INTRODUCTION TO AUDITING.

The practice of auditing existed even in the Vedic period. Historical records show that Egyptians, Greeks and Roman used to get this public account scrutinized by and independent official. Kautaly in his book "arthshastra" has stated that "all undertakings depend on finance, hence foremost attention should be paid to the treasury".
Auditing as it exists today can be associated with the emerging a joint stock company during the industrial revolution. The company's act of 1956 gives regulations regarding the audit work.

Meaning of Audit:

The word audit is derived from the Latin word **"AUDIRE"** which means to hear. Initially auditor was a person appointed by the owners to check account whenever the suspected fraud, he was to hear explanation given by the person responsible for financial transactions. Emergence of joint stock companies changed the approach of auditing as ownership was pestered from management. The emphasis now is clearly on the verification of accounting date with a view on the reliability of accounting statement.

Definition:

Spicer and **Peglar** define auditing as "An examination of the books, accounts and vouchers of a business's shall enable the auditor to satisfy himself whether or not the balance sheet is properly drawn up so as to exhibit a true and correct view of the state of affairs of the business according to his best of the information given to him and as shown by the book.
Mautz: defines auditing as being "Concerned with the verification of accounting data with determining the accuracy and reliability of accounting statements and reports."

The international auditing practices committee defines auditing as "the independent examination of financial information of any entity whether profit oriented or not and irrespective of size/legal form when such an examination is conducted with a view to express an opinion thereon".

Scope of Audit.

The scope of audit is increasing with the increase in the complexities of the busines. It is said that long range objectives of an audit should be to serve as a guide to the management future decisions.

Today most of the economic activities are largely conducted through public finance. The auditor has to see whether these larger funds are properly used. The scope of audit encompasses verification of accounts with a intention of giving opinion on its reliability. Hence it covers cost audit, management audit, social audit etc. It should be remembered that an auditor just expressed his opinion on the authenticity of the account. He has no power to take action against anybody, in this regard its said that "an auditor is a watch dog but not a blood hound".

Objectives of Auditing.

Auditors are basically concerned with verifying whether the account exhibit true and fair view of the business. The objectives of auditing depends upon the purpose of his appointment.

Primary Objective.

The primary objective of an auditor is to respect to the owners of his business expressing his opinion whether account exhibits true and fair view of the state of affairs of the business. It should be remembered that in case of a company, he reports to the shareholders who are the owners of the company and not tot the director. The auditor is also concerned with verifying how far the accounting system is successful in correctly recording transactions. He had to see whether accounts are prepared in accordance with recognized accounting policies and practices and as per statutory requirements.

Secondary Objective:

The following objectives are incidental to the main objective of audting.

1. **Detection and prevention of errors:** errors are mistakes committed unintentionally because of ignorance, carelessness. Errors are of many types:
   a. **Errors of Omission:** These are the errors which arise on account of transaction into being recorded in the books of accounts either wholly partially. If a transaction has been totally omitted it will not affect trial balance and hence it is more difficult to detect. On the other hand if a transaction is partially recorded, the trial balance will not agree and hence it can be easily detected.
   b. **Errors of Commission:** When incorrect entries are made in the books of accounts either wholly, partially such errors are known as errors of commission. Eg: wrong entries, wrong Calculations, postings, carry forwards etc such errors can be located while verifying.
   c. **Compensating Errors:** when two/more mistakes are committed which counter balances each other. Such an error is know an Compensating Error. Eg: if the amount is wrongly debited by Rs 100 less and Wrongly Credited by Rs 100 such a mistake is known as compensating error.
   d. **Error of Principle:** These are the errors committed by not properly following the accounting principles. These arise mainly due to the lack of knowledge of accounting. Eg: Revenue expenditure may be treated as Capital Expenditure.
   e. **Clerical Errors;** A clerical error is one which arises on account of ignorance, carelessness, negligence etc.

   Location of Errors: It is not the duty of the auditor to identify the errors but in the process of verifying accounts, he may discover the errors in the accounts. The auditor should follow the following procedure in this regard.
   1. Check the trial balance.
   2. Compare list of debtors and creditors with the trial balance.
   3. Compare the names of account appearing in the ledger with the names of accounting in the trial balance.
   4. Check the totals and balances of all accounts and see that they have been properly shown in the trial balance.
   5. Check the posting of entries from various books into ledger.

2. **Deduction and Prevention of Fraud:** A fraud is an Error committed intentionally to deceive/ to mislead/ to conceal the truth/ the material fact. Frauds may be of 3 types.
   a. **Misappropriation of Cash:** This is one of the majored frauds in any organisation it normally occurs in the cash department. This kind of fraud is either by showing more payments/ less receipt.
   The cashier may show more expenses than what is actually incurred and misuse the extra cash. Eg: showing wages to dummy workers. Cash can also be misappropriated by showing less receipts

Eg: not recording cash sales. Not allowing discounts to customers. The cashier may also misappropriate the cash when it is received. Cash received from 1st customer is misused when the 2nd customer pays it is transferred to the 1st customer's account. When the 3rd customer pays it goes forever. Such a fraud is known as "Teaming and Lading". To prevent such frauds the auditor must check in detail all books and documents, vouchers, invoices etc.

b. **Misappropriation of Goods:** here records may be made for the goods not purchase not issued to production department, goods may be used for personal purpose. Such a fraud can be deducted by checking stock records and physical verification of goods.

c. **Manipulation of Accounts:** this is finalizing accounts with the intention of misleading others. This is also known as "WINDOWS DRESSING". It is very difficult to locate because its usually committed by higher level management such as directors. The objective of WD may be to evade tax, to borrow money from bank, to increase the share price etc.

to conclude it cab be said that, it is not the main objective of the auditor to discover frauds and irregularities. He is not an insurance against frauds and errors. But if he finds anything of a suspicious nature, he should probel it to the full.

ADVANTAGES OF AUDIT:

1. Audited account are detected as an authentic record of transaction.
2. Errors and frauds are detected and rectified.
3. It increases the morale of the staff and thus it prevents frauds and errors.
4. Because of his expertise the auditor may advise on various matters to his clients.
5. An auditor acts as a trustee of his shareholders. Hence he safeguards their financial interest.
6. For taxation purpose auditing of account is amust.
7. In case of any claim is to be made from the insurance company only audited account should be submitted.
8. Even in case of partnership firm auditing of accounts helps in the settlement of claim at the time of retirement/death of a partner.
9. Auditor account helps in managerial decisions.
10. They are useful to secure loan at the of amalgamation, absorption, reconstruction etc.
11. Auditing safeguards the interest of owners, creditors, investors, and workers.
12. It is useful to take certain financial decisions like issuing of shares, payment of dividend etc.

TYPES OF AUDIT:

1. **Statutory Audit:** any audit carried on as per the requirement of law is called as a statutory audit. eg: all companies have to get their accounts audited as per the provision of the company's Act of 1956.
2. **Periodical/ Annual Audit:** it is a kind of audit where the auditor verifies the account at the end of the financial year. He starts the audit work after the closure of financial year. This is a common audit and is mostly used by small organizations.
3. **Interium audit:** its an audit conducted in the middle of the accounting year before the accounts are closed. In other words any audit conducted between two financial audit is known s interium audit. The objective is to get periodical results, to declare interium dividend.
4. **Partial Audit:** when an auditor is asked to audit only a part of the account system. Its called partial audit. Eg: he may be asked to audit only the payment side of cash book.

5. **Balance sheet audit:** it's a kind of partial audit and is concerned with the verification of only those items appearing in the Balance Sheet. It is more popular in the USA. Infact while verifying BS items the auditor verifies/ checks all related items/accounts.
6. **Cost audit:** cost audit is defined as the verification of cost accounting records. Data and techniques for its accuracy and authenticity. It gets as effective managerial tool for the detection of errors and frauds in cost accounting records. The companies act implies the central government to order cost audit incase of specifies companies.
7. **Management audit:** Management audit may be defined as a comprehensive examination of an organizational structure of a company, institution/government and its plans and objectives it means of operations and use of human and physical facilities. The main objective of mgt audit is to see how far the objectives of mgt are fulfilled. It aims to ascertain whether sound mgt prevails throughout the organisation and evaluates its efficiency in the system of its operation.
8. **Continuous audit:** a continuous audit is one in which the auditor visits his clients office at regular intervals through out the year to verify the account. The objective of CA may be-
   a. To get final account audited immediately after the closure of accounting year.
   b. When the business is very large.
   c. When interval control system is into effective.
   d. When regular final accounts are required.

ADVANTAGES:

1. Errors and frauds are discovered and rectified quickly.
2. The chances of fraud are reduced.
3. The workers will be careful in their work.
4. Continuous audit acts as a valuable morale check on the staff.
5. Final audit becomes easier and faster.
6. If the company wants to declare interium dividend its easier to prepare interium account.
7. It increases the efficiency and accuracy in the accounts.

DISADVANTAGES:

1. After the auditor's visit is over, alternative may be made.
2. It affects the regular work.
3. Its not suitable for small organizations.
4. The auditor may loose the line of work if he does not complete his work in a visit.

Precautions to be taken for continuous audit:

1. He should record important balances, totals etc and verify the same in his next visit.
2. Strict instructions should be given prohibiting the alteration of figures after checked by the auditor.
3. For each visit special ticks should be used.
4. Its always better to verify the nominal account at the end of the year.
5. An exhaustive audit programme must be prepared.
6. He should ensure that normal working is not affected.
7. As far as possible, he should pay surprise visits.

