In case of continuous audit, work should be completed up to a certain date.

Routine Checking

When common records and books are checked by an Auditor, it is called routine checking and it involves checking of casts, sub casts, carry forward of balances, other calculation, posting in ledgers, balancing of ledgers and transfer of ledger balances to the trial balance.

It is helpful for the Auditor to find out clerical mistakes and simple frauds only. An Auditor should go beyond routine checking to find out all the material mistakes and frauds.

Test Checking

It is not possible for an Auditor to examine and physically verify all the business transactions of a big concern where the numbers of transactions are numerous. In such type of situations, if sufficient system of internal control and Internal Check exists, the Auditor can opt for test checking instead of checking all transactions.
Test checking is an accepted tool to substitute detailed checking. Test checking is based on the theory of probability. The following points need to be considered while test checking –

- The representative number of entries of each class should be selected by Auditor.
- Staff of client should not know and understand the method of test checking adopted by Auditor.
- Method of test checking should not be applied in audit of next year.
- Most of the period and section of transactions should be covered under over the years.
- There should be no pre-determined sample in form of size should be chosen.
- Auditor should apply the materiality concept while choosing samples.
- Auditor should pay more attention where chances of errors and frauds are high.
- If reliability of evidence is low, the Auditor should increase the size of sample.

**Auditing - Duties of Audit Staff**

**Supervisors**
Supervisors perform the following duties –

- Keep in touch with the audit staff.
- Assess and discuss the progress and completion of audit work.
- Take the Auditor’s advice on important issues.
- Rotate the duties of the audit staff.

**Section Audit Assistants**
Section Audit Assistants perform the following duties –

- Keep in touch with the client and the Auditor.
- Check the work done by junior staff.
- Prepare audit program.
- Ensure smooth audit work.
- Give advice, instructions and guidance to junior staff.
- Confirm whether legal requirements are met or not.
- Assess assets, liabilities and capital structure of company.
- To verify valuation of assets and liabilities.
Junior Audit Assistants

Junior Audit Assistants perform the following duties −

- Check schedules and reconciliations of the statements.
- Check all supporting data, documents and papers.
- Follow instructions of the seniors.

Audit Clerk

Audit clerk performs the following duties −

- Checking of posting, casting and carry forwards.
- Other routine checks.
- Follow instructions that come from the seniors.

Auditing - Audit Evidence

Being a professional person, Auditor is expert in examining the books of accounts and financial statements of a concern. Auditor gives independent opinion about the books of accounts and the financial statements audited by him. In the eyes of law, he is responsible for the opinions expressed by him. Therefore, each and every assertion should be carefully examined by the Auditor before giving expert advice.

During his audit he should try to collect as much audit evidence as possible and also evaluate the gathered evidence.

Procedures To Collect Audit Evidences

The Auditor might be able to collect sufficient and appropriate evidences through the following procedures −

Compliance Procedure

Assertions made in the financial statements can be examined on the basis of audit evidence obtained from compliance procedures. These assertions relate to existence, effectiveness and continuity of the control system of an organization.

Substantive Procedure

Assertions are examined on the basis of audit evidences obtained from substantive procedures; the assertions are as follows −

- Completeness of records relating to transactions, assets and liabilities
- Existence of Assets and Liabilities on a given date and their proper valuation.
Occurrence of an event during relevant period.
Rights and obligations relating to assets.
Disclosure and classification of an item according to recognized accounting policies, practices and legal requirements.

Formation of an Opinion
Following steps are involved in the process of opinion formation –

- Identification of the assertions
- Evaluation of the assertions
- Collection of evidences
- Evaluation of evidences
- Formation of opinion

Identification of Assertion
The Auditor has to report whether or not –

- Profit and Loss account reveals the true and fair profit or loss for the period.
- Balance sheet represents true and fair view of the financial statements.
- Books of accounts are maintained according to the generally accepted accounting customs and principles.

Evaluation of the Assertions
The identification of assertions is followed by evaluation. Assertion can be material or immaterial, materiality of assertion depends on the amount, nature, size and overall impact on financial statements.

Collection of Evidence
After identification and evaluation of the assertion, Auditor should collect all necessary evidences in support of assertions.
Auditor should assure himself that the collected evidence is reliable. The following factors decide the reliability of evidences –

- Whether sources are internal or external
- Documentary or visual and are evidences from different sources

Evaluation of Evidence
Following steps are involved in the process of opinion formation –
Whether evidence is sufficient and appropriate or not.

Examination of its quantity, reliability, validity and relevance.

**Formation of Opinion**

On the basis of the above assertions and evidences, the Auditor forms his opinions and this opinion is called the expert opinion worthy of being relied upon.

**Auditing - Types of Evidence**

In this chapter, let us understand the different types of evidence used in Auditing.

**Accounting System**

Accounting System of an organization must be reliable. On the basis of flow chart, the Auditor may come to know about the documents which originate at each state of transaction. Reliability of the internal control system in organization will decide the acceptability of evidence originating from the accounting system.

**Physical Evidence**

Physical Evidence is important in case of tangible assets. Physical verification can prove the actual existence of tangible assets like, land, building, plant and machinery, furniture and fixture, cash-in hand and stocks, etc.

**Documentary Evidence**

Documentary Evidence is very important and most of the evidence is in the form of documents. The following are the different types of documentary evidence –

- Documents that originated outside the organization but have been held by the client; for example, fixed deposit certificate is an evidence of deposit in bank.

- Cheques issued by the client is the second type of evidence which originated from within the organization but circulated to outsiders.

- Salary paid to employees is supported by salary sheet, time card, etc. This type of evidence is availed from within the organization and supported by internal control system.

**Journals and Ledgers**

Basic entries in journals are booked and supported by source documents like sale invoices, purchase invoice, payment advice, etc.

Ledger are books of final entry supported by journal book.
A Ledger is the base of financial statements like Trading Account, Profit and Loss Account and Balance Sheet.

**Oral Evidence**

Discussion with different officers of an organization is the basis for generation of some oral evidence. The Auditor should carefully observe if there is any inconsistency; he should look into it.

**Subsequent Events**

Subsequent events after the Date of Balance Sheet are also very important evidences; for example, huge deposits before balance sheet date and huge withdrawals after balance sheet date put a question mark on bank’s performance.

**Circumstantial Evidence**

Circumstantial evidence is not direct evidence but related to circumstances. For example, if any employee of a company spends hefty amount on any marriage, party or purchases a luxury apartment or car which is not possible with the income that he receives from his salary, it creates an uncertainty of something being wrong. An Auditor should make use of circumstantial evidence if he needs certain facts.

**Ratios**

If the Auditor finds any variation in the financial ratios, then he should look into it carefully. Comparison in ratio may be for same organization for different periods or it may be a comparison between two organizations.

**Computerized Records**

Evidences will remain same even in case of that organisation where computerised accounting system is maintained.

**Auditing - Audit Techniques**

Evidences are very important for an Auditor to form an opinion regarding financial statements. If Auditor fails to collect proper evidence, it will reduce the reliability of audit report. The method of collecting evidence is called audit technique. Following are a few important audit techniques –

**Vouching**

When the Auditor verifies accounting transactions with documentary evidence, it is called vouching. Through vouching, the Auditor verifies authority and authenticity of records.
Confirmation

Confirmation is a technique used by an Auditor to validate the correctness of the transactions; for example, an Auditor obtains written statement directly from debtors to confirm the debtors balance as appeared in the books of client.

Reconciliation

Reconciliation is a technique used by an Auditor to know the reason of differences in balances. For example, to know the difference in the bank book of the client and the bank balance as appeared in the bank statement or pass book, the Auditor prepares the reconciliation statement. The same method may be used for debtors, creditors, etc.

Testing

Testing is a technique of selecting representative transactions out of whole accounting data to draw a conclusion about all items.

Physical Examination

Physical examination requires verification and confirmation of the physical existence of tangible assets as appears in the Balance Sheet like cash in hand, land and building, plant and machinery, etc.

Analysis

Analysis is technique used by an Auditor to segregate important facts and to further study their relationship.

Scanning

By scanning of books of accounts, an experienced Auditor can identify those entries which would require his attention. It is also called scrutiny of accounts.

Inquiry

This method is used to collect in-depth information about any transaction.

Verification of Posting

To verify posting from books of original entry to ledger account and confirm the balance, an Auditor is required to verify the postings; for example, to verify a sale book, an Auditor may verify postings from the sale register to the sale ledger. He may further calculate balances of the sale register and the sale book.

Flow Chart
The Flow Chart technique is used by an Auditor to determine the stages of transaction and the generation of documents at all levels of transactions.

Observations
Through observation, an Auditor get an idea about reliability of the process and the procedure of an organization.

Auditing - Internal Control
In this chapter, we will discuss how Internal Control works in Auditing. Internal Control system is one of the basic and essential factors for efficient and effective management. It covers the whole management system of an organization, both financial or non-financial. Internal control system is helpful for the management and also the Auditor in achieving goals and targets effectively. Therefore, internal control system covers a number of checks and control to ensure efficient and economic working.

There are two types of controls — Financial Control and Administrative Control. Reliability of financial records and safeguarding of assets is a part of financial control. We will now understand in detail what Internal Control System.

What is Internal Control
Internal Control comprises of the plan of the organization and all the co-ordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data to promote operational efficiency and to encourage adherence to prescribed managerial policies.

Purpose of Internal Control
Let us now understand the purpose of Internal Control from different points of view.

From Auditor’s Point of View
It is very important from the Auditor’s point of view to study and evaluate the system of internal control. To obtain an adequate understanding of the internal control system, that must be tested. The Auditor has to determine whether audit is possible, if yes, then he should determine the scope of audit.

From Client’s Point of View
- Internal control system provides reliable and accurate data that is necessary for decision making and to run business activity efficiently.
- Adequate internal control system safeguard business assets, in absence of it, assets of the company may be stolen, misused or accidentally destroyed.
Internal control system within organization is necessary to discourage and stop non-performing business activities and to protect business from wastage is all aspects of the business.

Internal control system insures that rules and procedures are to be followed by business personnel.

**Characteristics of Internal Control**

Following are the main characteristics of Internal Control usually abbreviated as CROSSASIA –

- Competent and trustworthy personnel
- Records, Financial and other Organization plan
- Organizational plans
- Segregation of duties
- Supervision
- Authorization
- Sound practice
- Internal Audit
- Arithmetic and accounting controls

**Limitations of Internal Control**

Following are the inherent limitations of Internal Control –

- Management decision to choose cost effective control system may reduce the effectiveness of internal control system.
- There are chances of misuse by a person of authority who is operating on internal control system.
- Objectives of internal control systems may be defeated by manipulation of management.
- Since internal control system is involved in routine transactions, irregular transactions may be overlooked.
- Changes in conditions may affect the effectiveness of internal control system.

**Scope of Internal Control**

Following are the main areas which are generally covered by a good internal control system –
- **Cash** – Here, internal control is applied over payments and receipts of an organization. This is to safeguard from misappropriation of cash.

- **Control over Sale and Purchase** – With proper and efficient control system for transactions regarding purchase and sale of material, handling of material and accounting for the same is must.

- **Financial Control** – It deals with the efficient system of accounting, recording and supervision.

- **Employee's Remuneration** – Internal control system is applied to preparation and maintenance of records of employees and the payment methods also. It is also necessary to safeguard against misappropriation of cash.

- **Capital Expenditure** – Internal control system ensures the proper sanction of capital expenditure and also the use of it for the purpose intended.

- **Inventory Control** – It covers the proper handling of inventory, minimization of slow moving items or dead stock, proper valuation of stock, recording of it, etc.

- **Control over Investments** – Internal control system is applied to the proper recording of transactions be it purchases, additions, sale or redemption, income on investments, profit or loss on investment.

**Internal Control and Auditor**

An Auditor should ensure that certain rules and procedures are followed by the business unit he is working on, in spite of the fact that a sound system of internal control is as sole responsibility of the management. The Auditor can simply guide or help the management if he is asked to do so, because he has no authority to prescribe such rules and procedures. The degree of reliance on the system depends upon the effectiveness of internal control system; therefore, the Auditor should review and evaluate the internal control system of an organization to prepare his audit Program.

**Review of Internal Control System**

Internal control system should be reviewed by the Auditor before star audit as described below –

- Reviewing the system of accounting entries, whether recorded as per accounting standard or not.

- To frame audit program according to present circumstances.

- Frauds, errors and mistakes are likely to be located or not.
• To review existence of internal audit program and to check the efficiency of internal control system.

• To review the reliability of reports, records and certificates as presented by the management.

• To check if there is any possibility of improvement in existing internal control system.

Auditing - Internal Check

Internal Check is an integral function of the internal control system. It is an arrangement of duties of the staff members in such a way that the work performed by one person is automatically and independently checked by the other.

Objectives Of Internal Check

Following are the main objectives of Internal Check –

• To protect business from carelessness, inefficiency and fraud.

• To ensure and produce adequate and reliable accounting information.

• To keep moral pressure over staff.

• To minimize the chances of errors and frauds and to detect them easily on early stage if it is committed.

• To divide the work in such a way that no business transaction should be left unrecorded.

• To fix the responsibility of every clerk according to the division of work.

Principles of Internal Check

Let us now understand the principles of Internal Check –

• **Responsibility** – Allocation of business work amongst the various staff members should be done in such a way that their duties and responsibilities should be judiciously and clearly divided.

• **Automatic check** – Automatic checking of work of one employee by another forms part of a good Internal Check system.

• **Rotation** – Transfer or rotation of employees from one seat to another must be followed under good system of internal control.

• **Supervision** – Prescribed procedures and Internal Check should be strictly supervised.

• **Safeguard** – To safeguard files, securities, cheque books is also recommended in Internal Check.
Formal Sanction – Without formal sanction, no deviation should be allowed from the established procedures.

Reliance – Under good system, too much reliability on one employee should not be there.

Review – From time to time, system of Internal Check should be reviewed to introduce improvement.

Advantages of Internal Check
Following are the advantages of a good system of Internal Check –

From the Owner’s Point of View
- Good system of Internal Check provides accurate, reliable and genuine accounting record and data to the owner of the business on which he can rely upon.
- Economy in operations and overall efficiency in system due to good Internal Check may result in more profits.

From the Auditors Point of View
- Due to efficient system of Internal Check, the statutory Auditor can avoid deep and detailed checking of transactions. He may rely on test checks, hence Internal Check provides convenience to Auditor.
- Since the Balance Sheet and the Profit and the Loss account is prepared without wasting of time, hence quick preparation of final accounts is possible.

For the Business
- Moral Check – Great check to commission of errors and frauds is possible with knowledge of subsequent checking of work of each employee by others.
- Detection of Errors and Frauds – This helps in early detection of errors and frauds because work of each clerk is checked by another automatically and no one is allowed to do complete work from the beginning to the end.
- Proper Division of Work – According to qualification, experience and area of specialization of work, proper and rational distribution of work among the members of staff is done.
- Increases Efficiency – A good internal control system provides increased efficiency of work coupled with overall economy.

Disadvantages of Internal Check
Let us now discuss the disadvantages of Internal Check –
• It is costly for small business units.

• If Internal Check system is not properly organized, there are chances of disorder in the working of business.

• There might be instances where the quality of the product and the work is compromised with by the staff members due to greater importance to faster results.

• An Auditor cannot be relied on if he does not conduct tests with procedures of his own.

Auditing - Internal Check and Auditor

The nature and extent of the scope of the Auditor’s work depends upon the system of Internal Check in an organization. The system of Internal Check will determine the reliability on work which an Auditor can place. The External Auditor is ultimately responsible for the final accounts.

The Internal Check system cannot relieve the Auditor of his contractual responsibilities in case anything goes wrong in the final accounts, therefore it is the duty of the Auditor to check the whole transaction in detail. A good Internal Check system may relieve the Auditor of detailed checking and he can utilize the saved time to any other work of more importance.

We will further discuss Internal Check related to different aspects –

• Cash Payments
• Cash Sales at Counter
• Cash Sales by Salesmen
• Postal Sales
• Cash Receipts
• Purchases
• Sales
• Stores
• Fixed Assets
• Investments

Cash Payments

Consider the following points while doing Internal Check for cash payments –
• Excluding petty cash payments, all payments should be made through cheques, Demand Drafts, RTGS (Real Time Gross Settlement), NEFT (National Electronic Fund Transfer) or any other banking mode as available time to time.

• Person making payments should have no connection with the receipt of cash.

• Every paid bill or voucher should be stamped as “Paid” to avoid double payments for same bill or voucher.

• Confirmation of balances from creditors should be made directly.

• Cash receipt should be obtained for each payment.

• For petty cash payments petty cashier will be responsible instead of main cashier.

• Petty Cash should be maintained on Imprest system.

• In absence of cash receipt, proper bill or voucher should be obtained from the petty cashier.

• Petty cash book should be checked by the Cashier frequently.

• Bank reconciliation should be done on a regular interval.

• Pay-in slip to deposit cash in bank should be filled by the Cashier not by the person who is going to deposit the cash.

As per the provision given under section 40A(3) of the Income Tax Act, 1961 for payment exceeding Rs. 20,000/- it is stated that “Where the assessee incurs any expenditure and it is paid in a sum exceeding Rs. 20,000/- otherwise than by crossed cheque or crossed bank draft, whole of such expenditure is disallowed”

Cash Sales at Counter

• Every Salesman who is authorized to do cash sales should be specifically demarcated.

• Four copies of cash receipt should be generated out of which three will be handed over to the customer out of which customer will give one copy to cashier at the time of payment and one copy to gatekeeper at the time of delivery of goods and exit from gate and one copy will be retained by the customer.

• Three sales summaries will be prepared, one by the Salesman, second by the Cashier and the third by the Gatekeeper to tally the cash sales on daily basis.

• All Cash Sales should be deposited into bank on daily basis without any failure without deducting any expenditure or commission out of it.
• Cash received (as per cash recording machine), cash sales and amount deposited into bank should be same.

**Sales by Travelling Salesmen**

• Pre-numbered rough cash receipt book should be issued to every salesman for the collection of debt or advance from customers.