Preparation before commencement of the audit:

An auditor after receiving the appointment letter should communicate his acceptance/otherwise in writing to the company. The following steps are necessary to commence the audit work:

1. If it is not a statutory audit, he should find out the exact nature and scope of his duties i.e., whether he has to audit the account/prepare accounts also.
2. He should inform his clients to close all the books of account and keep them ready for verification.
3. He should acquaint himself with the nature of his client business.
4. He should examine the efficiency of the internal control system.
5. He should obtain the names of directors their power duties etc.
6. He should obtain a complete list of all books and documents maintained by the clients.
7. He should obtain a copy of previous year's audit report.
8. He should go through various documents like MOA, AOA, prospectus etc.

Audit Programme: before commencing the audit he should plan his work so that is over without delay. For this purpose the auditor chalks out a detailed programme explaining the procedure to be followed for audit. It explains the work to be done by the audit staff. an audit programme is defined as "a detailed plan of the auditing work to be performed, specifying the procedure to be followed in verification of each item in the financial statements, and giving the estimated time required'.
Hence an audit programme is a statement giving instructions and guidance to the audit staff as to the audit procedure. It arranges and distributes the work among the audit staff.

ADVANTAGES:

1. It provides the audit staff clear instructions about their duties.
2. It promotes division of work in a well organized manner.
3. It helps the auditor to monitor the progress of the work.
4. It will be easier to fix responsibilities for omissions and commissions.
5. It serves as a valuable evidence for the work done.
6. It serves as a guide for future audit.
7. It ensures that audit process in a systematic manner.
8. It eliminates inefficiency and saves time.
9. Incase if any audit assistant goes on leave, his work can be easily continued by others.
10. It avoids duplication of work.

Disadvantages of Audit Programme.

1. The audit work becomes mechanical.
2. It kills the creativity of the audit staff.
3. Chances of work not done properly/ high as the scope is to be completed within a scheduled time.
4. A rigid programme may not be suitable for all kinds of business.

The above disadvantages can be minimized if the audit programme is made more flexible and audit staff encourages to go beyond the work mentioned in the audit programme. The auditors should also periodically review the programme in the light of experiences gained in the previous year. He should impress upon the audit staff. The audit programee is only guidance and they should use their initiatives, intelligence and comman sense at all times during the course of the audit.

Audit Note Book: an audit note book is one of the most important document maintained by the auditor. It is defined as a record used mainly in recording audit, containing data on work done and comments made. Audit Note book contains information regarding the day to day work performed by the audit staff, notes about errors, explanations required etc. the auditor can use it as an authentic evidence in the court if there is any case against him.

Contents of Audit Note Book:

1. Nature of business and important documents such as MOA, AOA, Partnership deed etc.
2. List of books of accounts.
3. List of officials, their duties and responsibilities.
4. Copy of the audit programme.
5. Information on missing receipts, vouchers etc.
6. Details of errors discovered.
7. Explanations sought from the officials.
8. Points to be included in the audit report.

An audit note book should be preserved by the auditor as it contains valuable information in respect of the work done by its staff.

Audit Working Papers:

Audit working papers are those papers which contain essential facts about accounts, which are being audited. Its defined as the file of analysis, summaries, comments and correspondence build up by the auditor during the course of audit.
The auditor maintains papers as supporting evidence to the audit work. The institute of chartered accountants of India states that "an auditor is expected to maintain evidence of work done by him and his staff".
Usually, audit working papers contains a copy of the trial balances, schedule of debtors and creditors, reconciliation statements important correspondence etc.

Purpose of maintaining working paper:

1. They show the extent to which accounting principles and auditing standards have adhered to.
2. They provide the required support for the auditors report.
3. They also reveal the efficiency with which the audit work was done.
4. They can be used as evidence in the court to defend himself against negligence in his duty.
5. They help the auditor in finalizing his report quickly.
6. They help the auditor to understand the efficiency of the accounting system, internal check system etc.

Working papers should be clear complete, and contain the necessary information so that they may be of maximum utility. They should be properly organized, documented and signed. In this regard its said hat "an auditor is often judged by the quality of the working paper prepared by him under his guidance".
working papers are confidential documents hence he should not disclose the facts to others. Doing so results in professional misconduct. Working papers should be preserved properly because they are important documents.

OWNERSHIP OF WORKING PAPERS:

The auditor who collects information through working papers for his audit work. Usually claims that he is the owner of the working papers. On the other hand the company claims that the auditor was appointed by and he only acts as its agent. Hence, all the documents that the auditor had collected should belong to the company several cases have been referred to the courts regarding the ownership in one of the cases it was decided that the working papers belong to the auditor because he was an independent professional and not an agent of the client. In another case also, it was held that the working papers belong to the auditor.

Auditors Lien:

The auditors if has into been paid his audit fees has the right to keep the books of accounts and other related documents in his possession till his dues are paid. Such a right is known as Auditors Lien.

Differences between Accounting and Auditing.

Accounting	Auditing
1. It's a continuous process carried out throughout the year.	1.It's a one time activity after the closure of accounting year.
2. No prescribed qualification is required to be an accountant.	2. He must be the member of Institute of Chartered Accountants of India to become an auditor.
3. An accountant is a employee of the company.	3. An auditor is an independent professional.
4. An accountant gets regular salary for his work.	4. He gets remuneration for his professional work. Audit fees.
5. Accounting is concerned with recording of business transactions systematically. 6. Accounting precedes, auditing.	5. Its concerned with verification of accounts prepared by the accountant. 6. Auditing succeeds accounting.

Usually an auditor confines his work only to the verification of accounts. In small organizations he may also be asked to finalize accounts. In this case he acts both as an accountant and as an auditor but the audit work commences only when the accounting work is over. Hence, its said that "Audit begins where accounting ends".

INTERNAL CHECK.

The term internal check implies that the work of various members of the staff is allocated in such a way that the work done by one person is automatically checked by another. It is defined as "such an arrangement of book keeping routine where in errors and frauds are likely to be prevented or discovered by the very occupation of book keeping itself'.

Internal check is a system under which accounting methods and details of an establishment are laid out that the accounts and procedures are not under the absolute and independent control of any one person or the contrary the work of one employee is complementary to that of another.

The system of IC is based upon the principle of division of labor, where in performance of each individual is automatically checked by another. This is possible by properly allocation the work and integration of function of the employees in such a manner their work complements each others.

OBJECTIVES OF INTERNAL CHECK:

1. Eliminates frauds and errors to prevent misappropriation of goods in cash.
2. To encourage specialization of labor.
3. To reduce the time spent on a particular work.
4. To exercise moral pressure over staff members.
5. To make accounting system more reliable.

Points to be Considered in Framing a Good Internal Check.

1. No single employee should have independent control over any important aspect of the business. In other words the work of employed should be automatically received by another.
2. The duties of the employees should be changed from time to time without prior notice.
3. Employees who control physical assets should not have assets to goods of account.
4. It's better to follow a system of self balancing ledger.
5. Account must be periodically verified.
6. The allocation of work must be carefully done and the position must be reviewed periodically.
7. While stock taking the pricing and evaluation of stock should be done by the people who are not connected to stores department.
8. A cashier should not be in charge of maintaining accounts complete bank transactions etc.

Internal check and the Auditor:

The auditor before starting audit work evaluates the system of internal check. If it is efficient he may avoid detailed checking of the transactions and he can carry out a few test check of the transactions to what extent should an auditor rely upon the system of internal check will depend upon the degree of effectiveness with which, the system is followed as well as the size of the business. If the internal check system is inefficient, he had to check in detail all transactions. It should be remembered that even if the internal check system is efficient he should still test its existence and efficiency.

Efficient internal check system reduces his work but not his responsibility. If in the process of examination of accounts if he finds any weakness in his system, he should report it to his client. Thus the existence of a good internal check system may help an auditor to a great extent, but does not reduce his legal liability. If any fraud is discovered subsequently he may be held quietly of negligence. He can't defend himself saying that he relied upon the efficient internal check system that existed in the business.

Internal check regarding CASH SALES.

Sales over the counter. The following is the internal check system regarding sales over the counter.

1. Each counter should have a separate salesman.
2. Each salesman should be given a separate sales memo book. Usually different color is used for different counters,
3. Sales memo should be prepared by the salesman in 4 copies.
4. The sales memo is checked by another clerk before being handed it over to customer. A copy is retained by the clerk.
5. Payment is made at the cash counter.
6. One copy of cash memo is returned to the internal duly stamped as cash paid 2 copies are return the cashier.

7. The cashier records days total sales in cash sales register.
8. Every salesman should prepare total sales summary of the respective counters. At the end of the day total sales as recorded by salesman, total cash received and total sales as per register must agree with each other.

Postal Sales:

A separate register should be maintained to record details of postal sales. Cash may be received either with order (cwo) or at the time of delivery (cod). Proper records will be made in this regard for cash received and due. Usually, goods are sent by VPP (value payable post). The sales register must be checked in detail by a senior officer.

Sales by Traveling Agents:

1. Traveling salesman should not be allowed to issue final receipts to customers.
2. Amount received must be remitted to H.O. account on daily basis.
3. Salesman should not be allowed to deduct their expenses or commission from the sale proceeds.
4. The salesman should submit periodical sales report which must be examined in detail.

Internal check regarding Wages:

In a large organization, expenses on wages with form one of the major portions of expenses. The chances of frauds are also high in this regard. In this background, a good system of internal check assumes significance.

a. frauds might be in the form of recording more wages than actually paid.
b. Payment of wages to dummy/ghost workers.
c. Recording wages for which no payment has been made etc.

The design of internal check system should try to prevent the above fraud. The following internal check system is suggested in this regard.

1. **Maintaining Time Records:** A department is in charge of recording the time spent by the workers should be constituted as far as possible. Manual system of time keeping must be avoided. This brings down the fraud regarding the payment of wages for which no work is done.
   The time keeping check and the foremen should separately prepare the time recorded sheet recording the name of the worker, time of entry, names of absentees etc.
   In case if the workers are paid on piece rate system proper system of time booking must be followed each worker should be given a job and counter assigned by the supervisor.
   In case if workers work overtime, the overtime slips must be issued which is authorized by the concerned official. No worker should be allowed to work Over Time if he is not authorized to do so.