• Final receipt should be sent to customers directly.

• Without making any deduction, salesmen should deposit all the cash at the head office on daily basis without any fail.

• Regular reconciliation of account should be made with customer.

• To avoid any fraud every salesman should be replaced and transferred regularly to other areas.

**Postal Sales**

• Postal sales should be recorded in separate register.

• A separate register should be maintained to record the cash received against postal sale.

• Cash received through postal sale should be deposited into bank separately.

• Regular and careful checking of the sale and payment register should be done by an officer of the company.

**Cash Receipts**

A Cashier deals with the following tasks concerning cash receipts –

• Record cash receipts immediately upon the receipt of cash.

• He is not authorized to keep cash with him.

• He is not allowed to make any expenditure out of it.

• Cash receipt should be deposited in to bank on daily basis.

• Cashier should not be allowed to do primary entry in the books.

**Purchases**

• *Requisition slips* duly signed by the head of the department should be issued and sent to the purchase department, clearly mentioning the quantity, quality and the delivery date on the requisition slip.

• *Enquiry* about the required material should be done by the purchase department from different suppliers of the material.
- *Purchase order* should be issued on the basis of the lowest quotation received from the suppliers. There may be four copies of the purchase order, one for the supplier, second for the stores department, third for the accounts department and the fourth copy should be retained by the purchase department.

- Goods should be sent to store after proper examination at the time of receipt of goods. Store department will inform concerned department for the same.

- After proper *verification of purchase invoice* same should be sent to accounts department for their accounting and payment purpose.

- On the basis of the purchase order, the accounts department will book that invoice in our books of accounts and if there is any discrepancy, debit note should be issued to the supplier under intimation to the purchase department.

- *Payment* is made to the supplier according to the due date.

### Sales

- After receipt of the sales order, one copy of it should be sent to the dispatch department for further process.

- The dispatch department after receipt of the sales order packs the material according to the order.

- Preparation & verification of Invoice is done based on the sales order.

- Entry is done in goods outward register before sending it to customers.

- Sales return is entered in goods inward register and a credit note for the same is issued to customers accordingly.

### Stores

A Store is a very important and crucial department of any industry and proper control over store is very much essential to prevent theft, pilferage and misuse of inventory. Following points need to be considered for Internal Check on Stores –

- Every store must be equipped with all the facilities as require keeping inventory in order and convenient location of store is also important for any industry.

- Triplicate copy of G.R.N. (Goods Receipt Note) should be issued on receipt of material, one to be sent to purchase department along with invoices, second for accounts department and third will be retained by store department.

- Receipt goods should be stored at proper place. Proper stock accounting should be there for receipt of goods and on issue of goods.
• Physical stock taking at regular interval should be carried out and reconciliation of stock with books should be done without any fail. There should be a proper and quick action in case of any discrepancy.

• If material is issued to any other department, it needs to be specified on “Material Transfer Note”, the return of Material should be on the MRN (Material Return Note) and the material being issued to the customer should be on the basis of Sales Invoice only.

Fixed Assets
Purchase of Fixed Assets may be for normal addition to Fixed Assets, for new project or for expansion of business. Fixed assets are of permanent nature to earn income, i.e., Land, Building, Plant & Machinery, Furniture & Fixtures, computer and vehicles, etc.

Following are the important checks related to fixed assets –

• Sanction of capital expenditure should be done by a committee may be set up for this purpose or by the proper authority. Same procedure should be followed in case of transfer or discarding of any assets.

• Distinction between Capital and Revenue expenditure is must for proper accounting records.

• Fixed Assets register should be maintained giving all the description about qty, cost and location etc of fixed assets.

• Physical verification of fixed assets should be there from time to time.

• Accounting and depreciation of fixed assets should be done according to Accounting Standard-10 issued by the Institute of Chartered Accountants of India.

Investments
Following points need to be considered while dealing with investments –

• Sale and purchase of investment should be done by an authorized person only.

• Detailed investment register should be prepared and physical verification of the document of title on periodically basis to be done. These documents of title should be kept in safe custody of company.

• Correctness of charges of brokers should be checked.

• Checking of accounting entries on account of dividends interest, bonus and capital repayment should be done.

• Physical verification of investment should be done.
Auditing - Internal Audit

In this chapter, we will understand the concept of Internal Audit in Auditing. A team of experts reviews the procedures and operations of an organization and reports it to the management in cases such as non-compliance, lack of control and inefficiency, especially in big organizations where thousands of employees work and the business operations take place from various locations. The internal audit team not only requires expertise in accounting but also in organizational behavior and functional areas of management.

Statutory Requirement

As per Section 138 of the Companies Act, 2013 –

- Such class or classes of company as may be prescribed shall be required to appoint an internal Auditor, who shall either be a Chartered Accountant or Cost Accountant or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the company.

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

Scope of Internal Audit

Following is the scope of Internal Audit according to the Institute of Internal Auditors –

- Safeguarding the assets.
- Economical and efficient use of resources.
- Reliability and integrity of information.
- Accomplishment of established objectives and goals for operations or programs.

Objectives of Internal Audit

Following are the main objectives of internal audit –

- To comment about effectiveness of internal control system in force.
- To give suggestions about improvement of internal control system in organization.
- To check and ensure whether policies and procedure as laid down by the top management are being followed or not.
- Whether assets of organization are properly accounted for and safeguarded.
- To ensure whether standard accounting practices are followed by the organization.
• Earlier detection and prevention of errors and frauds.
• To ensure correctness, accuracy and authenticity of financial accounting.
• To do investigation at the special request of the management.
• To check whether liabilities of organization are valid and legitimate.

**Internal Check and Internal Audit**

Although Internal Check and Internal Audit are a part of the whole system of internal control yet there is a lot of difference between Internal Check and Internal Control –

**Internal Check V/S Internal Audit**

<table>
<thead>
<tr>
<th>Basis</th>
<th>Internal Check</th>
<th>Internal Audit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Meaning</td>
<td>It is an arrangement of the duties of staff members in such a manner that work performed by one person is automatically and independently checked by the other.</td>
<td>Internal Audit is a review of various operations and records of the company by staff specially appointed for this purpose.</td>
</tr>
<tr>
<td>Object</td>
<td>To prevent and minimize the possibilities of errors, frauds or irregularities.</td>
<td>To detect errors and frauds which have already been committed.</td>
</tr>
<tr>
<td>Timing</td>
<td>Internal Check works during the course of transactions.</td>
<td>Internal Audit begins after the completion of accounting process of different transactions.</td>
</tr>
<tr>
<td>Scope</td>
<td>Scope of Internal Check is very limited.</td>
<td>Scope of Internal Audit is very broad.</td>
</tr>
<tr>
<td>Staff</td>
<td>The arrangement of the duties is done with the existing staff, no new member of staff is required for Internal Check.</td>
<td>Separate staff is required to do internal audit.</td>
</tr>
<tr>
<td>Nature</td>
<td>Internal Check checks the progress of work automatically.</td>
<td>Internal Auditor reports to the management and suggest</td>
</tr>
</tbody>
</table>
Involvement

<table>
<thead>
<tr>
<th>Involvement</th>
<th>Improvement about various inefficiencies.</th>
</tr>
</thead>
<tbody>
<tr>
<td>A large number of employees are involved in the Internal Check system.</td>
<td>For implementation of Internal Audit, a small team with limited members can also perform the audit.</td>
</tr>
</tbody>
</table>

Device

<table>
<thead>
<tr>
<th>Device</th>
<th>Improvement about various inefficiencies.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal Check acts like a device and keeps check on the work.</td>
<td>Internal Audit is a device for checking the work.</td>
</tr>
</tbody>
</table>

**External Audit and Internal Audit**

The following are the differences between Internal Audit and External Audit –

**External vs. Internal Audit**

<table>
<thead>
<tr>
<th>Basis</th>
<th>External Audit</th>
<th>Internal Audit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appointment</td>
<td>Appointment of External Auditor is compulsory by the law; he is appointed either by the Shareholder or by the Government.</td>
<td>Appointment of Internal Auditor is optional and he is appointed by the management.</td>
</tr>
<tr>
<td>Status</td>
<td>External Auditor is an independent person.</td>
<td>Internal Auditor is a paid employee of the company.</td>
</tr>
<tr>
<td>Scope</td>
<td>Scope of work of External Auditor is laid down by the laws.</td>
<td>Scope of work and rights, duties and responsibilities of Internal Audit is laid down by the management.</td>
</tr>
<tr>
<td>Object</td>
<td>Assurance about whether the financial statements are presented fairly in all material respects and according to applicable financial reporting framework or not.</td>
<td>Object of Internal Audit is to serve the need of the management and to prevent errors, fraud and irregularities.</td>
</tr>
<tr>
<td>Remuneration</td>
<td>Remuneration is fixed by the shareholders of the company.</td>
<td>Remuneration is fixed by the management of the company.</td>
</tr>
<tr>
<td>Duration</td>
<td>External Audit starts after the preparation of final accounts.</td>
<td>Internal Audit is carried out throughout the year.</td>
</tr>
<tr>
<td>----------</td>
<td>---------------------------------------------------------------</td>
<td>--------------------------------------------------</td>
</tr>
<tr>
<td>Reporting</td>
<td>Report is submitted to the shareholders of the company.</td>
<td>Report of Internal Audit is submitted to the management.</td>
</tr>
<tr>
<td>Shareholder Meeting</td>
<td>External Auditor has a legal right to attend shareholders meeting.</td>
<td>Internal Auditor doesn’t have the right to attend the shareholders meeting.</td>
</tr>
<tr>
<td>Audit Procedure</td>
<td>Mostly External Auditor does text checking.</td>
<td>Internal Auditor mostly does detailed checking and examination of books of accounts and records.</td>
</tr>
<tr>
<td>Qualification</td>
<td>External Auditor must have the required professional qualification as laid down by the law.</td>
<td>Professional qualification is not compulsory for an Internal Auditor.</td>
</tr>
</tbody>
</table>

Auditing - Audit Sampling

These days, auditors may not go for detailed examination and verifications of records. With the introduction of efficient internal control system in organizations, Auditors pick selective portion of entries out of complete data for making judgement on the complete data.

Checking of all transaction and verifying entries and record of the business was a common practice in earlier years; this is almost obsolete in the present modern system of auditing. Since there is no statutory obligation for the Auditor to check whole transactions, thus the Auditor decides at his own level about the extent to which checking should be applied.

What is Audit Sampling?

Sampling is a technique, based on the assumption that, by and large, every sample has almost the same characteristics of the complete data it is representing. Sampling means the selection and verification of a portion of accounting entries and records out of total similar data. It provides reasonable basis to the Auditor to conclude about the population.
An Auditor may apply **test checks** where adequate internal control system is adopted by the organization and it is widely accepted in accounting and auditing profession. In it, the Auditor goes for selective verification instead of checking all the entries in the books.

No doubt, this technique may provide a certain degree of reliability instead of complete reliable results. If, there is a satisfactory internal control system in any organization, a lesser degree of reliability of sample result may be acceptable.

**Test Checking**

Nature, size and materiality of transactions are the basis, which are kept by the Auditor in his mind for his own judgements for selecting a sample of entries to be checked. Normally, accounts having material impact and entries involving large amounts are checked thoroughly and balance entries are checked on at random basis.

The advantage of this technique is that if any error or fraud detected out of unchecked entries will not create any material impact on fairness and truth of financial statements. Disclosure, presentation, accounting standards, provision of law and arithmetical accuracy are other aspects on the basis of which, the Auditor gives his judgement.

**Precautions**

Following precautions must be taken to apply test checking technique.

- Selected transactions for test check plan should be free from any bias.
- Number of transactions includes in test check should be on the basis of the experience of an Auditor.
- Purpose of voucher checking should be based on the clear objectives of authorization or payment made or recording in the books.
- Transactions might be classified in sub-group, in case where, there is a wide variety of transactions in a group.
- Some transactions should be identified during audit and those are to be checked thoroughly.
- During audit, if any error or fraud is identified, those should be further investigated thoroughly.
- Internal control system of organization should be studied thoroughly to decide at what extent the test checks are to be applied.
• Complete procedures and processing of transactions should be studied from starting to end.

What is Statistical Sampling?
Statistical sampling refers to an approach to sampling that has the following characteristics –

- Random selection of sample items, and
- The use of probability theory to evaluate sample results, including measurement of sampling risk.

Sampling without the above characteristics is to be considered as a non-statistical approach. Whatever may be the sampling approach, the sample must be similar to the larger data it represents? Non-statistical sampling is neither scientific nor objective. Reliability of audit objectives can be measured in statistical sampling.

Advantages of Statistical Sampling
Following are the advantages of Statistical Sampling –

- Increase in the size of population does not mean increase in sample size.
- Indication of specific risk and precision are associated with estimation of minimum sample size.
- This technique is free from any association of human bias.
- With minimum efforts, cost and time, it provides maximum information.
- Sample represents the whole population.
- For verification of work-in-progress and inventory, it is a very useful technique because total errors can be predicted on the basis of errors in the sample.

Limitations
Following are the limitations of statistical sampling –

- Without effective and adequate internal control system, this technique cannot work properly.
- Without adequate size and sample, result of it can be misleading.
- This technique requires more time and energy which is not practical in certain situations.

Prerequisites of Statistical Sampling
Following are the prerequisites of Statistical Sampling –
• Every item in population has equal chance of selection for sampling and each selected item for sample is of equal importance.

• There must be an appropriate size of sample to enable the Auditor to form an opinion about the genuinity of financial statements.

• Sample should be representative of the whole population.

Important Points From SA-530

Let us now discuss a few important points from SA-530.

**Sample design, size and selection of items for testing**

When designing an audit sample –

• the Auditor shall consider the purpose of the audit procedures and the characteristics of the population from the which the sample will be drawn.

• the Auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.

• the Auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

**Performing Audit Procedures**

The Auditor shall perform audit procedures, appropriate to the purpose, on each item selected. If the audit procedure is not applicable to the selected item, the Auditor shall perform the procedures on a replacement item.

If the Auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the Auditor shall treat that item as a deviation from the prescribed control, in the case of tests of controls, or a misstatement, in the case of tests of details.

**Nature and cause of deviation and misstatement**

The Auditor shall investigate the nature and causes of any deviations or misstatements identified, and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit.

In extremely rare circumstances when the Auditor considered a misstatement or deviation discovered in a sample to be an anomaly, the Auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population. The Auditor shall obtain this degree of certainty by performing additional audit procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the reminder of the population.
Projecting Misstatement
For the test of details, the Auditor shall project misstatements found in the sample to the population.

Evaluating Results of Audit Sampling
The Auditor shall evaluate –

- The results of sample, and
- Whether the use of audit sampling has provided a reasonable basis to conclude that the larger population has been tested.

Methods of Sample Selection
Following methods can be used for sample selection –

- Systematic Random Sampling
- Random number Table
- Stratified Random Sampling
- Systemic sampling
- Haphazard sampling

Auditing - Audit Vouching
Accounting entries made in the books must be supported by documentary evidence and inspection of that evidence is called vouching. The Auditor judges the authenticity, of the accounting entries using the technique of vouching. In case of unavailability of proper supporting documents, the Auditor may have all reasons to doubt about errors or fraud or manipulation.

Thus, auditing is incomplete without vouching.

In auditing process, based on evidence, there are two main functions

- collection of evidences – through observation, confirmation, inspection, inquiry.
- evaluation of evidences – with relevance, adequacy and validity.

Objective of Vouching
Following are the main objectives of vouching –

- To check whether all the business transactions are properly recorded in the books of accounts or not.
To see whether recorded transactions are duly supported by documentary evidence or not.

To verify that all the documentary evidence is authenticated and related to business transactions only.

To verify that transactions are free from errors or frauds.

To verify whether voucher is processed through all the stages of Internal Check system properly.

To verify and confirm that the entries are recorded according to the capital and the revenue nature or not.

To check the accuracy of accounting transactions.

**Importance of Vouching**

Vouching forms the base for auditing and has an important part of Auditor’s duty. In case of negligence in vouching, the Auditor will be held responsible; he cannot escape from his duty, if he has done vouching carelessly. Following points show the importance of vouching –

- Vouching is equally important as passing of original entry in the books of accounts. If, original entry is wrong, it will affect every process of accounting entry and its impact will be till the end result. Similarly, vouching is base of all auditing process.

- Efficiency of vouching will decide the success of audit.

- Any errors and frauds are easily detectable if vouching is conducting in searching and intelligent manner.

- Intelligent and faithful vouching will establish reliability on financial statements, i.e., Profit and Loss account and Balance Sheet of any organization.

- If adequate internal control system exists, the Auditor may choose to do test checking instead of complete vouching.

**Vouching and Routine Checking**

Routine checking covers the checking of every carry forward, posting to ledger account and balancing of account. Vouching includes routine checking which is a mechanical checking, whereas vouching is made on the basis of documentary evidence.

A voucher may be a sales bill, purchase bill, payment receipt, pay-in slip, etc. All such types of documentary evidence are known as vouchers.
Types of Voucher

There are two types of vouchers –

- **Primary Voucher** – Original copy of written supporting document is called primary voucher. Like purchase Bill, cash memo, pay-in-slip, etc.

- **Collateral Voucher** – Copies of supporting documents which are not available in original are collateral voucher like duplicate or carbon copy of sale invoice.

Example of Vouchers

<table>
<thead>
<tr>
<th>Transactions</th>
<th>Vouchers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>Sales order, sales invoice, goods outward register, cash receipt, bank pay-in-slip, etc.</td>
</tr>
<tr>
<td>Purchase</td>
<td>Quotations, purchase orders, purchase bills, goods inward register, etc.</td>
</tr>
<tr>
<td>Cash Payments</td>
<td>Demand note, cash receipt, cash memo, etc.</td>
</tr>
<tr>
<td>Cash Received</td>
<td>Duplicate or carbon copy of cash receipt, contracts and correspondence with payee, etc.</td>
</tr>
<tr>
<td>Bank Payments</td>
<td>Cheques, counterfoils, bank statements, etc.</td>
</tr>
<tr>
<td>Payment received through</td>
<td>Bank deposit slip, bank statements, etc.</td>
</tr>
<tr>
<td>Banking Channels</td>
<td></td>
</tr>
</tbody>
</table>

Important Points Regarding Vouching

Following points need to be considered regarding vouching –

- Accuracy of transactions.

- Authenticity of transactions.

- Proper classification of accounts.

- Voucher should be properly numbered serially and arrangement of vouchers accordingly.

- Every checked voucher should be tick marked with sign.
• Amount of receipt should be same in words and in figure.
• Period of payment should be there on receipt.
• Receipt should clearly mention “advance payment” if it is do.
• To check and investigate the books of accounts if they are in the name of Director, Manager, Partner or any other employee of the company.
• To verify that proper certification of voucher should be there by any responsible officer of the company.
• Investigation about missing vouchers in file if any.
• Every alteration in voucher must be authenticated by concerned officer.
• Vouching should be complete at once in one sitting for a particular period of time.
• All the expenses should be examined by the Auditor.
• Without existence of adequate internal control system in organisation, an Auditor should not opt for test checking.
• Checking the classification of account must be done.
• Cash purchase should not be recorded twice, once in cash purchase and second one in credit purchase.
• An Auditor should refer the resolution as passed at the meeting for certain transactions.
• An Auditor should verify that accounting entries are done on the basis of capital and revenue items.
• An Auditor should verify that every payment voucher of above Rs. 5,000/- should bear the revenue stamp.

Auditing - Mechanized Accounting

In the traditional manual system of accounting, a lot of steps were involved in recording the Accounting transactions. In the present day business scenario a lot of information can be fetched in very less time, without spending a lot of workforce and resources. Therefore, various machines are doing the work of recording and presenting accounting transactions.

Advantages of Mechanized Accounting

• It saves time and cost in recording accounting transactions.
• Machines works very efficiently, hence chances of errors are reduced.
• It enhances speed of work.
• Accounting through machines is neat and legible.
• Without any delay final accounts can be prepared any time.
• Cost of internal control system and Internal Check can be minimized.
• Desired number of copies of any record is easily available.
• Past year's data and record can be reproduced in desired form without any delay.

Disadvantages of Mechanized Accounting

Mechanized Accounting comes with its own set of disadvantages. A few of them have been mentioned below –

• Wrong punching of data at initial stage will produce wrong results.
• Loose cards and sheets maintained under it are not acceptable by court.
• It is very difficult to locate and rectify error in it.

Mechanized Accounting and Auditor

An Auditor should consider the following points while conducting audit of mechanized accounting records –

• He must verify original data punching.
• Scrutiny of internal control system is must.
• He must ensure that actual and authorized accounting transactions shall be recorded.
• He must obtain explanation, if any, required in any entry.
• He requires certificate whether machines are in order and working properly or not.

Auditing - Trading Transactions

Vouching of Purchase Book

The major purpose behind the vouching of purchase book is to confirm that every purchase bill is entered in purchase book and the invoices entered in purchase book are against the actually received goods and payment is made for those actual purchases.

We will further discuss the main duties of an Auditor concerning the vouching of credit purchases.

Internal Control for Purchase
The Auditor has to study the adequacy of internal control system in an organization. Normal internal control system for purchases is given below –

- Department which requires material or store department will send purchase requisition to the purchase department after getting it signed by the head of the department. Quality and quantity of the required material should be clearly mentioned on the requisition.

- After getting authorized requisition from the store or other department, the purchase department will invite quotations from different suppliers; the purchase department will then choose the best price quotation with the best quality products.

- A purchase order will be issued to the supplier of goods who is ready to supply the goods on most favorable terms and conditions. One copy of the purchase order will be sent to the supplier of goods, the second one to the store department, the third one to the accounts department and the fourth one to goods receiving department, and one copy will be retained by the purchase department itself.

- On receiving the goods, the Material Receipt Note (MRN) will be issued by the goods receiving department after the checking and verification of quantity, price and quality of material of goods with purchase order. The material along with the Material Receipt Note will be sent to the store department, one copy each of MRN will be sent to the accounts department and the purchase department.

- After the verification of the purchase invoice and the MRN, the accounts department will pass the bill for payment and the payment will be done by the accounts department according to the payment terms.

The Auditor has to verify the complete internal control system as stated above.

**Duties of Auditor**

The Auditor has to check and verify the following –

- Record of all purchase orders.

- Verification of quantity, price and payment terms of purchase invoice with purchase orders.

- Verification about whether goods actually received.

- Verification about proper recording of purchase bill in purchase book.

- Goods purchase should be for business purpose only, not for any personal use of any partner, director or officer of the company.

- The Auditor should verify the statements of accounts of suppliers.
Vouching of Purchase Return Book

There are times when due to the quality of purchase goods or due to excess supply of ordered goods or any other reasons, goods are returned back to supplier. The Auditor needs to verify the following points –

- A debit note or purchase return invoice should be prepared mentioning the original purchase invoice number, quantity, price, applicable taxes, etc. These should be according to the original purchase invoice against which material was purchased.
- A corresponding credit note should be received from the supplier.
- Separate goods return book should be maintained.
- Adjustment of the amount of goods return invoice should be done while making payments to the supplier.

Vouching of Goods sent on Consignment Basis

Consider the following points for the vouching of Goods Sent on Consignment Basis –

- Goods sent on consignment basis by the principle to his agent are not a sale.
- Entry of sale should be made only when goods are actually sold by the agent.
- At the time of valuation of stock of principle (Consignor), unsold goods lying at the godown of agent (Consignee) should also be considered as stock.
- Separate books for goods sent on consignment should be maintained by the consignor.
- At the end of the year, the consignee sends a statement showing the goods received, during the year, goods sold and the unsold stock at the end of the year.
- Auditor should verify the proforma invoice, goods outward register, etc.

Vouching of Credit Sale

Most of the sales are made on credit basis and the internal control system for the same is given below –

Internal Control for Credit Sale

- A separate sale order register should be maintained showing the detail of goods ordered, name of the customer, order number, quantity ordered, schedule time for dispatch, price, mode of delivery, payment terms, particulars of taxes and insurance. The sales order needs to entered in the register as soon as it is received.
- Sale order will send to dispatch department.
Dispatch department will arrange material to be sent to customer.

On the basis of sale order and dispatch challan, sale invoice is issued.

Sales invoices need to be entered both in the outward register and also the sales book.

Payment will be received according to the payment terms.

**Duties of Auditor**

- An Auditor should verify the complete internal control system of sale as described above.
- The sale invoice should check with sale order.
- Sale register will check through sale invoices.
- Sale of capital goods should not be recorded in sale account.
- Calculation of sale invoice should be check in case of manual invoicing.
- Accounting for taxes should be in separate account like excise duty, service tax, VAT, Central Sales Tax, etc.
- No sale invoice should be unrecorded in the sales book.
- Only the sales of the current year should be recorded for the current year.
- Cancelled invoices should be kept separate for verification of Auditor.
- No separate entry for trade discount should be passed; it should be adjusted in the sales value.

**Vouching of Sales Return**

There may be many reasons for return of sold goods by the customers. Few of them are wrong supply of material, excess quantity or below standard quality, etc. The Auditor should carefully check the following –

- Separate sale return register should be maintained for sale return.
- Credit note should be issued after obtaining proper sanction from the responsible officer.
- Goods inward register should be checked.
- The reason for return of goods should be analyzed.
- Date of return of goods should be verified with debit or credit note, goods inward register.
- Store records should be checked.
- Customer account should be credited with the sale return amount.
- At the time of valuation of the closing stock, returned goods should be valued at “cost or market price whichever is low.”

**Goods Sold on Sale or Return Basis**

Most of the online shopping companies are doing their business on Sale or return basis. Customer books their online order, on the basis of order goods are send to customer through courier or transport, customer receive the goods and make payment to courier boy or he may return the goods immediately just after opening the parcel in case if he is not satisfied. Even after accepting the delivery of goods and making payment of it, the customer is normally allowed to return the goods in the stipulated time (mostly 15 days), in case he is not satisfied with the quality of the product.

The Auditor should carefully verify all processes and documentation on the basis of above and consider the following points –

- Sale invoice can be raised only after the confirmation is received from the customer or after expiry of the stipulated time.
- Goods sent on sale or return basis should be considered as closing stock if the approval of sale is not received or stipulated time is not expired.
- Copy of sale invoice will be send to customer.

**Goods Sold on Hire Purchase System**

Consider the following points while vouching for a Hire Purchase Sale –

- Goods sold on hire purchase price which is cost + profit.
- Payment is receivable in the installments.
- Profit on hire purchase sale can be book only on the basis of installment actually released.
- Provision for profit in the Balance sheet should be made on the basis of pending installments.
- Amount of such provision will be deducted from the debtors account.

**Forward Sale**

If there is an agreement between the seller and the buyer for sale of specific quantity of good on any future date, it is called forward sale. The Auditor should verify that sale cannot be booked before such date and without dispatching goods to the
customer. In case of partial delivery, profit may be booked partially on the basis of actual sale.

**Sale of By-Products**

By-product is automatically produced at the time of manufacturing or production of any main product is called by-product. For example, Mustard cake is by-product of mustard oil. Sale may be treated separately if volume of sale of by-products is high or it may be reduced from cost of the product. According to nature and volume of industry Auditor can set an intelligent audit Program after discussing with the management.

**Sale of Scrap**

Scrap is produced during the manufacturing of product in the normal course of production. Scrap is a saleable item and sold to scrap vendor, who deals with it. The Auditor should verify the storage condition, the volume of scrap actually produced, the quotations from the scrap vendors, the quantity sold, the taxes applicable and the payment received.

**Vouching of Journal Book**

In addition to cash book, purchase book, sale book, purchase return and sales return book, the following entries are recorded in the journal book –

- Opening and closing entries
- Various provision for Taxes and doubtful debts
- Provision for depreciation
- Interest received and interest paid
- Transfer entries and adjustment entries
- Allotment of shares, Shares calls, forfeitures and reissue of forfeited shares
- Sale and purchase of assets
- Entries of bills receivable, bills payable and dishonour of bills

There are many chances of committing frauds by any senior official through these entries, Therefore, Auditor should be very careful while auditing journal transactions and should call for every documentary evidence as and when he require during his audit.

**Other Important Aspects**

The Auditor should always be careful, while auditing a trading transaction. Following points need to be considered for the same –
Stock in Trade
Correctness and verification of stock-in-trade is of great importance in any industry. The closing stock of a year becomes opening stock of the next year, hence constant check on it is very important. Opening stock + purchase - sale should be equal to the closing stock. This equation might be true, if there is any difference due to any reason, the Auditor should check and verify the reason behind it. Following points need to be considered while checking and verifying the stock in trade.

- Sample to customer and the loss of stock during processing, loading, unloading, fire and leakage, etc.
- Sale or purchase in transit.
- Sale return still excluded in stock and purchase return included in stock.
- Non adjustment of goods received or sent on the sale or return basis.

Stock is valued on the basis of physical verification at the end of the year and should reconcile with the book balance. There must be effective internal control system to control the stock in trade.

Capital and Revenue Items
The Auditor should always be careful about distinction between capital and revenue items otherwise profit of the concern will be overvalued or undervalued and the financial results will not present true and fair view of the organization.

Current Assets and Fictitious Assets
Over valuation of current assets will represent higher profit and vice-versa; for example, the inclusion of bad debts in debtor account. Fictitious assets of no value should be written off like patents or trademark of no use.

The Auditor should ensure that current assets and fictitious assets should be valued at actual otherwise profit will understated or overstated.

Auditing - Vouching of Cash Transactions
Vouching of Cash Receipts (Debit Side of Cash Book)
We will discuss the cash receipt which are placed on the debit side of cash book for following items –
Opening Balance of Cash Book

Opening balance of cash book represents cash in hand at the start of the year and should verified from the balance sheet of last financial year.

Cash Received from Debtors

Consider the following points for verification of cash received from debtors –

- The carbon copies or counterfoils of cash receipt book should be verified.
- Cash receipt should be serially numbered.
- Cash received should be entered on the same date when the cash is actually received.
- The discount allowed to customers should be properly authorized by a responsible officer.
- Correspondence with customer and ledger account should be tallied.

Following are the different ways used for misappropriation of cash –

- Cash received from customer not recorded in books and no cash receipt may be issued.
- Issuance of receipt for lesser amounts than amount actually received.
- Using teeming and lading method; it is a very common method to misappropriate the money, in which the cash received from any customer not recorded in the books and the cash received from same customer at a later instance or another customer recorded in the books and so on.

Repayment of Loan by Others

Repayment of loan by others may be verified in the following ways –

- Calculation of interest received and interest should be credited to interest received account.
- Verification from bank statement if directly deposited by party into bank.
- Checking of carbon copies or counterfoils of cash receipts.
- To ensure that there should be no violation of Income Tax rules as payment of loan exceeding Rs. 20,000/- cannot be repaid in cash. It should be through Cheques, Demand Draft, NEFT, RTGS or any other available banking channels.

Rent Received

- To check rental agreement or lease deed.
- In case where the rental income is received from more than one property, separate account for each property should be maintained.
- The Auditor should verify that the rent for all the twelve months is received or not.
- The amount of rent should be verified from the rent deed or the lease deed.
- If TDS (Tax Deducted at Source) is deducted by the party, there should be proper accounting of TDS.

**Sale of Investments**
- To check bank statement if the sales proceeds have reached the bank account.
- To verify broker commission, note or debit note, if investments are sold through broker.
- To ensure separate accounting is being done for capital receipts and revenue receipts.
  Dividend or profit or loss on sale of investment is a revenue receipt and the sales proceeds of the investment cost should be booked as capital receipt.

**Subscription**
Subscriptions are received from the members of a club and the following points need to be considered by the Auditor while vouching subscription –
- Subscription register should be verified.
- Verification of subscription received during the year and the subscription receivable.
- Counterfoil of cash receipt should be verified.

**Sale of Fixed Assets**
- To check minutes of the meetings of the Board of Directors.
- Sale agreement or sale contract.
- Verification of agent account if sale is made through an agent.
- Profit or Loss on sale of fixed assets should be booked to revenue account.
- Authorization of sale of fixed assets.
- Sale proceed of fixed assets should be credited to fixed assets account after deducting expenses on sale of fixed assets if any.

**Interest and Dividend Received**
- Verification of the dividend warrant letter along with the covering letter for verification of dividends in case of dividends received through cheque.
- Verification of bank statement, if the dividend is directly credited to the bank account.
- Interest on security can be vouched from the securities schedule.
- Interest on fixed deposit can be verified from bank statement and TDS certificates.
Interest received from outsiders to whom company has granted loan could be verified from statement of account of party along with TDS certificates.

Provision should be made for interest accrued but not due.

All interest received and accrued should be properly accounted for in the books of accounts.

**Commission Received**

- Verification of agreement on the basis of which the commission is received.
- Calculation of the commission receivable.
- The commission received should be verified from counterfoils, bank statements, cash receipts, etc. and the provision for commission receivable should be rightly accounted for in the books of accounts.
- Commission receivable on “sale of goods sent on consignment” should be verified from sale account.

**Installments Received on Hire-Purchase Sale**

- Study of the Hire-Purchase agreement for hire-purchase-sale price, number of installment, rate of interest etc.
- Segregation of principle amount and interest amount should be done and both should separately account for.
- Profit on sale on hire-purchase should be duly calculated on the basis of installment received during the year.

**Vouching of Cash Payments (Credit Side of Cash Book)**

All the payment made to creditors, expenses incurred in cash and all other payments done appear on the credit side of cash book and the Auditor is required to vouch cash payments because chances of cash misappropriation are very high.

Following points need to be considered for different types of cash payment –

**Opening Balance**

The opening balance of cash book can never be credited because cash of company cannot be in negative but the credit bank balance represents the overdraft account from bank or utilization of cash credit limit as sanctioned from bank.

**Payment to Creditors**

Payment to creditors may be examined by the following –
• Receipt issued by the creditors.

• If the creditor is paid amount as full and final settlement, the balance amount, if any stands in the ledger account of the creditor; this amount should be credited to discount received.

• If any advance payment is made to creditor that should be clearly mention.

• Statement of account of creditor.

Payment of Salaries

Depending upon the adequacy of internal control system in an organization Auditor will decide his audit Program. It is very important for Auditor to check the following –

• Attendance record of employee and salary register.

• Appointment letter of new employees.

• Comparison of current month salary with last month’s salary and if there is any abnormal change in amount, Auditor should verify the same.

• Alteration in amount of deductions on account of advance, loan, fine, funds, insurance, TDS, etc.

Payment of Wages

At the time of vouching of wages paid, the Auditor should verify the following points to avoid misappropriation of cash –

• Adequacy of Internal Control System.

• Payment of wages at higher rate than allowed.

• Payment shown to ex-workers in the current month.

• Lower or non-deduction of advance or other deductions due.

• Payment to fictitious workers.

• Payment to workers who were absent from duty.

• Wages sheet should compare with wages register.

• Comparison of current month wages with last month’s wages and proper verification should be there for extra ordinary changes.

• Detailed verification for payment to casual workers.

• Vouching and verification of treatment accounting treatment for unpaid wages.
Purchase of Plant and Machinery
The Auditor should pay attention to the following –

- Purchase invoice of machinery.
- Freight inward charges, installation charges, erection and commissioning charges should be capitalized.
- Treatment of Excise duty according to the excise rules.

Purchase of Land & Building
Purchase of Land and Building can be vouched as follows –

- Study of Lease hold agreement, if land is purchased on lease hold basis.
- Payment should be as per lease term.
- All the expenses incurred to acquire lease hold property should be debited to respective property account.
- Auditor should study the conveyance deeds in case property is purchased under free hold basis.
- For verification of payment, the Auditor can check the payment receipt and the conveyance deed.

Rent Paid
Consider the following points for the verification of rent by the auditor –

- Rent Deed.
- Rent receipt from Land lord.
- Provision for un-paid rent at the end of the year.