2. **Preparation of Wage Sheets:**
   Large scale organizations should evolve in an internal check system in such a manner that the chances of over payment, under payment, wrong payment to workers are minimized and prevented. Preparation of wage sheets should be the responsibility of a separate department.

Separate wage sheets should be maintained for workers under time rate system and price rate system.
Two clerks should examine the time and price wage records. Over time records etc another clerk should be in charge of preparing wage sheets of individual works. The 4th clerk checks the calculations deduct amount for PF, IT, etc to arrive at net amount to be paid to workers. All officials involved in the process, should sign the statements which will be approved by the work manager/ the production manager.

Payment of Wages: a person is not involved either in maintaining time records preparation of wage sheets should be in charge of payment of wages. Usually the cashier in the accounts department will allot the wages, according to the information given by the wage sheet. As far as possible wages should be distributed personally to the workers who sign the Wage Register. Absentee workers should be paid through others workers only after written authorization is received. A list of unpaid wages should be prepared after the distribution of wages. If there are casual workers, payment should be made to them separately on a different day.

Internal Check as Regards Purchase.
The purchase dept, will be responsible for proper control over purchases as far as possible. Purchases must be centralized for the purpose of internal check. The purchase process may be divided as:

1. Purchase.
2. Storage.
3. Issues of Materials.

1. **Internal Check regarding Purchase of Materials:** The concerned dept, head will send requisition letter to the purchase dept, for each dept, a separate file must be maintained for requisitions. Based on the requisition the purchase committee, purchase dept, calls for tenders from approved suppliers. These tenders must be opened by the purchase committee and the least bidder will be chosen.
   Purchase order has to be sent to the selected suppliers. Usually, purchase order will be prepared by the purchase dept, a copy of which will be sent to the supplier, second to the stores, third to the accounting dept, and the fourth is retained by the purchase dept.
   When goods are received the stores keeper inspects them and compared with the purchase order. If goods are acceptable he enters them in goods inward book and issues the acceptance letter. A copy of the acceptance letter will go to the accounts dept, which will again compare goods approved letter with the purchase order. The accounts manager if satisfied authorizes for its payment.
2. **Internal Check Over Storage of Goods:** The stores keeper should maintain proper records, regarding storage of goods. He usually maintains bin cards and stores ledger surprise.
3. **Internal Check as regards to issue of Materials:** Materials should always be issued against material requisition note. After each issue, and purchase proper record must be made in bin cards and stores ledger.

Internal Control:

Internal control is a broad term which is normally used to control financial and non-financial activities. It involves a number of checks and controls exercised in a business to ensure efficient and economic working.

Definition:

Internal Control is defined as "the whole system of controls, financial and otherwise established by the management in the conduct of a business including internal check internal audit and other forms of control.

Objective advantages of Internal Control:

1. From the clients point of view.
    a. Internal control system provides authentic and reliable data useful to take business decisions.
    b. It safeguards the physical and non-physical assets in the form of records, documentation etc.
    c. It promotes operational efficiency, by preventing waste, duplication of work and inefficient use of resources.
    d. A good system of internal control provides that the company follows the procedures and rules as required by the law.

2. From auditors point of view.
   An auditor evaluates a system of control before commencing an audit work his work becomes easier if the control system is efficient. He can also decide whether detail verification is necessary or not.

Disadvantages of Internal Control:

1. It involves expenditure which may not be affordable by the small organizations.
2. Internal control is concerned with routine transactions many times unusual transactions may be over looked.
3. The system of internal control may be weakened due to inefficiency in handling of the system.
4. There are chances of diverse objectives among employees in the departments and staff in charge of internal control.
5. Management may manipulate the operation of internal control system.

Elements, features characteristics principles of a good Internal Control System:

An effective internal control system should have the following factors:

1. **Competent and trust worthy staff:** people in charge of internal control system must be reliable and highly competent about the work. Lack of knowledge and dishonesty will spoil the efficiency of the system.
2. **Records of financial and other organizational plans:** A good internal control system must have good documentation system. Filing, recording, classifying, etc will help in this regard.
3. **Segregation of duties:** normally, there should be a separate department for internal control this reduces frauds, bias etc. normally, a clerk in charge of accounting function should not be in charge of assets also.
4. **Supervision:** proper reviewing of the operations of the company regularly makes the control system effective.

5. **Authorization:** all transactions must be properly authorized. In other words, the authority of each person should be well defined.
6. **Sound practices:** the company should have well established procedures, policies, delegations organizational manuals etc.
7. **Internal Audit:** it's a part of internal control and it should be independent of internal check.
8. **Accounting Controls:** proper accounting information systems should be established so that the information relating to accounts is properly collected, recorded and accounts prepared.

Scope of Internal Control or Areas of Internal Control:

1. **General financial Control:** It's concerned with control over all finance functions i.e., planning, acquiring and investing funds and management of profits. It deals with accounting supervision recording etc of the finance department.
2. **Cash Control:** it's concerned with proper control over receipts payments and balance of cash. The control system must ensure that misappropriation of cash is prevented.
3. **Control over wages:** this includes maintenance of time records, wage records, and payment to workers. The main area of concern in this regard is the check payment to wages for the work not done and misappropriations of cash.
4. **Control over purchases:** the system of internal control regarding purchases should be developed in such a manner that purchasing accounting, handling and issuing of goods are properly controlled.

Internal Audit:

Large scale organizations usually develop a system to review their activities to identify areas of non performances. Internal audit is a tool used in this regard.

Definition:

Internal auditing involves a continuous critical review of financial and operating activities by a staff of auditors functioning as full time salaried employees.

Objective of Internal Audit:

1. To comment of the effectiveness of the internal control system in force and means of improving it.
1. To verify correctness accuracy and authenticity of the records presented to management.
2. To facilitate early detection of errors and frauds.
3. To ensure that standard accounting practices are followed.
4. To ensure that assets are properly acquired, safeguarded and accounted for.
5. To investigate in the areas as requested by the management.
6. To see that exhibited liabilities are valid.

Advantages of Internal Audit:

1. Internal Audit makes the system of internal control more effective and efficient.
2. It makes the auditor's work more simple.
3. Errors and Frauds are detected early.
4. It increases the morale of the employees.
5. Employees will be more careful as their work will be audited immediately.

Disadvantages of Internal Audit:

1. Small organizations cannot afford to have internal audit system as it's expensive.

1. The regular work of the organization will be affected.
2. Internal auditor acts as a staff manager hence there are chances of differences of opinion between the internal auditor and the employees of the company.

Difference between Internal and Independent Audit:

Internal	Independent.
1. An internal auditor is a regular employee of the company.	1. He is a professional auditor appointed by the company who is not an employee.
2. His duties, rights and responsibilities are determined by management.	2. The scope of audit work liabilities, duties etc are explained by concerned statutes.
3. He is appointed by the management.	3. He is appointed either by shareholders or by govt.,
4. It's not compulsory.	4. It is compulsory for all companies.
5. Internal auditor acts as an advisor to the management.	5. He is independent of the management.
6. To become an internal auditor professional qualification is not necessary.	6. An independent auditor must have professional qualification as per the act.
7. Internal Auditor ensures that the system of accounting is efficient.	7. the internal auditor comment on the true and fair view of business.
8. An internal auditor reports to the management.	8. The Internal Auditor reports to the shareholders.
9. Internal audit is a continuous process.	9. It's a periodic process.

To conclude, it can be said that "the internal auditor's responsibility is to the management and he is not a servant of the independent auditor. His scope will be decided by the management and eh should be free to communicate to the external auditor but should not involve himself with the work of independent auditor.

Difference between internal checks and internal audit:

Internal Check	Internal Audit.
1. It is an arrangement of duties allocated in such a way that the work of one person is automatically checked by another.	1. It is independent appraisal of operation and records of the company.
2. The purpose of IC is to prevent minimize possibilities of errors and frauds.	2. The purpose is to detect errors and frauds that are already committed.
3. IC doesn't require separate staff. It represents only the arrangement of duties.	3. It requires separate staff employed only for this purpose.
4. IC is a continuous process.	4. The Internal auditor has to report periodically about various inefficiencies and suggest improvements.
5. IC begins along with the recording of transactions.	5. It begins when the accounting process ends.
6. It is devices of doing the work.	6. It is a device for monitoring the work.

7. Scope of Internal Check is limited especially to the accounting department.	7. The scope of internal audit goes on beyond accounting department.

Internal check in a Department Store:
A department store is a large scale retail organisation working on self service basis selling the daily requirements of the customers. These are centrally located and attract customers.

Operation of Department Stores:
As the name itself suggests a dept., store is divided into many small departments, each department offering a specific product line. These depts., are headed by supervisors assisted by stock assistants. While the accounting departments, takes care of recording all transactions, in the cash dept, will be in charge of receipts and payments of cash. As it operates on self service basis cash is paid by the customer at the counter.

Internal Check as regards Purchase.
Goods are to be purchased as per the order of the G.M. The General Manager prepares purchase order based on the requisition notes sent by the supervisor. No supervisor should be given independent charge of purchase. A copy of the purchase order is sent to the accounting department and stores dept., when once the goods are received the store keeper verifies them with the order and approves for payment. The accounts department makes the payments after verifying the Purchase order and goods.

Internal Check regarding Cash Receipts.
usually the cash counters are computerized which brings down the human errors. The customers make the payments directly at the counter. The counter clerk prepares the bill and receives the cash. Chances of error and fraud are less as goods are coded and price is mentioned against codes.
As far as petty cash expenses are concerned, the cashier should be in charge of petty cash expenses, which are recorded on daily basis. The goods are delivered after verifying the bill.

Verification and Valuation of Assets and Liabilities.

Verification:
Verification is a process carried out to confirm the ownership valuation and existence of items at the balance sheet date.
Spicer and Pegler define verification as, "the verification of assets implies an inquiry into the value, ownership and title, existence and possession and the presence of any charge on the assets.
It is also defined as a process by which the auditor substantiate the accuracy of the right hand side of Balance Sheet and must be considered as having 3 distinct objects, i.e., verification of the existence of assets, the valuation of assets and authority of their acquisition.
The auditor is required to report whether the Balance Sheet exhibits the true and fair view of the business. For this, he has to examine and ascertain the correctness of money value of assets and liabilities as shown in the Balance Sheet. In the case of London Oil Storage Company Ltd, it was held that it is the duty of the auditor to verify the existence of assets, stated in the Balance Sheet and that he will be liable for any damage suffered by the client, if he fails in this duty.
The Institute of CA of India, states that the verification of assets should be aimed at establishing their:
a. Existence
b. Ownership
c. Possession.
d. Free from Encumbrance.
e. Proper recording and proper verification.

Difference Between Verification and Vouching.

1. Vouching Proves the accuracy of book entries but certification on balance sheet can be made only after verification.

Vouching	Verification
1. Vouching examines the entries relating to transactions recorded in books of accounts.	1. Verification examines the assets and liabilities appearing in the Balance Sheet.
2. Vouching is done throughout the year.	2. It takes place at the end of the year.
3. Vouching is bases on only documentary examination.	3. Verification is based on personal as well as documentary examination.
4. It does not include verification.	4. It includes valuation.
5. Vouching is normally done by audit assistant.	5. It1 is done by the auditor himself.

Valuation: The accuracy of B.S depends on the correctness of estimation of value of assets. A company's BS is not drawn for the purpose o showing what the capital would be worth if the assets were realized and liabilities paid off. But to show how the capital stands invested. It's the responsibility of the auditor that items in the BS are neither over valued nor undervalued.

Auditor Position Regarding Valuation:

An auditor can obtain the certification of valuer and other competent persons. Usually, the assets are valued by responsible officials. An auditor audits many types of companies and he can't be an expert to value all kinds of assets.

An auditor is not a valuer, and can't be expected to act as such. All that he can do is to verify the original cost price and to ascertain as far as possible the current values are fair and reasonable and are in accordance with accepted principles.

It must be borne in mind that the actual valuations are made by officials who have a practical knowledge of such assets and that an auditors duty is confined to testing the valuations as far as he can and in this way satisfy himself with correctness of the BS position. However, he can't guarantee the accuracy of valuations.

In simple words, In the absence of suspicious circumstances he can rely on the trusted officials of the company but this will not relive him from his responsibilities if assets are incorrectly valued. He should exercise reasonable care and skill, analysis critically all the facts and satisfy himself that generally accepted. Accounting principles are followed. He should not certify what he believes to be incorrect.

Method of Valuation:

Assets may be valued in any 1 of the following methods.

1. **Cost Price:** Its price paid to purchase an asset including installation and other expenses incurred to make the asset into workable condition.
2. **Market Value:** Its value of which an asset can fetch in the market when it is sold.
3. **Replacement Value:** It's the price at which a particular asset can be replaced.
4. **Book Value:** It's the value of an asset, as shown in the Balance Sheet.

Differences Between Verification and Valuation.

Verification.	Valuation.
1. Verification is done to prove the existence, ownership and title to assets.	1. It certifies the correct value of the asset at the date of the BS.
2. Verification is done or both assets and liabilities.	2. Usually only values of assets are certified.
3. Verification is done by the auditor.	3. It's done by the experts and responsible officials.
4. Verification is made on the basis of evidence.	4. Valuation is made based upon the certificate issued by the officials.

Verification and Valuation of Assets.

A. Intangible Assets:

i) Goodwill: goodwill is an intangible assets representing the value of the reputation of the firm which enables it to earn more than normal profit. The value of goodwill varies with the earning capacity of the business.

When a business has been purchase and goodwill is paid for the auditor should verify the agreement with the vendors. Whenever a business is acquired, goodwill is the difference between the value of acquisition and cost of acquisition.

Sometimes, goodwill may also be created by spending huge amounts to innovate new products. Such goodwill is known as Deferred Goodwill. Its capitalized over a period of time. Goodwill is shown in the books at cost less the written off amount.

ii) **Patents:** patent rights should be verified with the certificates granting such rights. If a patent is purchased, he should verify the assignment deed. He should see whether the deed is registered in the name of his client and patents are the property of the client. The auditor should also examine whether fees paid to purchase patents are treated as capital expenditure. If renewal fees is paid, it should be treated as revenue expenditure. If the client has number of patents he should get the list of patents with details such as the date of acquisition, the period of which its acquired etc.

Patents are written off over the period of which they are acquired. Hence, they are shown in the BS at cost less written off amount.

iii) **Copy Rights:** copy rights are those rights to produce or reproduce any creative work. The auditor should verify the agreement between the holder of the copy right and his client. Copy right is shown is BS at cost price less written off amount.

iv) **Trademarks:** they are registered brands. It gives the holder exclusive right to own the brand and protect it from imitation. An auditor should verify the certificate issued by the concerned authority, the fees paid for renewal etc trademarks are valued at cost price less written off amount.

B. Fixed Assets.

i) **Land and Building:** For verifying land and building the auditor should differentiate between free hold and lease hold properties.

a) In case of free hold land and building, the auditor should verify with the title deeds to ensure that the property is in the name of the client.
He should check the other documents like the life encumbrance certificate etc to see whether the property is free of any charge. If it is mortgaged he should verify the mortgage deed. As long as the title deeds are in order the auditor can't be held liable for frauds. However, the auditor should obtain a certificate from the client's legal advisor confirming the validity of ownership.
Land is valued at cost price which includes purchase, price, commission pay registration and legal charges, etc. it should be remembered that the land is not depreciable assets.
On the other hand building is always valued at cost less depreciation. It should be remembered that is to be charged even if the building is not used during the year.
In case of building under construction valuation is made based upon the architect certificate.

b) Lease Hold Property: In case if the property is held in lease he should verify the lease agreement and see whether its registered or not it is valued at cost less depreciation.

ii) **Plant and Machinery:** He should obtain a schedule of plant and machinery certified by responsible official. It gives all details about each machinery. He should compare the schedule with the plant register. If machinery is acquired under hire purchase he should verify the hire purchase agreement. If the machinery is imported he should verify the export license copy of invoice, permission of RBI from foreign exchange payment.
Plant and Machinery is valued at cost less depreciation. Depreciation rate is decided by the management. The only duty of the auditor here is to see whether depreciation is charged as per the provision of the IT Act.

iii) **Furniture and Fixtures:** Furniture is a movable asset where as fixtures becomes a part of another asset. It any addition is made during the year, he should verify the

invoice and pass book. He should also verify the schedule of furniture and see whether they are properly numbered and proper accounts are maintained. Repairs to furniture should be treated as revenue expenditure and hence debited to P&L a/c. furniture is always valued at cost less depreciation at a reasonable rate. He should verify the method of depreciation. The amount of depreciation varies with the usage.
Eg: Furniture used in Canteen requires more depreciation than furniture used in office. Hence the auditor must verify carefully to satisfy himself about the adequacy of depreciation.

Motor Vehicle: if the company has more number of vehicles he should verify the schedule of vehicles. He should verify the registration book of each vehicle. He should check the insurance paid on the vehicle etc. motor vehicles are valued at cost less depreciation. He should see that reasonable depreciation is provided.

C. Current Assets.

i) Cash in Hand: Cash in hand is verified by actually accounting it on the date of Balance Sheet. The counting must be done in front of the cashier. To avoid frauds the auditor must ask the cashier to deposit all the cash except petty cash into bank account. This makes verification easier. In case of temporary advances, enough care must be taken in verifying the delays. Auditor will be held responsible for any negligence in this regard. In the case of the London Oil Storage Co., Ltd it was found that the auditor had committed breach of duty in not verifying the petty cash balance properly. The institute of CA of India had clearly stated that the auditor should actually count the cash. It further states that verification of cash should be of surprise nature and if cash in hand doesn't agree with the balance as shown in the Balance Sheet he should qualify his report by mentioning the same.

ii) Cash at Bank:
The following steps are taken in verifying cash at bank:
i) Comparison of B.S as shown in the cash book and the pass book.
ii) Preparation of Reconciliation Statement.
iii) Obtaining a letter of confirmation from the bank.

iii) Bills Receivable: B/R is the acceptances given by Debtors. The objectives of verifying bills receivable are:
i. To establish the accuracy of amounts.
ii. To know the validity of the bills.
iii. To know whether they are reliable and to see whether there is a fair disclosure in the BS.

While verifying the BS the auditor
a. should examine bills receivable book.
b. to see whether any bill is honored after the BS is prepared but before auditing for this he should vouch the cash book.
c. I bills are discounted; he should vouch the cash book and should see whether it is shown as a contingent liability in the BS with proper provision.
d. He should see that bills receivable dishonored and not renewed are not shown in the bills receivable book.

iv) Book Debts/ Sundry Debtors: Book debts are to be classifies as good, bad and doubtful. The auditor should see the accuracy, validity, and collectability and confirmation letters directly from the debtors. For any balance for which no confirmation is received, he should carefully verify the account. He should see that proper provision is made for bad debts. Failing to do so the auditor will be held guilty for negligence.

v) **Stock/ Inventories:** Stock is the life blood of the business. It consists of stores and spares, raw materials, work in progress, and finished goods. If stock is incorrectly recorded, verified or valued, the P&L a/c doesn't show correct balances. It also affects the BS if stock if overvalued profit is inflated and if its understated it encourages creation of secret reserves.