Insurance Premium
Consider the following points for the verification of Insurance Premium –

- Insurance policy issued by the Insurance Company.
- Insurance premium receipt
- Insurance premium should not be related to any official of the company.

Income Tax
Consider the following for the verification of Income –

- Advance Tax Challan
- Self-Assessment Tax challan
• Income Tax demand notice
• Assessment order

**Excise Duty**
Consider the following for the verification of Excise Duty –

• Rate of Excise Duty
• Excise records and sale invoice for verification of excise duty

**Commission on Sale**
Consider the following for the verification of Commission on Sale –

• Agreement of sale.
• Rate of commission on sale.
• Calculation of commission on the basis of sale.
• Cash receipt issued by agent.
• Provision for commission payable

**Director’s Fees**
Consider the following for the verification of Director’s Fees –

• Directors receive fees for attending the Board meetings.
• Verification of attendance register.
• Verification of payment receipt duly acknowledged by the directors.

**Internal Control System for Cash Transactions**
Following are the main features of a good internal control system –

• All cash received should be accounted for immediately.
• All received cheques should be crossed immediately on receipt.
• Cash receipt should be issued to debtors and daily reconciliation of account should be done where the debtors pay cash on daily basis.
• All cash receipts should be deposited in bank on a daily basis.
• Bank reconciliation account should be prepared on a regular basis.
• Payments other than petty payments should be done through crossed cheques.
• Cash receipt should be obtained for every cash payment to creditors.
• Cash expenses should be duly supported by proper and genuine bills or vouchers.
Auditing - Vouching of Ledger

We will start by discussing the types of ledger accounts and proceed to their verification and also the verification of other accounts.

Personal Ledger Accounts

All personal accounts are opened under this category. In big organizations where the number of transactions is quite high, a personal ledger may further be split up into two more ledgers –

- Purchase ledger
- Sales ledger

**Purchase ledger**

Purchase ledger is verified from the following –

- Creditor balances of last year
- Cash Book and Bank Book
- Purchase register
- Purchase return book
- Bills payable book
- Journal and other relevant books

An Auditor should carefully verify the following –

- Posting of all vouchers in ledger account should be done without any omission.
- Verification of all opening balances should be properly checked with last year’s balance sheet.
- If the creditor balance shows debit balance it may be due to advance payment made to him, the Auditor should confirm whether the material against advance is received or not.
- Periodical statements of creditor should be reconciled.
- Examination of internal control system.

**Sales ledger**

Sales ledger will be verified from the following –

- Debtors’ balances of last year
- Cash book and bank book
• Sales register
• Sales return book
• Bills Receivable book
• Journal and other relevant books

Auditor should carefully verify the following –

• Posting of all vouchers in ledger account from cash and bank book, sales register, bills receivable register, sales return register and journal should be verified.

• Verification of opening balances, castings, balances carried forward should be carefully examined.

• Credit balance of the debtors’ account may represent the advance received against the supply of goods; the Auditor should examine and confirm whether any material is supplied against it or not.

• Periodical reconciliation of account from debtors should be done without any fail.

• Provision for doubtful debts and bad debts should be done.

• Review and examination of credit policy should be made from time to time.

• Checking of posting in ledger account from subsidiary book.

• Checking of calculations.

• Reviewing truthfulness of debtor balances in customer account.

• Reviewing of Internal Control System.

Impersonal Ledger Accounts

All the nominal account, real account and capital account fall under impersonal ledger accounts. Income and expenditure account (nominal accounts) transferred to profit and loss account.

Capital account, real accounts, debtors and creditors account are transferred to balance sheet. Following steps are involved in the audit of impersonal ledger account –

• Opening balances should be verified from last year’s Balance Sheet.

• Timely posting of balances of subsidiary books (Sales Book, Purchase Book, Sales Return Book, Purchase Return Book) to ledger accounts.

• Checking of totals and castings.
• Checking of balances transferred to trial balances, debit and credit side of trial balance should be tallied.
• Checking of adequacy of internal control system in organization.

Outstanding Assets
It is necessary to include some expenses and income in current year though passing adjustment entries to show the correct profit or loss of the company. Therefore it is must for an Auditor to check each and every outstanding entries. Following are outstanding assets –

Prepaid Expenses
These expenses are paid in advance for next coming year(s), hence should not be debited to profit and loss account of current year to arrive at true financial results.

For example; Insurance of Fixed assets is normally paid on annual basis and if we paid insurance premium in the month of October for one year, then insurance for this current year will be calculated from October to March and from April to September it will be treated as prepaid insurance. Prepaid insurance will be shown as prepaid expenses under the head of current assets in the balance sheet.

Auditor should vouch every nominal account to confirm whether correct amount of expenses is debited to profit and loss account or not. Other examples of prepaid expenses are –

• Rent Rates and Taxes
• Subscription
• Annual maintenance Contract, etc

Income Receivable
Following are the examples of Income Receivable –

• Interest accrued but not due or received
• Taxation claims
• Commission
• Declared dividend by company yet to receive

All the above income should be included in the Profit & Loss account of the year to arrive at a correct figure.

Deferred Revenue Expenditure
The examples of deferred revenue expenditure have been described below –

**Preliminary Expenditure**

Preliminary expenditure is incurred at the time of incorporation of a new company. These expenses are of heavy amount and are incurred mainly for promotional reasons. Nature of these expenses are capital but not actually represent any asset, hence should be written off from profit and loss account over a period of 3 to 10 years in equal installments.

**Advertising and Sales Promotion**

These expenses are incurred at the time of establishing new business or at the time of introduction of any new product in the market. These expenses are shown as assets in Balance sheet and should be written off in profit and Loss account over a numbers of accounting periods.

**Heavy Repairs**

Expenses of heavy repairs of fixed assets shall not be debited to profit and loss account of year in which these expenses incurred but it should be spread to number of years like other deferred revenue expenses. Heavy amount of expenses is incurred on repair of Plant & Machinery due to increased production capacity of the plant or to maintain current production capacity of machine which is very old and need some heavy overhauling or repairing to increase it life.

Other examples of deferred revenue expenses are –

- Discount allowed on debentures
- Experimental expenditure
- Research & development expenses
- Development expenses on mines

**Outstanding Liabilities**

There are some expenses and liabilities that come up in due course of business; these are due for payment but not paid till the end of accounting period in question. The Auditor should see all those expenses and liabilities and all these expenses should be included in profit and loss of the current year to arrive at the true profit or loss of the firm.

Following are the main examples of outstanding expenses and liabilities –
Audit Fees
Audit fees are debited to profit and loss account of the same year for which audit is conducted. No doubt main audit work start after the close of financial year and finalization of financial statements are done in next financial year but it is a widely accepted practice to do so. It is also argued that audit fee should be debited to the profit and loss account in the next year in which the audit work is actually performed. In the first case, audit fees will be debited and the audit fees payable will be credited.

Purchases
In case where the purchased goods are received in the current financial year and invoices for the same are received in next year, purchase should be debited and outstanding liabilities should be credited.

Rent
Rent on factory premises, office building, godown, etc. is payable on monthly basis. The Auditor should confirm that any unpaid amount of rent for the last month of the financial year or any other month of financial year in question should be added to rent of the current year and the rent payable should be shown as current liabilities.

Commission on Sale
Commission on sale is payable to agent, director or salesmen on the basis of sales. Auditor should check the following –

- Sale agreement
- Rate of commission
- Calculation of commission
- Agent account to know advance payment to agent, commission due and commission payable.
- Applicability of TDS on it and to check whether TDS is deducted at due rate before making payment or not. Whether TDS is deposited in time or not.
- After adjusting all the above, if there is any amount that is payable to the agent, it will be shown in current liabilities as commission payable and if any excess amount is paid that will be shown as current asset representing the amount recoverable from the agent.

Interest
The Auditor should carefully examine the interest on loan from bank, loan from outsider parties, unsecured loan, financial institutions, term loan and interest on
debentures. He should see that the provision for interest payable should be duly provided in the books of accounts according to the applicable rate of interest.

**Salary and wages**

Salary and wages for the last month of the accounting year is normally paid in the next financial year. The Auditor should confirm that the salary and wages for last month should be debited to salary and wages account and credited to salary & wages payable account.

**Cartage and Freight**

Transporters normally provide bills for transportation charges after closing of financial year. It is a duty of an Auditor to take these expenses in the current financial year creating liabilities for the same.

**Contingent Liabilities**

Contingent liability may be payable in future or may not be payable in future it depends on the event. For example, if any person filed a suit against company, possibilities are there, it may be in favor of company or it may be against the company, in case it will decide against the company, company has to pay such amount of suit as the court decides. Therefore, contingent liabilities are said to be possible liabilities.

In case of above, no actual provision is made in the books of account but as a footnote of Balance sheet, it is compulsory to show the probable amount of liabilities.

**Contingent Assets**

Contingent assets are not shown as footnote of the balance sheet. Following are the examples of Contingent Assets –

- Claim for the refund of the Income Tax, Sales Tax, Excise Duty, etc.
- Uncalled share capital of the company.
- Claim for infringement of a copy right.

**Auditing - Audit Verification**

Verification means the inspection of assets appearing in financial statements, whether the assets are according to legislation or not. Verification of assets and liabilities are done to confirm the following –

- Existence
- Ownership
- Proper valuation
- Possession
- Freedom from encumbrances
- Proper recording

**Objectives of Verification**

Following are the objectives of Verification –

- Confirmation about the existence of assets through physical verification.
- Legal and official documents relating to assets are checked to confirm the ownership of assets.
- It is confirmed that assets are free from any charge of lien.
- Proof regarding proper valuation of assets.
- To confirm that assets are properly accounted for in the books of accounts.

**Vouching and Verification**

Both are considered to be same thing but there are lots of difference between vouching and verification.

Vouching relates to confirmation of the correctness and authenticity of accounting entries as appeared in the books of accounts whereas verification confirms the existence, ownership and valuation of assets as appears in the balance sheet. The Auditor’s duty is not only vouching the entries appearing in the books because vouching cannot prove the existence of the related asset or liabilities at the balance sheet date.

**Verification of Liabilities**

Following are the objectives of verification of liabilities –

- Creditors reflect a true position as to liabilities of the business.
- All liabilities are disclosed in the balance sheet whether recorded in the books or not.
- Value of liabilities is according to the generally accepted accounting principles.
- Liabilities are properly classified and disclosed in the balance sheet.

**Confirmation and Verification**

Let us now understand what confirmation and verification is.
**Confirmation**

Auditor requires confirmation from third party and management about any fact or figure. Few of the examples in which the Auditor requires confirmations are as follows –

- Confirmation from debtors about balances.
- Confirmation from creditors about balances.
- Confirmation from banks about bank balances, fixed deposits, interest accrued, overdraft or cash credit limit balance, etc.
- Confirmation from financial institutions about loan and interests.
- Confirmation from management about contingent liabilities, etc.

**Verification**

Verification means inspection of assets by the Auditor and it includes identification, weighing and counting of assets. Following items require physical verification –

- Land and Building
- Plant and Machinery
- Stock-in-hand
- Stores and consumables
- Investments
- Securities
- Cash-in-hand
- Bills receivable

Thus, confirmation and verification are altogether different processes of audit and both are equally important too.

**Valuation of Assets and Liabilities**

Valuation means estimation of various assets and liabilities. It is the duty of Auditor to confirm that assets and liabilities are appearing in the balance sheet exhibiting their proper and correct value. In the absence of proper valuation of assets and liabilities, they will exhibit either overvalued or under-valued.

It is therefore required for an Auditor to exercise reasonable care and skill to analyze the basis of valuation from technical experts and satisfy himself that assets shown in Balance-sheet are properly valued accordance with the generally accepted conventions and accounting principles.
Components of Valuation

Methods of valuation of assets are as hereunder −

- **Cost Price** – This is the cost price paid at the time of acquisition of assets plus the freight charges, octroi charges, and commissioning and installation charges, etc. to bring that asset in usable condition.

- **Book Value** – This is the value as appearing in the books of accounts; the cost price less depreciation.

- **Realizable Value** – A Value which can be realized from the sale of assets.

- **Market Value** – A value which the asset can fetch at the time of sale.

- **Replacement Value** – A value on which an asset can be replaced.

- **Conventional Value** – It means the cost price less depreciation written off ignoring any kind of fluctuation in the price.

- **Scrap Value** – If the asset is not in working condition and sold as scrap, then the sale value of asset is scrap value.

Basis of Valuation

Auditor should ensure that the basis of valuation is correct and reliable. He should keep in mind the process of valuation which is as follows −

- Original cost
- Expected working hours of the assets
- Wear and tear expenses
- Scrap value
- Chances of asset become obsolete

Fixed asset is valued at cost price less depreciation and current assets should be valued at cost or market price whichever is less.

Vouching, Verification and Valuation

In vouching, accounting entries are checked with the bona-fide vouchers.

- Verification proves the **existence**, **ownership** and **title** of assets.

- Valuation certifies the **correct value of asset**.

- Vouching is done after **original entry** in the books of accounts.

- Verification and valuation are done at the **end of the financial year**.
• Vouching is done by Senior Auditor and Audit Clerk.
• Verification and valuation are done by the Auditor himself.
• Bonafide vouchers are sufficient evidence for vouching
• For Valuation Auditor has to depend upon certification from owner/partner/director.
• Verification is done by physical verification, title deeds and receipt of payment, etc.

Verification and Valuation of Copyright
We will now discuss the verification and valuation of Copyright –

Copyright
Copyright provides legal protection and legal rights to an author by which the publication of his work by another is prohibited. Copyright remains with the author for lifetime and even 50 years after his death.

Verification of Copyright
• The Auditor should examine the agreement between the author and the publisher.
• If there are numbers of copyright with the same publisher. Auditor should ask for the schedule of copyrights.

Valuation of Copyright
Copyrights lose their value over a passage of time; hence the value of copyright is not stable. In case where the sale of publication is very low or nil, value of copyright should be written off.

Value of copyright in the Balance-sheet will be shown as cost less the value written off.

Verification and Valuation of Fixed Assets
We will discuss the verification and the valuation of different fixed assets –

Verification of Freehold Land and Building
• Auditor should examine the title deed of the land and building.
• Land and building shown in the books should be according to the title deed.
• Profit or loss on sale of it should be duly adjusted in the account.
• Any addition to it should be carefully examined by the Auditor.

Verification of Mortgage Property
• The Auditor should confirm that there should be no second or third mortgage on it.
The Auditor should obtain certificate from mortgagee that title deed is in his possession.

The Auditor cannot be held responsible if there is any defect of title. The Auditor can only verify that title deed apparently in order and in the name of client.

If Auditor feels necessary he can obtain certificate from legal advisor about the validity of title deed of the client.

**Valuation of Building**

- Building should always be valued at cost less depreciation.
- Although the market value of building may be much higher than the cost, still depreciation on building should be provided.
- Depreciation will be provided even if building is not in use.
- Market or releasable value should not be taken into account because both are fluctuating.

**Verification of Freehold Land**

- Freehold land is a non-depreciable asset, hence it will be shown at cost.
- Cost includes legal charges, registration fees, purchase price and broker commission, etc.
- Payment made to improvement trust or Municipal Corporation for water, sewerage, road, development charges, etc. it will also be included in the cost of the freehold land.
- If the basis of valuation of it is market value or realizable value, it should be clearly mentioned in the balance sheet.

**Verification of Building under Construction**

- Auditor should verify the architect certificate and contractor receipt for the amount paid.
- Auditor should obtain a certificate from a responsible officer to that effect, if the staff of client is also engaged in its construction.

**Verification of Leasehold Property**

There should be separate accounting for freehold and leasehold property. Leasehold property is acquired for fix duration on lease. The Auditor should consider the following –

- Inspection of lease agreement for value and duration.
- Lease agreement should be registered with the registrar.
- Terms and condition of the lease should be properly complied for.
The Auditor should examine the last receipt of rent to ensure the lease agreement is in continuation without any break due to nonpayment of rent.

Verification and Valuation of Current Assets

We will now discuss the verification and valuation of a few important current assets, cash and bank balance and sundry debtors.

**Cash-in-hand**

Cash-in-hand is verified by actual counting of cash. Cash-in-hand should be verified at the close of the business or on the date of the balance sheet. Counting of cash must be done in the presence of cashier. If physically verification of cash is not feasible for an Auditor due to branch located abroad or in remote area, the Auditor should ask the cashier to deposit all his Cash-in-hand in bank account on the last date.

It is the primary duty of an Auditor to verify the cash-in-hand and in case of non verification, the Auditor will be held responsible for breach of his duty. If there is heavy cash balance in hand at any time, the Auditor should immediately inform the management beforehand.

If the cashier is made accountable for payment to employees or others, the Auditor should carefully verify the same.

**Cash at Bank**

The Auditor needs to consider the following points for verification of cash at bank –

- The Auditor should prepare a bank reconciliation of account as on date. With the help of it, the Auditor will clearly come to know the status about the cheque issued but not yet presented in the bank and cheques deposited in the bank but not yet cleared. There are many kinds of frauds which are detectable through preparation of bank reconciliation of account.

- The Auditor should obtain different certificates from banks for different types of accounts like current account, fixed deposit account, savings account, overdraft account or cash credit account, etc.

- The Auditor should obtain a letter of confirmation of bank balances directly from banks.

- The Auditor should compare the bank balance as per the bank book and the pass book.

- If payments are deposited in foreign banks under exchange control regulation it should be verified by the Auditor.
Sundry Debtors

The Auditor is concerned with obtaining sufficient audit evidence to corroborate the management’s assertion regarding the following –

- All amounts are recorded in respect of outstanding debtors as at date of Balance sheet.
- Valuation of debtors is appropriate and properly applied.
- That all the debtors are disclosed, classified and described in accordance with recognize accounting policies and practices.

The verification process of the debtors involves the following –

**Examination of Records**

- Auditor should satisfy himself about the validity, accuracy and recoverability of debtors’ balance.
- Excessive discount allowed or bad debts written off should be verified.