The objective of verifying stock is to see that it exists and is correctly valued. It may not be possible to verify the entire stock. Hence he has to go for the checks to ascertain the accuracy of stock. In the case of Kingston cotton mills co., ltd the judge observed that,

"it is no part of the auditor's duty to take stock, he must rely on other people for details of stock in trade."

It was further observed that "an auditor is not bound to b a detective. He should not start his work with a foregone conclusion that there is something wrong. He is a watch dog and not a blood hound to be a detective. He is justified in believing in trust worthy servants of the company provided it takes reasonable care".

In another case it was decided that 'it is certainly not the duty of the auditor to take stock. He should check the calculation with proper care'.

While verifying stock:

a. He should review the procedure for maintenance of stock and records.
b. Examine the efficiency of internal check and control system.
c. See whether stock verification process contains adequate safeguards against possible errors and frauds.
d. Test check the physical existence of a part of the stock. Stock is valued at cost price/ market price whichever is lower/less.

vi) **Investment:** It may consist of govt., bonds, shares, securities etc. The auditor should examine whether the company is authorized to make investments. He should see whether the legal formalities have been completed. If the investments are larger in number he should obtain the schedule of investments certified by a responsible official. The statement should include name of the investment date of purchase, book value, market price, rate and date of interest, tax deducted etc. It is advisable to verify all investment at a time. It is always advisable that the auditor should personally inspect the investments in the case of city equitable fire insurance company limited. Where the investments were in the possession of brokers who had pledged them, the judge observed that "had the auditors not depended on the certificate form, their brokers and had demanded the actual production of securities, the fraud might have been detected.

Dividend received on investment should be examined by checking the counter foils of dividend warrants. Investments are valued depending upon the purpose for which they are held. If they are held as fixed assets (eg: trusts) they are valued at cost price, if they are held as current assets, they are valued at cost price or market price whichever is less.

Miscellaneous expenses and losses:

1. **Preliminary expense:** all expenses incurred in the formation of a company are called preliminary expenses. The auditor should vouch the payments made and see whether these expenses are written off regularly. The portion of preliminary expense not written off will be shown in the balance sheet on the assets side.

2. **Discount on issue of shares and debentures:** whenever shares and debentures are issued at discount, the company shows discount amount of the asset side till it is written off. The auditor should verify the relevant accounts and documents and see whether discount on the issue in particular on the re issue of forfeited share is as per the provision so act.

3. **Verification of liabilities:** if liabilities are not properly exhibited account do not show fair view of the business. While verifying liabilities the auditor should ensure that:
   a. all the liabilities in the Balance Sheet are actually payable.
   b. They are actually recorded.
   c. They have arisen out of natural business operation.
   d. There is a proper disclosure.

   He should obtain a certificated from the responsible official of the company about the existence of liability. In the case of West Minster Road Construction Company limited, it was held that the auditor must take reasonable care to satisfy himself that all liabilities have been brought into account. It was further observed that "If the auditor finds that a company in the course of its business was incurring liabilities of a particular kind it becomes his duty to make specific inquiries as to the existence of such liability before he signs his report.

   i) **Verification of Share Capital:** Share capital constitutes the amount contributed by the owners. He should verify the MOA, AOA, and Minutes Book of board meetings, cash book and pass book. If the shares are issued for 1st time (IPO) he should go for detailed checking of all transactions. He should also verify records regarding calls in arrears, forfeiture of shares and their re-issue.

   ii) **Debenture:** A debenture is a certificate issued by a company acknowledging its debt to the authorized holder. It carries a fixed rate of interest. Usually paid once in 6months. The auditor should verify the minutes of directors meeting the authorizing the issue. He should also verify cash book, pass book etc.

   iii) **Loans:** Loans may be either secured or unsecured. The auditors should verify the MOA and AOA and verify the borrowing powers of the company. In case of mortgage loans, he should see that the assets are mortgaged as per the provisions of the law. Its advisable to get confirmation from lending institution with a respect to amount of loan, security, interest etc.

   Current Liabilities.

   i) **Creditors:** The auditor should obtain the confirmation statement from the creditors and compare this with the statement of creditors as sent by the company. He should verify purchase ledgers, invoice etc. It is advisable to have a test check of all purchases mode during the year.

   ii) **Outstanding Expenses:** The auditor should obtain a statement of all outstanding expenses signed by a responsible official. He should see whether these expenses have been properly disclosed. He should ascertain the accuracy of the accounting records.

iii) **Bills Payable:** Bills Payable are negotiable instruments acknowledging the debt. He should get a statement of bills payable and compare it with the bill payable book. If any bills payable has been paid after the balance sheet date but before the audit, he should verify cash book and pass book. Such bills should not be included in the balance sheet.

iv) **Contingent Liability:** A future uncertain liability which is dependent on the happening of some event is called Contingent Liability. It may or may not arise in future. Eg: Bills receivable discounted claims against the company etc. the auditor should see whether all contingent liabilities are disclosed in the Balance Sheet.

AUDITOR'S REPORT / AUDIT REPORT.

The main objective of audit is to report to the owners on the true and fair position of the business. Audit report is the medium through which an auditor expresses his opinion on the financial state of affairs of the clients business. It summarizes the results of the audit work conducted by the auditor.

Importance of Audit Report.

In case of a company management is separated from the ownership share holders appoint the auditor to check the accounts and submit a report to them. However, the report doesn't guarantee accuracy of the accounts. The auditor is neither a guarantor nor an insurer. In one of the cases it was held that "the auditor must not be held liable for not tracing fraud, when there is nothing to arouse their suspicion and when those frauds are perpetrated by the trusted servants of the company".

The auditor is expected to act honestly with reasonable skill and care. Audit report is an extremely significant document as share holders rely upon it. The auditor will be guilty of professional misconduct if he deliberately fails to disclose material facts known to him. Conceals misstatements and fails to obtain necessary information to complete his audit.

TYPES OF AUDIT REPORT.

1. **Clean Report:** Its also known as Unqualified Report. It is given by the auditor if he is satisfied with the fairness of Balance Sheet and Profit and Loss account with all the contents of the financial statements and he is satisfied with evidences, documents and explanation given by his clients.

   Specimen of Clear Report.

   To,
   The Share Holders of ABC Ltd.

   We have audited the attached Balance Sheet of ABC Ltd as on 31.03.2009 and also Profit and Loss account annexed there to for the year ended on that date.
   1. We have obtained all the information and explanation which to the bet of our knowledge and belief were necessary for the purpose of audit.

2.Proper books of accounts are required by the law have been kept by the company so far as it appears from our examination of books and proper return adequate of our audit have been received from branches not visited by us.
3. The Balance Sheet and P&L account dealt with by his court are in agreement with the books of accounts and returns.
4. In our opinion and the to the best of our information and according to the explanation given to us the said Balance Sheet together with the notes thereon given the information required by Act of 1956 in manner so required and gives a true and fair view.

Date: Signed
Place: (Name, partner XY Associates)
Charted Accountant.

2. **Qualified Report:** When the auditor is not satisfied with the accounts presented to him if he finds any discrepancy in the recording of the transaction, if he thinks that the Balance Sheet and P&L account do not exhibit true and fair view of the business then he submits Qualified Report.

It means he submits his report with certain qualification (observation) a qualified report may be submitted in many cases such as improper valuation of assets, inadequate or excess depreciation, not following accounting standards etc.

The company Act doesn't lay down any specific requirement regarding the manner in which the auditor should qualify his report. It should not lead any confusion to the reader. Before submitting a qualified report he should discuss the issued with that of the management. He should see that qualified report is free from ambiguity, vague statements etc.

Specimen of Qualified Report.

To,
The Share Holders of ABC Ltd.

We have audited the attached Balance Sheet of ABC Ltd as on 31.03.2009 and also the P&L account of the company for the year ended on that date and report that:
1. We have obtained all information and explanation which to the best of our knowledge and belief were necessary for the purpose of our audit.
2. In our opinion proper books of accounts as required by law have been kept by the company so far as appears from our examination of the books subject to the comments given here under:-
In the absence of stock register, adjustments relating to balances on the registers have been accepted on the basis of management decision.
3. The Balance Sheet and P&L account dealt with by the report are in agreement with the books of accounts and returns.
4. Subject to the qualification given below in our opinion and to the best of our information and according to the explanation given to us the accounts together with the

notes there on and documents attached there to give the information required by the company's Act of 1956 in the manner so required and give a true and fair view.

a. The provision for depreciation of fixed assets is inadequate.

b. Stock has been valued at market price which is higher than the cost price.

Date: Signed
Place: (Name, partner XY Associates)
Charted Accountant.

Audit under Computerized Environment.

The process of account has undergone rapid changes in the recent years. The recording of business transaction has changed from Manual System to Computerized system. Computers are used for processing all kinds of accounting information. Useful to the management in its function of decision making. Most of the companies follow computerized accounting system to record, process and present accounting transactions. An auditor should see how efficient is the accounting information system is. It should be remembered that a computer does not take decision on its own, but only facilitate the process of decision making. Hence, the efficiency of accounting information system depends upon the knowledge of people related to it regarding computerized accounting.

Limitations or Problems associated with the computerized accounts.

1. In case of computerized accounts the auditor may not go for in depth auditing. In other words, he may not go to the original data to vouch and verify.
2. Knowledge of computer is a major deficiency in our country.
3. Each type of business has its own method of computerized auditing. This makes the auditor's work more difficult.
4. Documentation is completely different in case of computerized accounting which requires complete knowledge of input and output document.

Its therefore necessary that an auditor needs to be familiar himself with computerized accounting system and its environment. He has to review the system of internal control prevailing in existence, in recording, transmitting and processing of the data.

Internal Control System Under Computerized Audit:

The auditor should study the internal control system existing in a business where computerized accounting is followed. He should verify allocation of duties, systems of authorization etc.