**Direct Confirmation Procedure**

- Direct communication with debtors is the best way to ascertain whether the balances are accurate, genuine and undisputed.
- Debtors from whom confirmation of balances is required, the method of requesting confirmation is to be determined by the Auditor.
- Confirmation procedure may be carried out within a reasonable period from the end of the year.
- Replies received from debtors should be carefully gone through and in case, where balances do not agree, client should be asked to investigate.
- The Auditor must pay special attention to those balances for which confirmation is not received. They might be fictitious or made to conceal a fraud.

**Steps for Verification**

- Book debts can be verified by the books of accounts and those should be supported by sale documents.
- Book balances should be sent to debtors directly for confirmation. It will establish the existence of book debts.
- Ownership of book debts can be verified with the sales documents and the sales ledger.
- Debtors should enquire about any type of dispute with customers about discount, claim etc.
Steps for Valuation

- Debtor’s ledger should be supported by sales ledger.
- Auditor should obtain list of book debts, bad debts written off and for provision for doubtful debts.
- Sundry debtors should be valued at realizable value.
- Confirmation of balances shows that valuation of debtors is correct.

Verification and Valuation of Fictitious Assets

We will now discuss the verification and valuation of the following fictitious assets –

Preliminary Expenses

Preliminary expenses are incurred at the time of formation and commencement of company. These expenses are of capital nature and include stamp duties, registration fees, cost of printing, legal costs, etc. These expenses are shown in the balance sheet. These expenses are written off during a span of time of 3 to 10 years. The Auditor should verify that un-written amount is shown in the balance sheet.

Discount on Issue of Shares/Debentures

The Auditor should see that the discount on issue of shares/debenture should be written off as early as possible and the balance amount should be shown in the balance sheet.

Verification and Valuation of Liabilities

Let us now understand the verification and valuation of liabilities –

Trade Creditors

Auditor should take the following important steps for the verification and valuation of Trade Creditors –

- Auditor should collect schedule of creditors and that should tally with ledger balances.
- Purchase ledger should be checked and verified with purchase register, purchase invoices and debit notes etc.
- Auditor should verify the discount received or receivable from creditors.
- Auditor should minutely check the purchase of first month and last month of the financial year to avoid any possibility of booking purchases of current year to next year or last year purchase to current financial year.
Auditor should pay special attention on any unpaid amount stands in ledger of creditor since long. It might be possible that amount has misappropriated by the any official and balance stands as it is in books of accounts.

Confirmation of balances should be done directly by the Auditor and if there is any kind of discrepancy that might be sorted out.

Auditor should carefully study the hire purchase agreement to verify the purchases made on the basis of Hire-Purchase.

**Loans**

The Auditor should verify the following important points for verification and valuation of Loans –

- The Auditor should verify the amount of loan, type of loan, rate of interest and repayment terms, etc.
- He should collect and examine the agreement and certificate from bank in case loan is granted by any Bank or financial institutions.
- He should obtain balance confirmation from party from whom loan is accepted by the organization other than bank.
- Interest calculation should be duly checked by the Auditor according to agreement.
- Amount of interest due but not paid during the current financial year should be duly accounted for in books of accounts and should be shown as current liabilities.
- In case of company, the Auditor examines the borrowing power, register of charges and created charge should be registered with the Registrar of Companies.

**Capital**

Capital of a partnership firm can be verified through partnership deed, Bank book, cash book, etc. Capital of a company can be verified through following:

**First Audit**

- In case of first audit, Memorandum of Association and Article of Association should be examined to know the maximum authorized capital.
- To verify the classes, number of shares issued, amount due on calls, amount received and pending amount of calls, the Auditor should examine the minute book, cash book and bank book.
- Examining of vendor agreement if shares are allotted to vendors.
Subsequent Audit

The Auditor should consider the following points for subsequent audits –

- Any addition in capital by fresh issue should be according to Sections 61, 64 and 66 of the Companies Act-1956.
- Authorized capital to be shown separately in the balance sheet.
- Issued and subscribed capital should be shown separately according to each class of shares.
- Shares allotted of each class as bonus shares along with source of issue.
- Amount of unpaid calls from Directors and others.
- Capital account should be shown as Equity Capital, if only one class of share is issued.
- Ascertain the amount called up in respect of each class of shares.
- The number of shares being allotted without payment being received in pursuance to contract.
- Date of redemption should be clearly shown with the earliest date of redemption, where company has issued redeemable preference shares.
- If any amount received earlier against forfeited shares that should be shown separately after adding it to share capital.
- Capital profit on issue of forfeited shares should be transferred to capital reserve account.

Depreciation, Reserves and Provision

In this chapter, we will discuss auditing related to Depreciation, Reserves and Provision. We will proceed by discussing Depreciation and move on to discussing Reserves and Provision further.

What is Depreciation?

Value of depreciation reduces the value of assets on residual basis and also the current year profits.

Depreciation indicates the reduction in value of any fixed assets. Reduction in value of assets depends on the life of assets. Life of assets depends upon the usage of assets.

There are many deciding factors which ascertain the life of assets; in case of a building, the deciding factor is time, the deciding factor for leased assets is the
lease period, the deciding factor for plant and machinery is both production and time. There may be many factors but ascertainment of life should be based on some reasonable basis.

**Reason of Depreciation**

Following are the main causes of depreciation –

**Wear and Tear**

One of the main reasons of depreciation is normal wear & tears, it depends upon the usage of machinery. More the machinery is in use, more will be the wear and tear. Wear and tear of a machine in use for one shift will be less than with a machine being used in two shifts.

**Exhaustion**

Some assets may lose their value due to consumption, for example, mines, quarries, oil walls and forest stands. Due to continuous extraction a stage will come where all above are completely exhausted.

**Obsolescence**

New technology or invention may bring down the value of old asset and outdated technology become cheaper. For example, television became obsolete with the introduction of new LED Television, the users are discarded old televisions although they are in good condition.

**Effusion of Time**

Value of assets may reduce over a passage of time. For example, a patent becomes useless after expiry of the period of patent.

**Other Causes**

- Assets also lose their value due to weather conditions.
- Market value of assets may fall down drastically.
- Accidents also lead to a decrease in the value of assets.

**Need for Depreciation**

- To ascertain the true profit of the year, it is desirable to charge depreciation.
- To ascertain true value of assets, depreciation should be charged and without correct value of assets, true financial position of the company cannot be ascertained.
• Instead of withdrawal of overstated profit, it is desirable to make provisions to buy new asset and replace the old asset. Accumulated value of depreciation provides additional working capital.

• Depreciation help us to ascertain uniform profit in each accounting year.

• Depreciation is also useful to gain advantage of tax benefits.

**Basis of Depreciation**

The important factors related to the depreciation chargeable are as follows:

• Cost of Asset or Value of Asset
• Estimated life of an asset
• Scrap value of asset
• Addition and extension in asset along with date
• Provision of Companies Act and Income Tax Act for providing depreciation
• Working hours of an asset
• Working conditions of organization and handling skill of operator
• Major repairing that increases the life of an asset
• Chances of obsolescence of an asset

**Depreciation Methods**

Following are the methods of depreciation:

• Straight line method
• Written down value method
• Annuity method
• Insurance policy method
• Machine hour rate method
• Depletion method
• Revaluation method
• Depreciation fund method
• Mileage method
• Production unit method
• Global method
• Accelerated Method
• Double-declining Method
- Year's digit method

Depreciation may be charged by applying any of the above methods. We will discuss a few important methods –

**Straight Line Method**

Under this method, fixed amount of depreciation is charged every year. The formula to determine the amount of depreciation is as follows:

\[
\text{Depreciation} = \frac{\text{Cost of Asset} - \text{Scrap Value}}{\text{Estimated Life of an Asset}}
\]

**Written Down Value Method**

It is also called the Diminishing Balance or the Reducing Balance Method. Under this method, a fixed percentage of depreciation is charged on written down value of asset. Written down value of asset means (Cost of asset – depreciation).

**Auditor’s Duty Regarding Depreciation**

The Auditor cannot be held responsible for estimating the working life of an asset; it is the job of an expert valuer.

- A company can adopt different methods for different type of assets provided that the methods are adopted consistently over the years.

- If a company opts to choose new depreciation methods, then depreciation should be recalculated applying new methods from the date on which the asset is put to use for the first time. The difference of amount of depreciation as charged with old rate and the amount calculated from new rate should be debited to profit and loss account in case of loss and difference should be credited to general reserve in case of profit.

- According to Schedule II of the Companies Act, if asset is sold or discarded during the year, depreciation will be charged on pro-rata basis up to date of sale or discard. Similarly, depreciation will be charged on pro-rata basis, in case of addition to fixed asset.

- Account must disclose method of depreciation.

- Depreciation must be according to provisions of Companies Act and Income Tax Act.

- If depreciation is charged more than prescribed rate, Auditor should examine whether it is based on some professional and technical advice.

- Depreciation should be charged on revalued amount, if there is revaluation of assets.

**What is Provision?**
Provisions means “any amount written off or retained by way of providing depreciation, or diminution in the value of assets or for providing any known liability of which the amount cannot be determined with substantial accuracy.”

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Debiting Profit and Loss account, provisions are created and shown either by deduction on the assets side or on the liabilities side under relevant subheads in the balance sheet.

Provision for bad and doubtful debts, provisions for repair & renewals, provision for discounts and depreciation are the most common examples of provision.

**What are Reserves?**

Reserve is an appropriation of profit and on the other hand, provision is a charge against profit. Reserves are not meant to meet out contingencies or liabilities of business. Reserve increases working capital of a company to strengthen the financial position. There are two types of reserves –

**Capital Reserve**

Capital reserve is not readily available for distribution as dividends among the shareholders of the company and it is created only out of capital profit of the company; this works like premium on issue of shares or debentures and Profit prior to incorporation.

**Revenue Reserve**

Revenue reserves are readily available for distribution of profit as dividend to the shareholders of the company. Some of the examples of revenue reserves are - general reserve, staff welfare fund, dividend equalization reserve, debenture redemption reserve, contingency reserve, and investment fluctuation reserves.

**Auditor’s Duty Regarding Capital Reserves**

Auditor should examine the following –

- Capital reserve can be created out of capital gains only.
- If the Article of the company permitted, capital reserve can be utilized for the distribution of dividends.
- Capital reserve should be shown separately from revenue reserve and general reserve in the balance sheet.
Secret Reserves
Banking companies, insurance companies and electricity companies create secret reserves, where public confidence is required. In this case, to create secret reserve assets are shown at lower cost or liabilities at higher value; following examples will help you understand how this is done –

- By undervaluing goodwill or stock.
- By excessive depreciation.
- By creating excessive provisions.
- Showing free reserves as creditors.
- By charging capital expenditure to profit and loss account.

Auditor’s Duty Regarding Secret Reserves
Duties of Auditors regarding secret reserves are as follows

- Creation of secret reserve is not permitted by the Companies Act.
- Only Banking Company, Insurance Company and Electricity companies are allowed to create secret reserve.
- In some cases where the creation of secret reserves is allowed under the Companies Act, the Auditor should examine the necessity of creating such a reserve. If the Auditor is satisfied he need not to qualify his report.

General and specific Reserves
Specific reserves are created and utilized for the purpose only for which they are created like dividend equalization reserve and debenture redemption reserve.

General reserves are created for any future contingency or to utilize at the time of expansion of business. The purpose behind the creation of general reserve is to strengthen the financial position of the company and to increase the working capital.

Auditor’s Duty Regarding General Reserves
There is no liability on the Auditor’s part to report on the creation, adequacy or inadequacy of such reserve. He may advice to the management towards the long term interests of the company.

Auditor’s Duty Regarding Specific Reserves
The Auditor should examine that specific reserve should not be available for distribution as this reserve is meant to meet out specific liabilities only.
Sinking Fund

Sinking funds are of great help when it comes to repayment of liabilities or replacement of fixed assets, for this some amount is charged or appropriated from profit and loss account every year and invested in any outside securities. Without any extra ordinary burden, replacement of asset may be done in a systematic manner or pay any known liability on maturity of sinking fund.

Auditor’s Duty Regarding Sinking Fund

Following are the duties of an Auditor regarding sinking fund –

- Sinking fund should be shown separately in the Balance-sheet.
- Purpose of fund should be clearly indicated.
- It should be according to Article of Association and the Trust Deed meant for this purpose.

Investment of Reserves

It is a controversial issue, whether reserve should be invested in outside securities or not. Thus, to decide anything, it is important to study the needs and the requirements of a firm according to financial position of a firm. Therefore, investment in outside securities is justified only in case where company have extra fund to invest.

Nature of Reserve

In spite of showing reserves on the liabilities side of a balance sheet, reserves are actually not at all any liabilities of a firm. Reserves represent accumulated profits which are available to be disbursed among shareholders –

Distinction between Provisions and Reserves

- Reserves can be made only out of profit and provisions are a charge to profit.
- Reserves reduced divisible profits and provisions reduce the profit.
- Reserves, if remain unutilized for some period can be distributed as dividends but provisions cannot be transferred to General Reserve for distribution.
- Purpose of provision is very specific but reserve is created to meet out any probable future liabilities or losses.
- Creation of provisions is legally necessary but reserves are created to save a concern from future losses and liabilities.

Auditing - Capital and Revenue
In this chapter, we will discuss the Auditing of Capital and Revenue.

It is essential to distinguish revenue expenses and capital expenditure to prepare correct financial statements. The absence of these will lead to misleading results where no one can conclude anything. As per this principle, revenue item should be posted in Trading and Profit & Loss account and capital item should be posted in the balance sheet of any firm.

There is no firm rule for making distinction between capital expenditure and revenue expenses. Expenses may be of capital nature and capital expenditure may be of revenue nature. Allocation can be done only after knowing all the facts & figures. However, we have the following rules that act as guiding principles for making a distinction between capital expenditure and revenue expenses –

**Capital Expenditure**

Consider the following points to decide the nature of capital expenditure –

- The expenditure, the benefit of which cannot be consumed or utilized in the same accounting period should be treated as capital expenditure.
- Expenditure incurred to acquire fixed assets for the company.
- Expenditure incurred to acquire fixed assets, erection and installation charges, transportation of assets charges, travelling expenses directly relates to purchase fixed assets are covered in capital expenditure.
- Capital addition to any fixed assets which increases the life or efficiency of those assets; for example, additional expenses made on a building.

**Revenue Expenditure**

The benefit of which is consumed in the same accounting year in which those are incurred comes under the category of revenue expenditure. Following are a few examples of revenue expenditure –

- Purchases
- Wages
- Freight inward & outward
- Salary and wages
- Selling and distribution expenditure
- Depreciation
• Assets purchased for resale purpose
• Repairs and renewal expenditure which are necessary to keep fixed assets in running and efficient conditions
• Accidental losses like loss on account of fire, etc
• Interest on borrowings
• Royalty paid
• Annual lease rent
• Loss on sale of fixed assets

How to Allocate Revenue or Capital?

An item can be classified and allocated as revenue or capital on the basis of principles discussed above. Allocation requires proper care and attention otherwise there will be misleading financial results. Complete situation and facts are important before any allocation. Treating revenue expense as capital expenditure will increase profit and treating capital expenditure as revenue expense will reduce the profit.

Treatment for same nature of expenses can be different at two different point of time; for example, inward freight, insurance, wages and brokerage are of revenue nature in ordinary course of business but the same are treated as capital expenditure when they are incurred to purchase or development of any assets.

Following points can be considered to decide the nature of expenses –

• Whether expenses are incurred to purchase or development of an asset.
• Is it for an addition or improvement to fixed asset?
• Whether it increases the revenue earning capacity.
• Whether expenditure is towards raising of the capital sum.

If answer is in the affirmative, then expenditure is of capital nature otherwise of revenue nature.

Revenue Expenses Which are Treated as Capital Expenditure

Let us now discuss in brief the revenue expenses which are treated as capital expenditure.
Following is a list of expenses which come under revenue expenditure but should be treated as capital expenditure –

- **Raw material and consumables** – If these are used in making any fixed assets.
- **Cartage and freight** – If these are incurred to bring in fixed assets.
- **Repairs & renewals** – If incurred to enhance life or efficiency of the assets.
- **Preliminary expenditure** – This is the expenditure incurred during the formation of a business.
- **Interest on capital** – If paid for construction work before the commencement of production or business.
- **Development Expenditure** – In some businesses, long-term development and heavy amount of investment is required before starting production especially in Tea and Rubber plantation; such expenditure should be treated as capital expenditure.
- **Wages** – If paid to build up assets or for erection and installation of Plant and Machinery.

### Deferred Revenue Expenditure

Some non-recurring and special nature of expenditure for which heavy amount is incurred and the benefits for the same spreads to upcoming years, such expenditure is to be treated as capital expenditure and will show as assets of the firm. Part of the expenditure should be debited to Profit & Loss account every year. For example, if heavy amount is paid for the advertisement of a product, the benefit of which are expected four years down the line, then it should be debited as 1/4 of the part in Profit & Loss account as revenue expenses and balance 3/4 will be shown as assets in Balance Sheet.

### Auditor’s Duty regarding Deferred Revenue Expenditure

Let us now understand an Auditor’s duty regarding deferred revenue expenditure. The duties are listed below –

- The Auditor should investigate the whole transaction in totality to understand the treatment of the transaction.
- The Auditor should check the complete details of transaction, like total expenditure incurred initially, year wise amount written off and the amount carried forward to next year.
- Carried forward amount should be shown in Balance Sheet.
The Auditor should ensure that the amount of exceptional loss should not be mixed with the deferred revenue expenditure.

**Capital and Revenue Profit**

Premium received on issue of shares and profit on sale of fixed assets is main example of capital profit and should not be treated as revenue profit. Capital profit should be transferred to capital reserve account which is used to set off capital losses in future if any.

**Capital and Revenue Receipts**

Sale of fixed assets, capital employed or invested and loans are example of capital receipts. On the other hand, sale of stock, commission received and interest on investment received are examples of revenue receipts. Revenue receipts will be credited to profit and loss account and on the other hand capital receipts will affect the Balance-sheet.