Its necessary to identify and decide the extent to which the internal control is reliable. It should be understood that computerization of accounts does not eliminate errors and frauds. Its advisable that he management should consult the auditor while installing the system of computerized accounting. This helps the auditor to satisfy himself as to its adequacy from the point of view of audit work. The control systems may be of the following types:

a) Organizational Controls:

It is necessary to have an effective control system at various levels of organization. Eg: A programmer can always manipulate facts if he desires to do so, if the organization has a weak control system.

Its advisable to divide the work in such a manner that functions like programming, system design and analysis, testing, operating etc are assigned to different people. It is always necessary that the programmer does not have access to the data files.

b) Control Over Documentation, Testing etc:

This includes preparation of flow chart, instruction to operations etc. the control should be in such a manner that no alteration is allowed in programmes without authorization. For new programming and changing the existing programme a proper procedure should be laid out.

c) Input Control:

Quality of output depends upon the quality of input. It must be ensured that only authorized, accurate, and complete input data are fed into the system. Errors in these areas results in unreliable output.

control over creation of original documents to overcome the entry errors or error and frauds at the input level. Companies can develop a system of indentifying such errors at the entry level only before original documents are forwarded to data processing centre. A senior officer should review the documents to ensure their correctness.

d) Control over handling and movement of Original Documents:

To prevent loss of document either at data processing centre of while transferring them to the following controls are suggested:

i) Documents should be sent in a well defined process or routing system.

ii) The document sourced from one department should be consecutively numbered.

iii) It should be verified whether number of documents sent agree with the number of documents processed.

COMPANY AUDITOR

According to Section 224 of the Companies Act, every company whether private or public must appoint an Auditor or auditors to audit the final accounts. The provisions relating to the appointment of auditor are as follows:

1. Board of Directors:

The first auditor of a newly floated company is appointed by the board of directors, within one month of registration of the company. Such an auditor or auditors shall hold office till the conclusion of the first annual general meeting.

The directors are also empowered to fill a casual vacancy of an auditor if it is not caused by resignation. The auditor so appointed shall hold office till the conclusion of the next annual general meeting. But in case, if the vacancy is caused by the resignation of an auditor, it shall only be filled by the company in its annual general meeting.

2. Annual General Meeting:

The auditor or auditors are appointed in the annual general meeting under the following circumstances:

1) If the board of directors fail to appoint an auditor, the shareholders shall make an appointment in the annual general meeting.
2) Every company shall at each annual general meeting appoint an auditor to hold office from the conclusion of that meeting until the conclusion of the next annual general meeting.
3) The company has to give intimation to the auditor so appointed within seven days of his appointment.
4) The auditor so appointed shall within 30days of the receipt of intimation from the company regarding his appointment, has to inform the registrar of the company in writing whether he has accepted or refused the appointment.

In every annual general meeting the appointment of the company's auditor is made by the simple majority of votes by the present members.

3. Central Government:

According to section 224 (3), if the auditor has not been appointed in the annual general meeting, the company has to inform within seven days to the Regional Director to whom the Central Government's power to appoint an auditor in such an event has been delegated under section 637.

The said application must disclose in sufficient detail the reasons why the company could not appoint the auditor at its general meeting. In the case of default, the company and every officer of the company who is in default shall be punishable with a fine which may extend to Rs.500 as per section 224(4).

Appointment of Auditor by Special Resolution.

In 1974, Companies Act 1974 was amended by adding sub section A to section 224. After that, in some cases, the appointment of auditors or auditor requires special resolution. That is in case of a company, in which not less than 25% of the subscribed share capital is singly or jointly held by.

a. A public financial institution or a government company or the central government or any state government or
b. Any financial or other institution established by any provincial or state Act in which a state government holds not less than 51% of the subscribed share capital or
c. A nationalized bank or an insurance company carrying on general insurance business.

In the above mentioned circumstances, the appointment of an auditor shall me made by passing a special resolution (that is 75% or more of the members present should agree for the resolution). If not, it shall be deemed that the appointment has not been made and the central government will get the right under section 224(3) of the Companies Act to make an appointment.

Compulsory Reappointment.

Section 619 of the Companies Act specifies that in the case of government companies, the appointment or reappointment of an auditor by the central government can be made only on the advice of the comptroller and Auditor General of India.

In other cases, that is, whether auditors are appointed by the board of directors in the annual general meeting or by he central government, the retiring auditors are compulsorily reappointed, unless

1. He is not qualified for reappointment.
2. He has given a notice in writing to the company of his unwillingness, to be reappointed
3. Where a notice has been given or an intended resolution to appoint some other person in the place of the retiring auditor and by reason of death, in capacity or disqualification of that person or of all the persons as the case may be, the resolution cannot be proceeded with or
4. A resolution has been passed at that meeting, appointing somebody instead of providing expressly that he shall not be reappointed. This is as per section 224(2) of the Companies Act.

Ceiling on Number of Audits

In 1974, a group of young charted accountant, academicians and other sections of the public argued that the opportunities of professional practice are concentrated in the hands of a few well established and leading chartered accountants of the country. They demanded this monopoly be liquidated in the general interest of the profession thereby providing an opportunity to young chartered accountants also to earn their living. Therefore, the companies act was amended in 1974, by introducing section 224 (1- B). This came into effect from February 01, 1975 to ensure a more equitable distribution of audit work among all the practicing chartered accountants and to avoid the concentration of audit work in few leading firms of chartered accountants.

Therefore, according to section 224(1-B) of the Companies Act, no individual and no partner of the firm of auditors shall hold office as auditors of more than 20 companies of which not more than 10 be companies with paid up share capital of Rs.25 lakhs or more.

Filling of Casual Vacancies [Section 224(6)]

1. A vacancy caused by the resignation of an auditor shall only be filled by the members in the annual general meeting.
2. If a casual arises for any other reason (that is, death, insanity or insolvency) it can only be filled by the board of directors.
3. An auditor appointed to fill up the casual vacancy shall hold office until the conclusion of the next annual general meeting of the company.

Qualification of Auditor.

According to Section 226(1) and 226(2) of the Companies Act, the prescribed qualifications of an auditor are as follows:

1. A person who is a chartered accountant within the meaning of the Chartered Accountant's Act 1949.(Section 26(1)]
2. A person who holds a certificate under the Restriction Auditors Certificate Rules 1956 is also qualified to act as an auditor of a company. Such persons are also known as certified auditors and are always subject to rules made in this behalf by the central government [section 226(2)]

   The central government in empowered to frame rules relating to granting renewals, suspension or cancellation of such certificates.

Disqualification of a Company Auditor.

According to section 226(3) of the Companies Act, the following persons shall not be appointed as auditors of a company.

1. A body corporate.
2. An officer or an employee of the company.
3. A person who is a partner in the business.
4. A person who is indebted to the company for an amount exceeding more than Rs.1000/- or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding Rs.1000/-.

If an auditor, after his appointment becomes a subject of any of the above mentioned disqualifications, he shall be deemed to have vacated his office forthwith.

Removal of an Auditor.

1. The first auditors appointed by the directors prior to the first annual general meeting of the company may be removed by the members in the annual general meeting even if there tenure of office has not expired.
   The general meeting may in their place, appoint any other person, notice for whose nomination has been given by any member not less than 14days before the date of the meeting.
2. In any other case, the auditor may be removed from office before the expiry of his term by the company in the annual general meeting after obtaining the previous approval of the central government in this behalf. This provision is as per section 224(7) of the Companies Act.
3. But section 225 of the Companies Act makes special provisions in this respect, in order to safeguard the interests of an independent auditor against unfair and unjust removal at the hands of an unscrupulous management.

The procedure so laid down is as follows:

a. Special notice of intention to make such resolutions to remove the existing auditor must be given to the company by the shareholder not less than 14days before the annual general meeting.
b. On receipt of such a notice, the company must forthwith send a copy to the retiring auditor.
c. The retiring auditor has the right to send a representation to the company which he can ask the company to send to the shareholders.
d. If a copy of the representation is not sent to the members, either because it was received too late to be thus sent, or because of the default of the company, the auditor may insist that the representation shall be read out in the meeting.
e. The auditor, who is proposed to be removed, has the right to attend the general meeting where his removal is to be discussed. He also has the right to speak at such a meeting.
f. As a matter of professional conduct, the auditor so appointed in place o another should communicate with the retiring auditor in writing before accepting the appointment. If he does not do that, he may be held liable for disciplinary action as per the regulations of the Institute of Chartered Accountants of India.

Remuneration of an Auditor.

1. The general rule is that the appointing authority is authorized to fix the remuneration f an auditor as per Section 224(8)
2. In the case of a new company where the auditors are appointed by the board of directors, the remuneration will be fixed by the board of directors.
3. Similarly, if an auditor is appointed to fill a casual vacancy the remuneration will be fixed by the board of directors.

4. When an auditor is appointed by the Central Government the remuneration will also be fixed by the Central Government.
5. If the auditor's appointed at the annual general meeting, the remuneration is also fixed at the annual general meeting.
6. Remuneration includes the sum paid by the company in respect of the auditor's expenses.
7. Where the auditor is reappointed in the next annual general meeting, the amount fixed in the previous year is considered for the currency year also, if nothing more is specifically provided as remuneration in the current annual general meeting.
8. A part from the routine audit work, if a chartered accountant is entrusted with the work of taxation, writing up of the account books and other professional services then the auditors and the board of directors can fix up the remuneration mutually for the additional work. Moreover, the sanction of the share holders is not needed for the same.
9. Any remuneration paid for services other than routine audit work should be explained in the Profit and Loss account separately as under:
   i. Remuneration as an Auditor of the company.
   ii. In the capacity of an adviser in respect of:
      a. Taxation representation.
      b. Company Law matters
      c. Management Services.
      d. Internal Auditing
      e. Other professional services and
      f. For travelling and out of pocket expenses.

Rights of Company Auditors.

According to Section 227(7) of the Companies Act, a company auditor has the following rights.

1. **Right of Access t Books of Accounts**:
   As per Section 227(1) of the Companies Act every auditor of the company has the right to access at all times to the books of accounts and vouchers of the company, whether kept at the head office of the company or elsewhere.
   Under section 209(1) (d), a company auditor has the right to examine the cost records also which are required to be maintained by certain companies relating to production sales, stores etc.
2. **Right to Obtain Information and Explanations**:
   An auditor can call for any information or explanation from different officers of the company which he may think necessary for the performance of his duties.
   Under section 221, apart from the auditor's right to obtain information and explanation it is the duty of every officer of the company to furnish without delay the information to the company auditor.
   The power is so wide; the decision as to what information and explanation is left entirely to the discretion of the auditor. If the directors or officers of the company refuse to supply some information on the ground that in their opinion it is not necessary to furnish it, then the auditor has the right to mention that in his audit report.
3. **Right to Receive Notices and Other Communication Relating to General Meetings and to attend them.**
   According to section 231, of the companies act an auditor of a company has the right to receive notices and other communications relating to the general meetings in the same way as that of the members of the company.
   Similarly an auditor also has the right to attend any annual general meeting and also to be heard at those meetings which he attends and which concerns him as an auditor.
   The auditor also has the right to make a statement or explanation with regard to the accounts he has audited. But he auditor is not expected to answer questions in the general meeting.

4. **Right to Visit Branches.**
According to section 228 of the companies act the auditor of the company has the right to visit the branch office or offices of the company.
He can also audit such accounts of eh offices of the company provided that there is not qualified auditor to audit the accounts of the branch office or offices of the company, in such cases, the auditor has the right to access at all times to the books of accounts and vouchers that the company maintains at branch office or offices.
Moreover section 226 of the companies act provides that in case of the company gets the branch accounts audited by some of the local auditors, even the auditor has access at all times, to the books, accounts an vouchers of the company and he can also visit the branches, if he feels necessary.
5. **Right to Correct Any Wrong Statement.**
The company auditor is required to make a report to the members of the company on the accounts examined by him of the final accounts and the related documents which are laid down before the company in the general meeting.
Similarly, the auditor can advice the directors to amend their system of maintaining accounts. If the suggestions are not carried out, he has the right to refer the matter to the members and also to report that in the audit report.
6. **Right to sing the Audit Report**
As per section 229 of the companies act only the person appointed as auditor of the company or where a firm is so appointed, only a partner in the firm practicing in India, may sign the audit report or authenticate any other document of the company required by law to be signed.
7. **Right to Being Indemnified.**
Under Section 633 of the Companies Act, an auditor is considered to be an officer of the company and he has the right to be indemnified out of the assets of the company against any liability incurred by him in defending himself against any civil and criminal proceedings by the company if it is proved that the auditor has acted honestly or the judgment is delivered in his favour.
8. **Right to seek Legal and Technical Advice.**
The company auditor has the full right to seek the opinion of the experts and to take their legal and technical advice so as to discharge his duties efficiently.
9. **Right to Receive Remuneration.**
As per Section 224(8) of the Companies Act, the company auditor has the right to receive remuneration provided he has completed the work which he has undertaken to do so.

Duties of Company Auditor.
The various duties of the company auditor are as follows:

1. **To make special enquiries and investigation:** in connection with the following matters under section 227(1-A) of the Companies Amendment Act 1965.
A company auditor shall enquire:
   a. Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms of which they have been made are not prejudicial to the interests of the company or its members.
   b. Whether the transactions which are not supported by any fact or evidence, though recorded in the books are not prejudicial to the interests of the company.
   c. Whether personal expenses have been charged to the revenue account.
   d. Whether it has stated in the books of accounts of the company that any shares have been allotted for cash and whether cash has actually been received in respect of such allotment, and if no cash has actually been received, whether the position as stated in the account books and the Balance Sheet is correct and regular.
2. **Duty to make a Report to the Shareholders.**

Under Section 227(2,3,4&5) of the Companies Act, the auditor shall report to the share holders about the accounts examined by him. The report so mentioned shall contain the following.

a. Whether in his opinion, the Profit and Loss Account referred to in his report exhibits a true and fair view of the profit or loss.
b. Whether in his opinion, the Balance Sheet referred to in his report is properly drawn up, so as to exhibit a true and fair view of the state of affairs of the business according to the best of his information and explanations given to him and as shown by the books of accounts.
c. Whether he has obtained all the information and explanation which to the best of his knowledge and belief were necessary for the purpose of his audit.
d. Whether in his opinion, proper books of accounts as required by law have been kept by the company and proper returns adequate for the purpose of his audit have been received from branches he visited or not.
e. Whether report on branch accounts audited under section 28 by a person other than the company's auditor has been forwarded to him as required by clause (c) sub section (3) of that section and how he had dealt with the same in preparing the auditor's report.
f. Whether the company's Balance Sheet and Profit and Loss Accounts dealt with by the report are in agreement with the books of accounts and returns.
   If the answer to any of the above mentioned questions is in the negative, the auditor should submit his report accordingly.

3. **<u>Duty to comply with the Directives of the Central Government.</u>**
   It is the duty of the auditor to comply with the various directives issued to the auditor of the joint stock companies from time to time to give specific reports on the financial accounts of the companies.
   For example in 1975 it was made compulsory for some of the specified companies which are engaged in any of the below mentioned activities to conduct cost audit, that is, those companies engaged in
   a. Manufacturing, mining or processing.
   b. Supplying and rendering services
   c. Trading
   d. Business of financial investments, chit funds, nidhi or mutual benefit societies.
4. **<u>Duty to sign the Audit Report.</u>**
   As per section 229 of the companies act 1956, it is the statutory duty of the company auditor to sign the report prepared by him. Only a partner practicing in a firm in India can sign the audit report for and on behalf of a partnership firm practicing as chartered accountants.
5. **<u>Duty to give a Statement in the Prospectus.</u>**
   As per section 56(1) of the companies act, the prospectus issued by an existing company shall contain a report from the auditor of the company regarding
   a. Profits and losses during the previous year.
   b. Assets and liabilities of the company and its subsidiaries and
   c. The rate of dividend paid by the company in respect of each class of shares in the company for each of the five financial years preceding the issue of prospectus.
      So it is the statutory duty of the company auditor to submit his report containing the above mentioned points.
6. **<u>Duty to Certify the Statutory Report</u>.**
   According to section 165(4) the auditor of the company has to certify the statutory report regarding the shares allotted by the company, the cash received in respect of shares, and the receipts and payments of the company. The statutory report should also be certified as correct by two directors, one of whom shall be managing director.

Every company shall within a period of not less than one month and not more than 6months from the date which the company is entitled to commence business has to conduct a general meeting of the members of the company which is known as the statutory meeting.

7. **Duty to make a declaration of Solvency, if the company Goes into Voluntary Winding up**
   When a company goes into voluntary winding up, then a declaration of solvency is to be made by the directors of the company. Under section 488(1) of the Companies Act, this declaration is to be accompanied by the report of the auditor of the company under the section 488(2) of the companies act. So it is the duty of the auditor to make such reports.
8. **Duty to produce information and to assist the investigation, if any investigation is conducted regarding the working of the company.**
   Under section 240(6) (b), it is the duty of an auditor to preserve and produce to the inspector or any other person authorized by him in this behalf with the previous approval of the central government, all books and papers of or relating to the company or as the case my be, of relating to the other body corporate which are in their custody or power and other wise to give to the inspector all the assistance in connection with the investigation which they are reasonably able to give.
9. **Duty to perform the contract**
   It is the duty of the auditor to discharge the duties according to the terms of contract between the auditor and the party who has appointed him. It is to be remembered that the scope of statutory duties of a company auditor cannot in any way be curtailed. But on the other hand, the scope of duties of the auditor can be enlarged by passing a resolution at the annual general meeting making a provision in the Articles of Association of the company. If so, it is the duty of the auditor to perform the additional work.
10. **Duty to care and caution.**
    The auditor is appointed in the capacity of an expert, therefore, he must act honestly and exercises cure care and caution in the performance of his duties. The auditor can never give ignorance as an excuse for defense. So the auditor must prove that in the course of his audit work, he has employed skills that would reasonably be applied by any other auditor.

Special Audit of Companies.

As per section 233 A of the companies act, the central government has the power to direct special audit in the following cases for a specified period. That is, when the central government is of the opinion.

1. That the affairs of any company are not being managed in accordance with sound business principles or prudent commercial practices or
2. That any company is being managed in a manner likely to cause serious injury or damage to the interests of the trade, industry or business to which it pertains or
3. That the financial position of any company is such as to endanger its solvency.
   Auditor appointed under this section under the above mentioned circumstances are known as Special Auditors. Special audit is entirely different from investigation as per section 235. For example: the audit firm Lovelock and Lewies was asked by the central government to conduct a special audit for ITC company for which they audited the accounts and to submit a report when the ITC scam was reported.

Powers and Duties.

The powers and duties of the special auditors are identical to the rights and duties of a company auditor as specified in section 227.

Remuneration.

Although the special auditor is appointed by the Central Government his remuneration is paid by the company as determined by the Central Government.

Report

Special auditors have to submit their report to the Central Government to take necessary action as per the provisions of the Companies Act. But if the Central Government does not like to take any action on the submitted report within four months, in that case, the central government will send the copy of the report or its relevant extracts with comments to the company to be circulated to the members or to put such copy or extracts in the company's next annual general meeting.

The Liabilities of a Company Auditor.

1. **Civil Liability of an Auditor for negligence**.