**Auditor’s Duty regarding Capital and Revenue Receipts**

- Knowledge about the nature of business is very important for an Auditor to decide the nature of transaction; for example, purchase of motor vehicle is a revenue expenditure for a motor vehicle dealer whereas, it is a capital expenditure for any other businessman.
- The Auditor should study and verify the complete transaction by obtaining relevant data and documents relating to transaction.
- He may discuss any doubtful or controversial point with concerned official of a company before reaching to any conclusion.
- The Auditor should observe the classification of transactions according to correct accounting principles.

**Capital and Revenue Losses**

Discount on issue of shares and losses on sale of fixed assets are capital loss and only would be set off against capital profits only. Revenue losses on normal business activity are part of profit and loss account.

**Auditing - Audit of Hospitals**

**Maintenance of Accounts of Hospitals**

Being non-profit organizations, hospitals prepare Receipt & Payment account, Income & Expenditure account and Balance Sheet; following are various items that fall under income and expenditure in the hospitals.
Main Items of Income

- Room Rent
- Medical Care
- Dentistry Charges
- Delivery Room Charges
- Anesthesia Charges
- Laboratory Charges
- Grants for Operating Needs of Hospital
- Grants for Fixed Assets
- Donations
- Miscellaneous Income
- Interest on Investments
- Fees from Nursing Training School
- Bed Charges
- Operating Room Charges
- X-ray Charges
- Pharmacy Charges
- Physiotherapy Charges

Types of Expenses/ Payments

- Electricity & Water Charges
- Pharmacy Charges
- Salaries and Wages
- Pharmacy Expenses
- Building Repair & Maintenance
- Laundry Charges
- Rent for Nursing Hostel Accommodation (In case of rented premises)
- Telephone Expenses
- Laboratory Expenses
- Surgery Expenses
- Operation Tools and Equipment Expenses
- Depreciation
Preliminary Audit of Hospitals

An Auditor should follow the below mentioned procedure while conducting Audit of a hospital –

- He should obtain a list of books, documents, register and other records as maintained by the Hospitals.
- He should examine the audit report of last year and should note down qualifications, if any.
- He should examine the system of receiving grants and donations, whether received through cheque or otherwise.
- According to the overall objectives of audit, he should examine the scope of responsibilities.
- He should note down the important clause of Trust Deed or Charter, which may affect the audit and accounts of hospitals.
- He should examine the Minutes of Meetings of the Board of Directors/Trustees or the Managing Committee. He should note down the important decisions concerning the financial transactions relating to fixed assets, investment and financial powers as required by him during his audit.
- He should examine the internal control system regarding purchase of fixed assets, medicines, stores, consumables, clothing and provisions, etc.
- He should examine the internal control system for recording of purchases, issue and storage of all items and physical verification of them.
- He should obtain the rate structure for fees, medicine and other services, power to do concession or waiver of fees. There should be adequate system for charges and waiver.
- He should calculate and examine the input-output ratios.

Audit of Expenses of Hospitals

Vouching of expenses in hospitals is almost the same as in other organizations; however, the following points need to be considered by an Auditor are given below –

- An Auditor should adopt the usual way to vouch purchases and other expenses of the hospitals.
- Clear distinction should be made between capital and revenue expenses.
- Salary of staff should be vouched according to general auditing principles.
Audit of Assets and Liabilities of Hospitals

The Auditor should consider the following points and carefully examine the assets and liabilities of the Hospitals –

- Title documents and other records relating to land and building should be carefully examined by the Auditor.
- Resolution of Trustees/Managing committee should be verified for sale and purchase of fixed assets.
- Depreciation should be charged on the basis of the policies of the Managing Committee.
- Liabilities should be verified in the usual manner.
- An Auditor should physically verify the investments like shares, debentures, bonds and security certificates. He should also verify them with the investment register.
- Stock and stores of medicines, clothing, consumables, etc. should be physically verified at the end of the year.

Audit of Income of Hospitals

An Auditor should consider the following points and carefully examine the income/receipts of the hospitals –

- An Auditor should check the bill book, bill register and copy of bills.
- It should be verified that bills are prepared properly according to visit charges of doctors, medicine, stay charges, room rent, etc.
- Bills should be verified with the fees/charges structure.
- Concession and waiver on account of fees and other charges should be verified.
- Bills should be verified with cash receipt book, counterfoil of receipts and cash book.
- Verification of arrears of bills should be done.
- Unrecoverable arrears should be written off with the approval and consent of proper authority.
- Rental income should be properly verified. He should properly vouch property register, arrear of rent, advance rent and provisions for the same.
- Interest and dividend income should be verified with investment register, cash book and share warrants, etc.
- Documents and correspondence relating to donations and grants should be verified; the list of donors, grant sanction letter should be obtained to verify the same.
• Unutilized grant should be verified at the end of the year. In case of non-fulfillment of conditions, grant will be taken back by the authority.

• Distinction between revenue and capital donation should be checked and verified. In case donation is for some specific purpose, the Auditor should assure that the money is used for the same purpose only.

Auditing - Audit of Educational Institutions

In this chapter, we will discuss the Audit of Educational Institutions.

Maintenance of Accounts of Educational Institutions

A large number of educational institutions are registered under the India Society Registration Act, 1860. The purpose behind the formation of educational institutions is to spread education and not just earn profits. The following table lists out the sources for collection of amount and also the different types of expenses incurred by the educational institutions

Main Source of Collection

• Admission fees, tuition fees, examination fees, fines, etc.
• Securities from students.
• Donations from public
• Grants from Government for building, prizes, maintenance, etc.

Types of Expenses / Payments

• Salary, allowances and provident fund contribution for teaching and non-teaching staff.
• Examination expenses
• Stationery & printing expenses
• Distribution of scholarships and stipends
• Purchase and repair of furniture & fixture
• Prizes
• Expenses on sports and games
• Festival and function expenses
• Library books
• Newspaper and magazines
• Medical expenses
Audit fees and audit expenses
Electricity expenses
Telephone expenses
Laboratory running & maintenance
Laboratory equipment
Building Repair & maintenance

Preliminary Audit of Educational Institutions

Following points need to be considered by an Auditor while conducting audit of educational institutions –

- It is to be confirmed whether the letter of his appointment (the Auditor’s) is in order.
- The Auditor should obtain a list of books, documents, register and other records as maintained by the educational institutions.
- He should examine the audit report of last year and should note down the observation and qualification, if any.
- He should note down the important provisions regarding to accounts and audit from the Trust Deed, Charter of Regulations.
- He should examine the Minutes of Meetings of the Board of Trustee or the Governing Body for important decisions regarding the sale or purchase of fixed assets, investments or delegation of finance power.
- In case of colleges and university, the Grants Commission provides Grants to them subject to certain conditions. The Auditor should study all the conditions concerning grants.
- The Auditor should examine the Code of State regarding grant-in-aid.
- He should be aware of all the provisions and rules of related laws concerning books of account and audit.

Internal Control System

The Auditor should independently check the internal control system regarding authorization procedures, record maintenance, safeguarding of assets, rotation and division of staff duty, etc. Following are some of the important aspects that need to be considered by an Auditor to keep a check on the internal control system –

- Whether internal control and internal check system is working, if yes, how effectively.
• Is there any system to physically verify the fixed assets, stores and consumables at regular interval.

• An Auditor should verify the control system concerning proper authorization, obtaining quotations, proper maintenance of accounts and record regarding purchase of fixed assets, purchase of material, investment, etc.

• Whether bank reconciliation statement is prepared at regular intervals and what kind of action is taken for uncleared cheque which were pending since long.

• Whether waiver of fees is properly sanctioned by appropriate authorities.

• The person who is collecting fees and the cashier should not be the same person.

• Class wise fees receivable and the actual fees received reconcile or not.

• Whether collected fees is deposited in bank on a daily basis.

• Fees collection register should be maintained on a daily basis.

• Whether approved list of supplier of sports material, stationery, lab items are readily available.

• Whether control system for payment is adequate or not.

• The system of letting out conference hall and class rooms, etc. for seminars and conventions.

• Whether fees structure is properly authorized along with change in fee structure if any.

Audit of Assets and Liabilities

The following points need to be considered while conducting an audit of Assets and Liabilities –

• Verification of Assets register should be done considering grants on purchase of assets, if any received from State Government/ University Grant Commission (UGC).

• Verification of depreciation is very important; it should be according to useful life of assets or as per the Companies Act, whichever is applicable.

• If educational institution is running under Indian Public Trust Act, it is must for an Auditor to check, where investments have been made, because as per the Indian Public Trust Act, investment can be made in specific securities only.

• If donation is received in the form of investment, an Auditor has to check all related correspondence with the donor.
All the applicable requirements of law should be fulfilled for the purchase of investments and fixed assets.

An Auditor should read and note down the state code and provisions relating to the conditions and procedures of Grants. He should also verify the requirements of State/UGC which are to be fulfilled by educational institutions for receiving Grants and also for continuations of Grants.

Audit of Income of Educational Institutions

The following points need to be considered by an Auditor while conducting audit of the Income of Educational Institutions –

- Fees and charges received on account of admission fees, tuition fees, sports fees, examination fees etc. should be verified based on the approved fees structure.
- Verification of counterfoil copies of fees receipt with fees received register should be done.
- Prescribed conditions by the State Government and the University Grants Commission should be verified whether fulfilled or not.
- Cash book should be verified with counterfoil of receipt book and fees register.
- Fees receivable and actual fees received should be reconciled.
- Charges and fees received and receivable should be examined on account of hostel accommodation, mess, housekeeping and clothing, etc.
- Cash book should be verified with the donation received register.
- Donation received should be accounted for according to the nature of donation means careful distinction should be there for revenue nature donation and capital nature donations; the same procedure is to be followed for Grants received.
- The purpose and utilization of grant should be same.
- Investment register and cash book should be verified for income received on account of interest on investment and dividends, etc.

Audit of Expenses of Educational Institutions

The following points need to be considered by an Auditor while conducting audit of Expenses of Educational Institutions –

- Electricity expenses, telephone expenses, water charges, stationery and printing, purchase of sports items should be properly verified with quotation, purchase bills, inward register and Bills received from service providers, etc. All purchases should be authorized by appropriate person.
• In case where hostels purchase food items, provisions, clothing, etc. should be properly verified.

• Verification of Tax Deducted at Source, Employee State Insurance and Provident Fund should be checked. It is also very important that all deducted amount should be deposited in appropriate Government accounts well within time without any default. These can be verified from relevant bank challans.

• Payment made on account of salary should be verified from terms of appointment and increment policy. Auditor should verify the computation of salary and check whether all required deductions are made out of it or not like advance salary, loan installment, absence from duty, ESI (Employee State Insurance), PF (Provident Fund), etc. The Net Salary Payable amount will be verified from cash book and bank pass book for salary paid.

• Terms and conditions, cash book, voucher and receipts should be the basis for the verification of scholarship paid.

• Appropriate provision should be made on account of outstanding payments.

Auditing - Audit of Charitable Institutions

The following points need to be considered by an Auditor while conducting audit of Charitable Institutions –

• He should know about the constitution and the legal status of Charitable Institutions.

• An Auditor should study the Rules and Regulations of the State Government, Central Government and other applicable law to such institutions.

• He should obtain a list of accounts, correspondence and all related documents which are required for the purpose of audit.

• To know the detail which may affect important decisions of institutions, Auditor should study the Minutes Book of Governing Body.

• Auditor should obtain list of members to verify the amount of subscriptions and list of regular donors to know the nature and purpose of donation of regular donors.

• Auditor should vouch the amount of subscription and donations from counterfoils of receipts, members list, donation register and cash book, etc.

• He should ensure that the funds received for a specific purpose are being utilized for the same purpose or not.
• He should verify nature of donation and accounting treatment of such donations. Capital and revenue donations should be treated separately.

• He should study the state code to verify whether any grant is applicable to the concerned institutions or not.

• He should verify the provisions for subscription due but not received. Subscription receivable for last year whether received or not in the current year should also be verified.

• Investments should be verified according to the rules of Institutions, whether investments are in approved fund.

• Investments should be checked in the Investment register along with physical verification.

• Income on investments in form of interest and dividends, etc. should be vouched carefully.

• Title deed and other related documents of Land & Building should be verified.

• Legacies can be verified with receipts book and legacies register.

• An Auditor should verify assets and liabilities on institutions on the date of Balance-sheet.

• He should verify the cash in hand and the cash at bank.

• All the related expenses should be vouched carefully according to general auditing practices and principles.

Auditing - Audit of Clubs & Theatre

In this chapter, we will discuss the Audit of Clubs and Theatre.

Audit of Clubs

The following points need to be considered while conducting Audits of Clubs –

• An Auditor should decide his scope of work from his appointment letter.

• He should know whether he is engaged for only accounting and financial matter or some other assignment too.

• He should know about the constitution and the legal status of the Club under which Act the club is registered.

• A Club may be registered under the Companies Act, the Societies Registration Act or the Public Trust Act.
• An Auditor should note down all the related provisions of the applicable Act relating to the accounts and audit.

• He should study the Memorandum of Association and the Articles of Association to know the powers of executive committee.

• An Auditor should be aware of the important decisions relating to accounts, finance, sale and purchase of fixed assets and investment from the minute book of meeting of the Board of Directors or the Trustees or the Managing Committee.

• He should obtain a list of books of accounts, related documents and other records maintained by that club.

**Internal Control System**

An Auditor should review the internal control system of Club to conclude on the effectiveness of it and to decide the area and scope of his work.

• He should study the letting out system of the club premises, equipment and other facilities.

• The Auditor should know the bills raising system.

• He should study the rate and the basis of guest house charges, temporary membership charges, eatables, sports equipment.

• If Auditors find that the internal control system is adequate in club, he may opt for test checking, otherwise he might have to go for detailed vouching.

**Audit of Income and Expenditure of Club**

In addition to the general procedure of auditing, an Auditor should consider the following points while conducting Audit of Income and Expenditure of Club –

• The donation received by club will be verified with the counterfoils of receipt, donation register and cash book.

• To verify whether it is a capital donation or a revenue donation, an Auditor should know the policy of the Managing Committee.

• To know the policy regarding membership fees of the new members, an Auditor should check the policy of club, whether membership fees will be treated as revenue receipt or capital receipt.

• Membership fees should be vouched with counter foil of receipts, membership register and cash book.
• Annual subscription of members should be vouched from counterfoil of receipt and cash book.

• On the basis of the members register, annual subscription dues received in advance and arrears of subscription should be reconciled.

• Verification of rent received and outstanding rent may be verified with the rental agreement, receipt book and cash book. An Auditor should ensure that the provision for rent outstanding has been provided in books of accounts.

• Income received on account of interest and dividend on investment should be verified with cash book, investment register and documents.

• Bills raised for sports, canteen, health club and restaurant should be verified and he should check the payment against these bills are duly accounted for in cash book and ledger accounts.

• Capital expenditure should be verified from minutes of meeting of managing committee.

• Auditor should verify in due course of audit purchases on account of eatables, sports equipment, health club equipment, general provisions, stationery and printing expenses, etc.

• Staff salary and annual increment to staff should be verified from appointment letters, attendance register, salary register, time records, etc.

• Physical verification is recommended for food items, wines, crockery, sports equipment etc. on the basis of stock register.

Audit of Cinemas and Theatre

Following are the sources of income for cinemas and theatres. We will also understand how the income is to be verified by the Auditor.

• Sale of tickets
• Parking
• Canteen Sale
• Advertisements
• Rental income

An Auditor should verify the income from various sources in the following manner –

• He should verify the rules regarding rates for different class of tickets, free passes, benefit shows, concessional tickets for booking of groups of student of schools and colleges etc.
• An Auditor should ensure that each ticket should be serially numbered.

• Daily collection should be deposited in bank.

• An Auditor should verify the daily return for sale of tickets for different class and different shows from counterfoils of sold tickets.

• He should verify the amount of Entertainment Tax collected on account of sale of tickets.

• Auditor should ensure that Entertainment Tax collected on sale of tickets should be deposited with Government within due time without any fail.

• Auditor should verify the rate of parking for each class of vehicle.

• Auditor should verify the cash collection on account of parking from issued slips.

• Auditor should ensure that the parking slip should be different for each class of vehicles.

• If parking and canteen are allotted to contractor, an Auditor should examine the contract between client and contractors.

• The payment received from contractor should be verified from the receipt book and the cash book.

• The payment received on account of advertisement should be examined and verified with cash book and receipt book.

• The premises of cinema or theatre may at times be let out on rent. An Auditor should verify the rent received from rental agreement, cash book and receipt book.

Audit of Expenses of Cinemas and Theatre

An Auditor should consider the following points while conducting audit of the expenses of cinemas and theatre –

• An Auditor should verify film hire charges from the terms and conditions of agreement.

• Accounting for the film purchased and the film hired should be done accordingly.

• Film purchased but not shown should be accounted for properly.

• Operating expenses should be thoroughly vouched.

• Outstanding liabilities should be duly provided in the books of accounts.

• Adequate depreciation should be provided on furniture & fixtures of cinemas and theatre. Rate of depreciation should be more than normal depreciation provided in other business.

• Stock of various items should be verified.
• Payment of revenue expenses like electricity, salary and wages, stationery and printing, and purchase of various items should be vouched with available supporting of vouchers.

• Revenue and capital expenditure should be treated accordingly.

• All the books like cash book, petty cash book and ledger accounts should be properly examined.

**Internal Control System**

An Auditor should examine the internal check and the internal control system of business operations, concerning the cash received, payments made and unsold tickets. He should ensure that the unsold tickets are kept under proper control and in good security conditions. Sold tickets should be duly signed by the authorized officer of the business.

**Auditing - Audit of Sole Proprietary Concern**

There is no obligation for a sole proprietor under any law to get the accounts except in case where the turnover of a proprietary business in any financial year exceeds One Hundred Lacs Rupees and gross receipt from profession exceeds Twenty-five Lacs Rupees. In both the cases, the audit of accounts is compulsory for a proprietor under Income Tax Act, 1961.

In spite of no obligation, so many sole traders who have vast and varied expenditure prefer to get their books of accounts audited by a chartered accountant. In such case Auditor do the work of accountant as well as Auditor depending on terms of agreement. Audit of accounts is very much essential in such case where the owner of the business is sitting in a remote area and he does not have any direct control over transactions of his business.

The Auditor should get clear instructions from the client regarding the scope of his Audit Program before starting his work. It is the primary duty of an Auditor to see that all the necessary books of accounts are maintained by the client and also those books of accounts should be appropriate and accurate showing true picture of his business. Following are the main advantages of audit of sole proprietary business —

• Chances of frauds and misappropriation are minimized as accounts staff become more efficient because they know that work is to be checked by an Auditor.

• Early and easy assessment are done by the Income Tax department as the department considers the audited books of accounts as more reliable than nonaudited.
The Proprietor of business is more confident and relaxed when it comes to financial issues and he is able to contribute his time for other business activities.

The Proprietor can take the benefit of expert advice of a Charted Accountant on financial matters to utilize his working capital in an efficient way.

He can help in borrowing money from banks or financial institutions.

Audited accounts can be used as evidence in court or in front of any Government official as and when required.

Auditing - Audit of Partnership Firms
Although no compulsory audit is provided by the Indian Partnership Act, 1932 but in practice most of the partnership firm get their accounts audited. As per the Income Tax Act, 1961, Tax Audit of partnership firm is mandatory if the turnover/gross receipt exceeds Rupees One Crore in case of business and Rupees twenty five laces in case of profession. It is highly recommended that every partnership firm should go for audit of his accounts.

The following points need to considered by an Auditor while conducting audit of a partnership firm –

- Agreement between Auditor and firm is very important because the rights and duties of an Auditor depend on it.

- He should be equally fair to each partner of the firm, even if his appointment may be due to efforts of single partner only.

- An Auditor might at times be required to do bookkeeping work also, thus his scope of work should be clearly defined in writing to avoid any future dispute.

- A written report should be submitted by Auditor at the end.

- An Auditor should carefully read the partnership deed and note down all the important provisions regarding;
  - Nature of business
  - Profit sharing Ratio
  - Interest on capital and drawings
  - Loans and drawings
  - Borrowing power of partner
  - Salary and remuneration
Capital of the partner

- Restriction on the rights of a partner

- Basis of valuation of goodwill at the time of admission, retirement and death of any partner

Important Provisions of Indian Partnership Act, 1932

An Auditor should consider the following important provision of the Indian Partnership Act, 1932 when the deed is silent in a partnership firm –

- Partners are entitled to share profit and loss of the firm equally.
- Partner is not entitled to any remuneration.
- Partner is only entitled to get interest @ 6% on amount advanced by him in addition to his share of capital.
- Goodwill is to be included in assets at the time of dissolution of a firm.
- After dissolution losses and deficiencies are to paid first from profit, next out of capital and at last if necessary by contribution of each partner in profit sharing ratio.
- Every partner has implied authority to bind the firm for acts done in usual course of business.
- No partner has any implied authority to submit a dispute relating to business to arbitration, to open bank account on his personal name on behalf of firm, to compromise of claim which the firm may have against third party, withdraw a suit on behalf of firm, to acquire an immovable property and enter into partnership on behalf of a partnership firm.

Auditing - Audit of Doctors

The following points need to be considered by an Auditor while conducting an Audit of Doctors –

- The auditor should first list out books of accounts, register, document, etc. as maintained by the doctor.
- He should note down the fees charged by the Doctor to attend patient at his clinic, visit charges, operation charges of each kind of operation done at his own operation theater or at any other hospital.
- He should study system of recording of all transactions and control over staff.
- He should vouch cash receipt on account of patient attended, visit charges, operation charges, drugs charges from bills; cash receipt counterfoils, patient register and cash book.
- He should verify the stock of drug store on account of medicines, surgery and other instruments.
- He should vouch the expenses of Ambulance from the log book.
- An Auditor should assure that proper accounting should be done for revenue and capital expenditures.
- Provision of depreciation should be adequate.
- Staff salary should be vouched carefully with cash book, bank book, attendance register and salary register.
- Purchases of drugs, equipment, housekeeping items, stationery and printing should be vouched carefully.

**Audit of Electricity Supply Company**

The following points need to be considered by an Auditor while conducting Audit of Electricity Supply Company –

- He should carefully study the internal control system related to billing, payment collection, collection of debts and payments of wages, electricity charges, etc.
- He should be well versed with the Provisions of Electricity (Supply) Act, 1948 and the Indian Electricity Act, 1910.
- He should verify the bills issued to consumers.
- He should verify tabular ledger of consumers with original records.
- He should verify the receipt of cash from cash receipt counterfoils, cash book, bank book.
- He should examine the total number of bills generated, payment received and pending for payments.
- He should verify whether late deposit bills are paid inclusive of late payment charges or not.
- Auditor should verify whether proper accounting is done for arrear of bills.
- Payment received on account of arrears should be properly accounted for.
- Proper accounting should be done according to the revenue and capital expenditure.
• Auditor should vouch payment for repair of sub-power stations, transformers and meters; all these repairs should be treated as revenue expenses.

• All allowances and rebates should be properly sanctioned by the appropriate authority.

• All accounting forms should be according to the requirements of the Act.

• Depreciation should be properly verified according to applicable provisions of the Act.

**Auditing - Audit of Shipping Company**

The following points need to be considered while conducting audit of Shipping Company –

• As per appointment letter Auditor should know the scope of his audit work along with legal requirements to prepare his audit Program accordingly.

• An Auditor should study the Articles of Association.

• He should also study the contracts between Captains of ship and third parties.

• An Auditor should thoroughly study the internal control system and should prepare his audit Program accordingly.

• He should ensure that separate account has to be maintained for each voyage.

• He should verify that all revenue expenses are to be charged to Voyage account and all incomes should be credited to Voyage account.

• Separate ledger account for each voyage should be maintained.

• Transactions relating to foreign exchange must be duly incorporated in the books of accounts.

• An Auditor should ask for advices from agents and receiving officers to vouch freight charges paid. He should also verify the provisions relating to outstanding freight amount.

• Proper depreciation should be charged for each ship.

• Auditor should verify the rates of freight, commission and brokerage etc.

• Proper allocation of insurance premium of each voyage is very much important. Balance amount of unexpired insurance should be carried forward. The claim received on account of insurance should also be properly accounted for.

• Proper adjustment and accounting is must for outstanding liabilities and assets.
• He should ensure that the capital expenditure should not be charged to revenue account and vice versa.

• Heavy amount of repair and expenditure should be treated as deferred revenue expenditure.

• He should verify the title deed of ships and other related documents on account of purchase of ships.

Auditing - Audit of Co-Operative Societies

Any ten persons who are competent to enter into contract may make an application to the Registrar of Co-operative Societies as per section 6 of the Co-operative Societies Act, 1912. By-laws may be framed by each society and should be registered with Co-operative Societies. Effectiveness of change in by-laws of societies is applicable only when changes are approved by Registrar of Societies. There are two types of society’s, limited liabilities and un-limited liabilities societies. Any member is not liable to pay more than the nominal value of share held by them and no member can own more than 20% of shares of societies.

Government is encouraging co-operative societies to help society. Co-operative societies are operative in various sections like consumer, industrial, service, marketing, etc.

Under accounting system of Co-operative societies, the terms receipt and payment are used for two-fold aspect of double entry system.

Members are elected at the annual general meeting of the society. Day-to-day work of cooperative society is managed by the managing committee.

Audit of Co-operative Society

Let us now discuss the provisions for Audit as Per Section 17 of the Co-operative Society Act, 1912 –

• The Registrar shall audit or cause to be audited by some person authorized by him by general or special order in writing on his behalf, the accounts of every registered society once at least every year.

• The Audit under sub-section (1) shall include an examination of overdue debts, if any, and a valuation of the assets and liabilities of the society.

• The Registrar, the Collector or any person authorized by general or special order in writing on his behalf by the Registrar, shall at all-time have access to all the books, accounts, papers and securities of a society, and every officer of the society shall furnish
such information concerning the transactions and working of the society as the person making such inspection may require.

**Qualification of Auditor**

- A chartered accountant within the meaning of the Chartered Accountant Act-1949, Or,
- A person who holds a government diploma in Co-operative Accounts or in Cooperation and Accountancy; or,
- A person who has served as an Auditor in the co-operative society department of the State Government and whose name has been included by the Registrar on the Panel of Certified Auditors maintained and published by him in the official Gazette at least once every year.

**Appointment of Auditor**

The appointment of an Auditor is done by Registrar of Co-operative Societies. The Auditor conducts his audit on behalf of the Registrar. The Audit fees is paid by co-operative society according to the statutory scale of fees prescribed by the Registrar in this regard according to the category of society. The Auditor is required to submit his audit report directly to the Registrar and one copy of the audit report is submitted to the concerned society.

**Rights of an Auditor**

- As per Section 17, an Auditor can access all the books, accounts, documents and securities of the society.
- He has to see that Balance-sheet of the society shows a true and fair view of a business according to information and explanation given to him.
- Every officer of the society is bound to give all information regarding working and transactions of the society.

**Duties of An Auditor**

An Auditor needs to consider the following points to be able to perform his duties in an efficient way –

- An Auditor should be well-versed with the Co-operative Society Act, 1912 and the by-laws of the society.
- If there is any type of irregularities and improprieties found by an Auditor during his audit regarding Co-operative Societies Act, 1912 and by-laws, he should immediately point out the same.
An Auditor should ascertain that how many shares are held by each member of the society; for this, he should check the membership registers.

An Auditor should be well aware of power of officers regarding loan, investment, borrowings, advancing of the funds.

He should thoroughly check and vouch the cash book and bank book.

An Auditor should check all the receipts and payments of the society according to standard auditing practice.

He should go through the agreements between society and borrower to check the interest due on loan and repayment schedule. An Auditor should also check and compare the actual interest received and the repayment of loan received with dues from them.

He should carefully vouch and verify that loan given to members of the society is according to agreement, regulation and resolution passed by the Managing Committee of the society or not.

An Auditor has to assure that a loan given to a non-member is not without the permission of the Registrar.

He should verify the loan given by Co-operative bank should be according to the prescribed limit.

An Auditor should physically examine and verify the assets of a society.

He should adopt different methods for different kind of societies.

Balance-sheet, profit and loss account and Auditor report should be according to the proforma given by the Chief Auditor of the Co-operative Society of the State.

Accounts should be according to the Co-operative Society Act and also with the provision of Income Tax Act.

All the assets, expenses, income, cash-in-hand, etc. should be vouched and verified according to standard accounting procedures and principles.

Books, Accounts and Other Records of the Society

Under Section 43(h) of the Co-operative Society Act, 1912, the Government of a state can frame rules prescribing the books of accounts to be kept by a Co-operative society. Following books and accounts are prescribed by the Maharashtra Government.

- Cash Book
- General Ledger
• Stock register
• Personal Ledger
• Register of Members
• Register of Shares and debentures
• Minutes books of general body meeting and committee meetings
• Property Register
• Register recording loan applications
• Maintenance of register of audit objections and their rectifications

Special Features of Co-Operative Audit

The checking of posting, arithmetical accuracy, vouching, verification of assets and liabilities and scrutiny of balance sheet are same as Auditor do in any other case.

We will now discuss a few important aspects related to the Audit of Co-operative societies.

Examination of Overdue Debts

An Auditor has to examine and classify overdue debts

• from six months to five years and,
• overdue above five years in two categories and shall have to report it in his audit report.

Overdue Interest

While calculating the profit of Co-operative society overdue amount of interest outstanding should be excluded.

Valuation of Assets and Liabilities

General principles of accounting and auditing conventions and standard are adopted at the time of valuation of assets and liabilities. No specific provisions or instructions under the Act and Rules are provided.

Adherence to Co-operative principles

An Auditor should ascertain how far the objectives, for which the Co-operative society is set up, have been achieved in course of its working. It is not necessarily in terms of profit, but in terms of extending of benefits to members who have formed the Society.

Certification of Bad-debts

As per Rule No.49 of the Maharashtra State Co-operative Rules, 1961, it is very interesting to note that no bad debts can be written off unless they are certified as
bad debts by the Auditor. Where no such requirement of law exists, the managing committee of the society must authorize the write-off.

**Observation of the Provisions of the Act and Rules**
An Auditor should be well versed with the Provisions of the Act and Rules of the Cooperative Society and the by-laws thereof. If the Auditor finds any irregularity, it should be immediately assessed and reported to the next level.

**Verification of Members Register and Examination of their Pass Books**
This is essential especially in rural and agricultural credit society where members are illiterate, the Auditor should verify the pass book and members register to verify the amount of loan granted and their repayments. It will help to ensure that the books of accounts are free from any manipulation.

**Special Report to the Registrar**
During audit if any irregularities are found by the Auditor that should be reported to the Registrar and an appropriate action may be taken by the Registrar against the society.

**Audit Classification of Society**
After assessing the overall performance, an Auditor has to award a class to the society. Judgement of Auditor should be based on the criteria fixed by the Registrar. The Auditor should be very careful when making decisions related to the classes in the society; if management is not satisfied by the award he may file an appeal to the Registrar and the Registrar may direct to review the audit classification.

**Discussion on Audit Draft**
After completion of audit, minor irregularities may be settled and rectified; matters concerning policies should be discussed in detail. The audit report can never be finalized without discussing with the managing committee.

**By-laws**
Each registered society is required to frame its own by-laws which have to be registered with the Registrar of Co-operative societies. According to Section 11 of the Act, the amendment of the by-laws of a registered society shall not be valid until the same has been approved by the Registrar of the Co-operative societies.

**Investment of Funds**
A registered society can invest or deposit its funds only in –

- Saving bank account of Government Banks.
Restriction on Co-operative Society

Let us now understand the restrictions that are imposed on co-operative society.

Restriction on Shareholding

According to Section 5 of the Act, where liabilities of the members of a society is limited, no member other than a registered society can hold more than 20% of the shares capital or shares of the society worth more than Rupees one thousand.

Restriction on Transfer of Share

A member of registered society with unlimited liability, cannot transfer any shares held by him or his interest in the capital of the society unless –

- He has held that share for at least one year, and
- The transfer and change is made to the society or to a member of the society.

Restriction on Loan

- According to Section 29 of the Act, a registered society cannot advance any loan to any person other than a member except with the prior permission of the Registrar.
- A society with unlimited liability cannot lend money on the security of a movable property except with the sanction of the Registrar of Co-operative society.
- The State Government has the power and can prohibit or restrict loans against mortgage of immovable property by any registered society or class of registered societies.

Restriction on Borrowings

A registered society can receive deposits and loans from persons who are not members of the society, only such an extent and under such condition as may be prescribed by the rules of the Co-operative Societies Act or by-laws of the concerned society.

Exemptions

According to Section 28 Central Government may exempt any registered societies or class of registered societies from Income Tax (Payable on the profits of the society...
or on dividends or other profit related to payments received by the members of the society). Stamp duty or registration fees.

**Reserve Fund, Contribution to Charitable Funds and Distribution of Profit**

- According to Section 33, the first 25% of the net profit earned during the year should be transferred to a Reserve Fund.
- 10% of Balance amount of net profit after transferring 25% to Reserve fund, a registered society can contribute for charitable purpose with the sanction of Registrar.
- Under such conditions as may be prescribed by the rules or by-laws, the balance amount of current profit plus past years profit can be distributed to members of the society.
- Dividend can be distributed according to rules and by-laws but cannot be more than 6.25%.

Only after special order of the State Government, unlimited liability society can distribute his profit otherwise not.

**Auditing - Audit of Hotels**

In this chapter, we will discuss the Audit of Hotels.

There are many types of facilities that are provided by the hotels to their customers these days. Hotels generate their income from room rent, room service, laundry, restaurants, swimming pool, bar-room, sports room, health clubs, conference halls and banquet hall for marriages, parties and seminars. In addition to these, few hotels are also letting out shops to companies to promote and sell their products and services.

**Audit of Hotels**

An Auditor should consider the following points while conducting Audit of Hotels –

**Detail of Applicable Law**

For audit of hotels, it is very crucial and important for an Auditor to go through the following laws normally applicable to the hotel industry –

<table>
<thead>
<tr>
<th>List of Applicable Law</th>
<th>Subject</th>
<th>Levy On</th>
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<tbody>
<tr>
<td>Luxury Tax Act</td>
<td>State Act</td>
<td>Room Rent for luxury provided</td>
</tr>
<tr>
<td>Act</td>
<td>Act</td>
<td>On</td>
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<td>----------------------------------------------------------------------</td>
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<td>-------------------------------------------------------------------</td>
</tr>
<tr>
<td>Service Tax</td>
<td>Central Act</td>
<td>Restaurants, Dry-cleaning service, Banquet revenue and room rent</td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>Note</strong> – Service Tax on room rent and restaurant are charged on some specific conditions.</td>
</tr>
<tr>
<td>State Excise Act</td>
<td>State Act</td>
<td>On liquor and regulated sale/service of liquor.</td>
</tr>
<tr>
<td>Central Excise Act</td>
<td>Central Act</td>
<td>On pastries and cakes.</td>
</tr>
<tr>
<td>Value Added Tax (VAT)</td>
<td>State Act</td>
<td>On food and other goods.</td>
</tr>
<tr>
<td>Standards of Weight and Measures Act, 1976</td>
<td>Central Act</td>
<td>To establish standards of weight and measures.</td>
</tr>
<tr>
<td>Contract Labour (Regulation and Abolition) Act</td>
<td>Central Act</td>
<td>On employing contract labor.</td>
</tr>
<tr>
<td>Shops and Establishment Act and the Catering Establishments Act</td>
<td>State Act</td>
<td>To regulate the working of hotels.</td>
</tr>
</tbody>
</table>

The Companies Act, 2013 may also be applicable to hotels in case if the status of hotel is like a company. Whereas, the Income Tax Act, 1961 will be levied in all the cases irrespective of whatever the status of that hotel is.

- An Auditor should determine the scope of his audit from his letter of appointment. It should be seen whether he is asked to express his opinion on financial statements only or some additional responsibility being assigned to him.

- An Auditor should obtain list of books of accounts, documents and registers maintained by hotel.

- He should see whether relevant hotels have independent status or a part of chains of hotels.
• An Auditor should study the Memorandum of Articles and the Memorandum of Association.

• He should obtain the title deed and other related documents to verify the land and building.

• He should also obtain Minutes of meeting of the Board of Directors to note down the important decisions relating to accounts, finance and audit.

Point of Sale (POS)

In order to conduct audit of a hotel, an Auditor should study, verify and vouch books of accounts, keeping in mind the different points of sale.

Points of Sale

Let us now understand the different points of sale.

Revenue from Room Rent

An Auditor has to carefully examine the following points regarding revenue from room rent –

• One of the main revenue generation points in hotel industry is room rent. The billing is done through accounting software (most of the hotels are using PMS software which is very popular in hotel industries).

• Room rent is charged on the basis of fixed tariff according to the category of room.

• Discounts may be offered to customers; this depends on various factors like season, holidays and other things. Special discount is also offered to groups of students, delegates, corporate customers, VIP customers, etc.

• Complementary rooms are provided by hotels for some special guests and hotel staff.

• An Auditor has to get the structure of discount and he should also ensure that the discount offered is within permissible limit or not. Authorization from appropriate authority should be done on discounts.

• An Auditor should verify the Luxury Tax on the room rent charged. In some states, the Luxury Tax is charged on actual room revenue received from the customers and in some states it is chargeable on the published rack rate.

• In most of the states, Luxury Tax is chargeable on complementary rooms also.

• Exemption on Luxury Tax is provided in case where complementary rooms are provided to the hotel staff.

• An Auditor has to verify that all collected Luxury Tax is deposited with state within time.
He should verify the retention charges which are collected from customers due to either cancellation of a reservation or due to non-arrival upon reservation.

An Auditor should verify applicable law of Luxury Tax regarding retention charges; in a few states, Luxury Tax is applicable on retention charges also.

**Revenue from Food & Beverages (Restaurants)**

The following points need to be considered by an Auditor to examine the revenue coming from Food and Beverages in Restaurants –

- There are two types of sale at restaurants; one is to the resident customer and the second is to walk-in customers.
- An Auditor should verify that the sale to resident customer is recorded in the combined bill and a cash receipt is issued in case of sale to walk-in customers.
- VAT should be charged on the bill as per applicable rate.
- Service Tax is also chargeable as per applicable rate on food bills in case where the restaurant is air-conditioned and restaurants providing liquor to customers. An Auditor should verify the amount of VAT and Service Tax according to the applicable rate.
- An Auditor should examine that all collected VAT and Service Tax have been deposited with government within time or not.

**Revenue from Food & Beverages (Room Service)**

The Revenue from the sale of Food and Beverages through room service is also a very common feature and an Auditor should consider the following and verify the revenue –

- All generated bill should be accounted for in the main bill of the resident customer.
- An Auditor should examine the KOT (Kitchen Order Ticket) to verify the F&B bills.
- Applicable VAT and Service Tax should be charged on bills.
- An Auditor should verify the rate of service charges if any applicable on F&B bills.

**Food & Beverages Revenue from Minibar**

Food & Beverages Revenue from Minibar The revenue from the food and beverages from the minibar also needs to be verified by the Auditor; the following points need to be considered for the same.

- Most hotels keep minibar stocked with liquor, soft drinks and snacks, etc.
- Billing of these items is based on self-declaration by the Guest through filling up of the form kept in the minibar.
• The minibar attendant checks the consumption and bills.
• The Auditor should verify the daily report of consumptions and stock of these items and should match with the billing to guest.

**Revenue from Banquets**

An Auditor needs to consider the following points and verify the revenue from Banquets –

• Normally, rate offered is a composite rate for food and beverages and rent of hall.
• Composite rate as above is based on per person.
• If actual cover (means per person) is less than the contracted rate, billing is done on minimum guaranteed covers. For example, banquet rent including F&B is Rs. 1,00,000/- for 100 persons and the per person rate is Rs. 1,000/-...
  - If the actual number of persons is 90, then the hotel will charge Rs. 1,00,000/- at the minimum guaranteed rate.
  - If the actual number of persons is 120, then the hotel will charge Rs. 1,00,000 + 1,000 x 20 = 1,20,000/-.
• Service Tax and VAT both are chargeable on composite rate.
• If the rent of banquet hall and the F&B charges are separate, Service Tax and VAT will be charged accordingly.

**Revenue from Business Centre**

An Auditor needs to consider the following points and verify the revenue from Business Centre –

• Business centre services means meeting room, fax service, photocopy service and secretarial services, etc.
• An Auditor should carefully examine the business centre services because these services are manually tracked to billing; if manual tracking through appointment register is missed, billing will be omitted.

**Arcade Revenues**

An Auditor needs to consider the following points and verify Arcade Revenues –

• Hotels provide shopping space at a fixed monthly rent at lobby of hotel or any other public area.
• An Auditor should verify the rent deed, contract deed, cash book, bank book, cash receipt counter foil to verify this revenue.
Revenue from Car Hire
An Auditor needs to consider the following points and verify the Revenue from Car Hire –

- Car facility is provided by hotels to their guest through dedicated travel agencies.
- Whenever guests hire cars, charges are posted to the guest folio.
- A hotel gets commission from travel agency which is based on the charges earned by the travel agency.
- An Auditor should examine the bills issued to customers and the amount paid to the travel agencies.

Revenue from Telephone & Internet
An Auditor needs to consider the following points and verify the Revenue from Telephone and Internet –

- Telephone bills are charged through EPABX system and internet service is charged through internet service providing system.
- For internet charges, Service Tax is charged.
- In some states like Kerala, Luxury Tax is charged on telephone bills.

Revenue from Housekeeping
This revenue is normally charged for sale of wardrobes and baby-sitting, etc.

Revenue from Laundry
An Auditor needs to consider the following points and verify the revenue from Laundry –

- Laundry service is provided to employees of hotel and resident guests.
- Billing is done through accounting software according to the rate provided.
- An Auditor should get the rate list to verify the rates and the billing should be verified with the housekeeping record.

Revenue from Beauty Parlors and Health Clubs
An Auditor needs to consider the following points and verify the Revenue from Beauty Parlors and Health Clubs –

- These facilities are provided to resident guests, walk-in guests or through membership.
- An Auditor should verify the rate charged for service provided and guest attendance register.
He should ensure the all services should be charged and recovered from customers.

**Revenue from Sale of Scrap and Disposal of Empties**

An Auditor needs to consider the following points and verify the Revenue from Sale of Scrap and Disposal of Empties –

- Scrap and empties can be sold on the basis of contract price or on the basis of onetime evaluation at the time of sale.

- An Auditor should verify the agreement for contract price in case where there is a time bound agreement between hotels and scrap buyer.

- Sale of dry scrap is also very important in hotels like sale of empty cans, bottles and other containers.

- He should verify the outward register, weighing slips, etc. and the rate charged for the same.

- An Auditor should verify the cash receipt & cash book, etc.

**Audit of Expenses**

An Auditor needs to consider the following points and verify the Revenue from Expenses –

- An Auditor should verify the appointment letter, policy of increment, time record, salary register, cash book and bank book to verify the salary payments of employees.

- He should verify all purchases through requisition slip, quotations, purchase order, inward register, quality control verification record and stock ledger.

- Every purchase should be passed by appropriate authority in this regard.

- Vouching should be done properly and should be verified with documentary evidences.

- At times, there may be a contract between a seller and a buyer (hotel) to sell a particular product at the same rate for a specific period like a week or a month, especially in case where the supply of material is done on daily basis like milk, bakery products, fresh vegetables, etc. The Auditor should verify purchases on the basis of such agreement.

- An Auditor should apply all other precautions and experience to audit the expenses as he does in any other industries.

- Verification of purchases, consumption and stocking is very crucial in hotel industry and it is a real challenge for an Auditor to verify all these very carefully. An Auditor should apply all his experience and knowledge to do audit of it.
Auditing - Management Audit

Management audit is a new concept in auditing. Area of Management audit is beyond conventional audit; it reviews all aspects of management. It is an audit of overall performance of management. It covers planning, organizing, co-ordination and control, etc. Management audit detects and diagnoses the problem and suggests various means to avoid and solve the problems.

Need of Management Audit

These days, reports on matters of policies and their implementation is very important to improve the efficiency of the management. Management Auditors advise the management on various matters related to performance of various departments as well as of the organization as a whole. Management Auditors may or may not be any finance and accountancy person. Management Auditors evaluate the actual performance by comparing it with predetermined standards. Auditors reveal any kind of defect and irregularities in the working of management. It can be said management audit helps in improving the performance and efficiency of management.

Objectives of Management Audit

- It helps management in setting sound and effective targets.
- To suggest management to obtain desired results and to reveal any defect and irregularities in the process of management.
- Management audit help in effective discharge of their duties.
- To help in co-ordination of various department.
- To help in training of personnel and marketing strategies.
- To compare input with outputs.
- To ensure strong relations with outsiders.
- To ensure most efficient internal organization.

Advantages of Management Audit

- It is helpful in making plan, objectives and policies of the management.
- It is helpful to efficiently achieve the set objectives of the management by coordinating with the personnel.
• It is very helpful to create strong communication system with outsiders and within the various departments.
• It is helpful to evaluate the performance of management.
• To establish good relations with employees.
• To elaborate duties, rights and liabilities of staff members and to make market strategies.
• It is helpful in preparation of budgets of organizations.
• It is helpful in preparation of budgets.
• It is helpful in resource management.

Appointment of Management Auditors
This team has experts with expertise in different fields of Management. Management audit team coordinates with the other levels of management and runs a smooth audit process. It is a team of experts with full knowledge about management science. Most of the team members have practical working experience of being a part of management. Such experience helps them handle actual work situations in a better way.

Qualities of Auditor
Following are a few important qualities of a Management Auditor –
• Good knowledge and experience of Managerial functions.
• An Auditor should have good knowledge of the financial statements analysis techniques.
• Knowledge of social accounting.
• Knowledge of human resource accounting.
• Good knowledge about economics and business laws, etc.
• Understanding about the working of organization and its problems.
• An Auditor should have sound knowledge of preparation and understanding about financial statements.
• He should know and understand the objectives of organization very well.
• He should understand about planning, budgets, rules and procedures to be applied in management.
• He should be well-versed with the entire production process.
• He should have enough knowledge and experience to understand the reason behind the lack of co-ordination between different departments.

• He should have the quality to give practical and achievable solutions instead of providing bookish suggestions.

Scope of Work of Management Audit

It is not possible to define complete working of management audit and the scope of work and the areas covered by management audit. Following are a few important areas covered by Management Audit –

• Administration
• Sales Management
• Purchase Management
• Distribution Management
• Stores and Inventories Management
• Production Management
• Personnel Management
• Finance and Accounts Management
• Management Information System
• Advertisement and Sales promotion

Management Audit Program

Audit Program means the planning of the outlines for the whole process and procedures of management audit from the beginning to the end. Following examples depict the outline of an Audit Program –

• Study about the organizational structure.
• Study to see whether the principles of a good organization have been followed or not.
• Detailed discussion with the top management about the objectives and the plans.
• Study of current policies adopted to achieve the desired objectives and also to study if there is any chance to improve them for better results.
• To decide the area of improvement whether it is planning or its implementation or both.
• Recommendations for improvements.
• To study whether the control system of an organization is adequate and effective.
Study of the manufacturing process to locate the factors which are hindering the maximization of production.

Study of personnel departments about policies, training, motivational schemes adopted currently for employees of the organization and what can be done further to improve the relations between employees and department.

Study about the optimum utilization of the space available and also of the physical equipment.

Audit Report

The report submitted by an Auditor should give true and correct assessment of the working of the organization and should contain suggestions for improvements as required in management policies, procedures or any other area. He should not hesitate in criticizing the management but on the other hand his report should not be merely condemning in nature. Although there is no fixed Management Auditor Report as per statute but still an Auditor should cover the following areas in his report –

- An Auditor should also see whether the relations between staff members and the management is healthy or nor. He should also highlight the areas of weakness and the suggestions for improvement, if any.

- About Methods and procedures of production.

- About operating efficiency.

- About rate of return on investment.

- About return to shareholders whether adequate or not.

Criticism of Management Audit

In spite of the various advantages of management audit in modern business world, it has faced criticism too

- According to managers and accountant it is just a vague concept which serves no material purpose at all.

- Management Auditors usually pin point shortcomings of managers in action, therefore they hesitate to take initiative.

- Normal practice of managers is to keep their record up to date instead of improving efficiency and reducing costs.

Auditing - Tax Audit
Tax audit is done by an Auditor on behalf of the Government to make sure that every provisions of Income Tax has been compiled by the assessee or not. Practically it is not possible for the Income Tax department to verify each and every detail of the assessee.

Tax audit can be conducted by a Chartered Accountant or any other person who can be appointed as an Auditor u/s 141 of the Companies Act, 2013.

**Mandatory Tax Audit**

According to Section(44 AB), provisions relating to Compulsory Tax Audit are as follows –

- If the total sales or gross receipts of a business during the previous year exceeds Rupees One Crore.
- If the gross receipt of a profession exceeds Rs. 25 lacs in previous year.
- If the business or profession of a person is covered under section 44AD, 44AE, 44B, 44BB, 44BBA and 44BBB and assessee claims that his income from said business is less than as computed under above said sections.

In all the above cases, audit of accounts is compulsory.

**Section 44(AD)**

The main features of Section 44AD are as follows –

- This section is applicable to profit from any business whether it is retail trading or civil construction business or any other business.
- The Assesse should be a resident individual of Resident Hindu Undivided Family or Resident Partnership Firm.
- According to Section 44AD income of assessee deemed to be 8% of total turnover or gross receipt.
- If the assessee claims that his income is below 8%, audit of his account is compulsory.
- This section is applicable only in case where gross receipts or turnover of the business is less than one Crore.
- This section does not cover income coming out of any profession.
- Total turnover of all business will be taken into one account where assessee carrying more than one business.
• If the assessee is carrying both business and profession, this section will be applicable to his business income only.

• Turnover of business or gross receipt will cover VAT, Excise duty, Cess and other levy, packing sale and freight if not shown separately in sale invoice.

• Turnover or gross receipt of business will be computed excluding sale of fixed assets, sale of investments and cash or other discounts, packing sale or freight charges if shown separately in invoices.

Section 44(AE)
The main features of Section 44(AE) are as follows –

• This section is applicable to any person engaged in playing, leasing or hiring truck.

• He should not own more than 10 trucks any time during the previous year including taken on hire-purchase or Installment basis.

• This section is not applicable to those who operate trucks on hire without owning them.

• His deemed income will be Rs. 5,000/- per month or part of the month in case of heavy vehicle and Rs. 4,500/- per month or part of the month in case of other than heavy vehicle or income as declared by the assessee whichever is higher.

• If the assessee does not opt for the scheme, he shall get his accounts audited.

Section 44(B)
The main features of Section 44(B) are as follows –

• This section is applicable to profits and gains of a non-resident from shipping business.

• His deemed income will be equal to 7.5% of the aggregate amount receipt in India.

• If the assessee does not opt for this scheme he will have to get his account audited.

Section 44(BB)
The main features of Section 44(BB) are as follows –

• This section is applicable to non-residents whose profits and gains of business of oil-exploration.

• His deemed profit will be equal to 10% of amount payable to him in India or outside India.

• If the assessee does not opt for this scheme he will have to get his account audited.

Section 44(BBA)
The main features of Section 44(BBA) are as follows −

- This section is applicable to non-resident assessee for profit and gains of business of operation of air-craft.
- His deemed profit will be 5% of amount paid or payable to him in India or outside India.
- If the assessee does not opt for this scheme, he will have to get his account audited.

**Section 44(BBB)**

The main features of Section 44BBB are as follows −

- This section is applicable to profit of foreign company engaged in business of civil construction or erection of plant and machinery or and commission thereof.
- His deemed profit will be equal to 10% of amount payable to him in India or outside India.
- If the assessee does not opt for this scheme, he will have to get his account audited.

**Last Date of Filing of Tax Audit Report**

Every assessee is bound to file his Tax Audit Report till 30th September.

**Penalty for Non-filling of Tax Audit Report**

If any person is required to get his account audited under Section 44AB but fails to do so before the specified date, he is liable to pay a penalty equal to 1/2% of Turnover/Gross receipt subject to maximum Rupees 1,50,000/-. However, Section 273(B) states that no penalty shall be levied under section 271(B) if there is a reasonable cause for such failure.

**Appointment of Tax Auditor**

Any practicing Chartered Accountant or firm of Chartered Accountants can conduct Tax Audit. The Board of Directors in case of Company, Partner of a firm and proprietor of the business can appoint Tax Auditor.

**Removal Tax Auditor**

Assesse can remove Tax Auditor on some valid ground only. In normal case, an Auditor cannot be removed during specified period.

**Ceiling of Tax Audit Assignments**
Under Section 44(AB), an Auditor cannot accept more than 60 Tax audit assignment; otherwise, he will be guilty of professional misconduct. In case of firm of chartered accountants, the limit of 60 will be applicable for each individual.

Audit Report
An Auditor gives his opinions through Audit Reports; opinions such as the following –

- whether financial statements give true and fair view of profit or loss and state of affairs.
- whether the prescribed particular of statement submitted with the report are true and correct.

According to Rule 64 of Income Tax Rule –

- If accounts of the business are required to be audited under any law, then the Auditor has to submit his report in form 3(CA) first, but for the statement, it has to be in a particular form 3(CD).
- If accounts of business are not required to be audited under any law, then the Auditor has to submit his report in form 3(CB) first, but for the statement, it has to be in a particular form 3(CD).
- If person is occupied in some profession, form 3(CC) is to be used for audit report and form 3(CE) for statement of particulars.