   The liability of an auditor to pay damages are known as Civil Liabilities. Every auditor in the performance of his job is expected to exercise reasonable care and skill as per the circumstances, because the shareholders of the company appoint the auditor as their agent and therefore, he must exercise reasonable degree of skill and care in the performance of his duties. If not, the auditor will have to face the consequences.

   Therefore, we can conclude that an auditor can be held liable for negligence of his duty if it is proved that

   a. There has been a negligence in the performance of his duty and it may be due to the absence of requisite professional skills or failure to exercise it.
   b. There happens to be a loss or damage as a result of his negligence and
   c. The loss was suffered by his client.

      However, the court has the power to grant relief, wholly or partly to an auditor. We can also present the situation as given below.

      1. Loss without negligence and
      2. Negligence without loss.

   a. Liability of the Auditor for Mis-statements in the Prospectus.

   As per section 65 of the companies act 1956, an auditor may be held liable for damages suffered by those persons who subscribed to the shares or debentures of a company or debentures of a company proposing in the faith of the prospectus, which included auditor's report containing some untrue statements or facts. The auditor and every person who has authorized the issue of the prospectus shall be punishable with imprisonment for a term which may extent of 2years or with fine, which may extend to Rs. 5000 or with both, for the damages sustained directly resulted from those untrue statements. For the purpose of this clause, even those statements shall be taken to be untrue which are misleading in form and the context in which they are included.

   But the auditor can escape from his liability if he is able to prove:

   i. That he withdrew his consent in writing before the delivery of the copy of the prospectus for registration.
   ii. That he withdrew his consent in writing from such a prospectus on coming to know of the untrue statement by giving a reasonable public notice before the allotment of shares.
   iii. That he was competent to make the statement and that he has reasonable grounds to believe up to the time of allotment of the shares, that the statement was true or he relied upon the opinion of an expert whose name he has quoted in his certificate.

   b. Civil Liability of an Auditor for Misfeasance.

   By misfeasance we mean breach of trust or duty imposed by law for negligence in the performance of duties, which results in some loss or damage to the company. If an auditor does something wrong in the performance of his duties resulting in financial loss to the company he is guilty of misfeasance.

   As per section 543 of the companies act. The liquidator can bring the suit in the name of the company against the auditor, that is "in the course o winding up of a company, it

appears that any officer, including eh auditor or any other person associated with the promotion or the management of the company has misapplied or retained wrongfully, any property of the company or is guilty of breach of duty, he can be held liable for the damages caused to the company"
But section 633 grants relief to directors, officers, and auditors of the company against liability in respect of negligence, default, breach of duty, misfeasance or breach of trust. But for getting any relief there under, it must be proved by the person concerned.

a. That he has acted honestly.
b. That he has acted reasonably and
c. That having regard to all the circumstances of the case, he ought fairly to be excused.

2. **Criminal Liabilities of a Company Auditor.**

The auditor of a company becomes criminally liable for various offences during the course of his audit. Criminal liability of an auditor will arise when he is found to be guilty of willful non compliance under the provisions of law. Under the criminal liabilities, he may be imprisoned, fined or punished with both as per the companies act, income tax act, and the Indian Penal Code. Criminal liability of an auditor arises from errors in the performance of audit.
The auditor can be held criminally liable under:

1. The Companies Act.
2. The Income Tax Act.
3. The Chartered Accountant Act

a) **Criminal Liabilities under the Companies Act.**

i. **Section 233**
If the auditor does not comply with the requirement of section 227 and 229 as to make of his report, of signing or authenticating any document and if such default on his part is willful, he shall be punishable with fine which may extend to Rs. 1000

ii. **Section 240**
If the auditor of a company doesn't give the required assistance to an inspector appointed by the central government to investigate into the affairs of the company, the auditor of the company is punishable with imprisonment up to 6months or fine up to Rs.2000 or both. For persistent default a further fine at Rs. 200 per day may also be charged.

iii. **Section 242**
When on the basis of the report submitted by an inspector, the central government takes action and prosecutes any person connected with the affairs of the company is required to assist the prosecution. If he does not do so, he is guilty of contempt of court and punishable to the extent of imprisonment for 6months of fine of Rs 500 or both.

iv. **Section 477**
When the company is wound up, the auditor is subjected to a private examination by the court and is also liable to return to the court any books and documents of the company in his possession. If he does not appear before the court he can be arrested.

v. **Section 478**
On an application from the official liquidator, the auditor of a company is liquidation can be publicly examined in high court. Notes of the examination shall be taken down in writing and that should be signed by the auditor which may thereafter be used as evidence against him in any other civil or criminal proceedings.

vi. **Section 539**
If an auditor destroys, mutilates, alters, falsified or secretes or is a partly to the destruction mutilation alteration or falsification or secreting of any books papers or

securities or makes or is a party to the making of any false or fraudulent entry in any register books of accounts or documents belonging to the company, he shall be punishable with imprisonment for a term which may extend to 7years and also be fined.

vii. Section 545

The court may direct the liquidator of a company in winding up to prosecute the auditor if he is found guilty of any criminal offence in relation to the company.

viii. Section 628

An auditor is also liable to criminal prosecution, if he in any return, certificate, balance sheet, prospectus, statement or any other document required by or for the purpose of the act makes a statement.

1. Which is false in any material, particularly knowing it to be false.
2. Which omits any material fact knowing it to be material.

The punishment on conviction is imprisonment for a term which may extend up to 2years and shall also be fined.

ix. Section 629

If any person including an auditor intentionally gives false evidence upon nay examination up on oath or solemn affirmation authorized under the act or in any affidavit, deposition or solemn affirmation in or abut he winding up of any company under he act, he shall be punishable with imprisonment for a term which may extend to seven years and shall be liable to fine also.

Conclusion.

If the Articles of Association or any special agreement between the company auditor and the company contains any provision which exempts the auditor from any of the above legal liabilities for negligence, defaults, misfeasance, breach of trust, breach of duty etc it shall be considered void. However, according to section 633 the company can indemnify such officers including he company auditor for any of the losses suffered by him.

b) **Criminal Liabilities under the Income Tax Act.**

A qualified chartered accountant or the auditor of the company can act as authorized representative and may attend the Income Tax Authority or the Appellate Tribunal in connection with the proceedings under the Income Tax Act.

a. Section 288

This section provides that if a person who is convicted of an offence in connection with taxation proceedings will be disqualified from representing an assesse. The commissioner of Income Tax has been empowered to determine the period of such disqualification.

If the council of the Institute of Chartered Accountants of India finds that any chartered accountant is guilty in his professional misconduct, default in taxation etc. the institute can also declare him disqualified for certain specified period.

b. Section 277

As per this section 2years imprisonment may be imposed on the auditor if he auditor submits knowingly any false statements in the form of accounts for the preparation of income tax returns.

c. Section 278

As per this section any person who induces in any manner any other person to make and deliver to the income tax authorities, some false statements or declaration relating to chargeable income tax, highlighting the fundamental principle of criminal law that any person who aids, counsels or procures the commission of an offence is liable to be punishable with rigorous imprisonment for a minimum period of 3months and maximum of 3years with fine. In case the amount of tax to be evaded is in excess of Rs. 100000 the minimum and maximum period of rigorous imprisonment will be 6months and 7 years maximum with fine.

c) **Criminal Liabilities of an Auditor under the Chartered Accountants Act 1949.**

1. If a person not being a chartered accountant within the meaning of chartered accountants act of 1949 acts as an auditor of a company and signs any documents, then he may be held liable for criminal prosecution under section 29 of the chartered accountants act 1949. The punishment for this is fine which may extend to Rs.1000 on first conviction and with imprisonment extending to 6months or fine amounting to Rs.5000 or both on any subsequent conviction.
2. According to Part III of the first schedule of Chartered Accountants Act 1949 a member of the institute whether in practice r not, shall be deemed to be guilty of professional misconduct if he:
   a. Includes in any statement return or form to be submitted to the council any particulars knowing them to be false.
   b. Not being a fellow styles himself as fellow
   c. Does not supply he information called for or does not comply with the requirements asked for by the council or any of its committees.
3. **Auditors Liabilities to Third Parties.**
   Besides the client, the creditors, bankers, prospective share holders, tax authorities etc depend fully upon the final accounts certified by the auditor and do different dealings with the company.
   The liability of an auditor towards third parties can be discussed under 2circumstances.

   a. **For Frauds.**
   If in case there is any fraud on the part of the company's auditor, the third parties can however hold him liable. This 3rd party can sue the auditor if the report of the auditor is of such a nature, as amounts to fraud, even in there is no contractual obligation between the auditor and the 3rd party.
   It was decided in the case of Derry Vs Peek (1882) that the auditor can be held liable to 3rd partied only when the following facts are proved against him.
   i. That the statement or balance sheet signed by the auditor was materially untrue
   ii. That the statement or the Balance Sheet was made an intention that a 3rd party should act on it.
   iii. That the auditor knew that the statement of balance sheet was untrue.
   iv. That the 3rd party acted upon such a statement and consequently suffered a loss.
   v. That the auditor gave his consent for the inclusion of such a statement in the prospectus.

   b. **For Negligence**.
   An auditor in general is not liable to 3rd parties for negligence of duty as no contractual obligation exists between the auditor and the 3rd party. As he is not appointed by them, he owes no duty towards them and hence there is no question of any type of liability.

DISTINCTION BETWEEN PROFIT AND DIVISIBLE PROFITS:

One should clearly understand the difference between these two terms. All the profits of a company are not divisible. Only those profits, which can be legally, distributed in the form of dividend to the shareholders of the company are called as Divisible Profits. There is no definition of the term divisible profit in the companies act.
There are two main principles which he observed before declaring dividends to the shareholders:

1. In every case, dividend must be paid in accordance to the provisions of section 205 of the companies act and of the company's memorandum of association and articles of association. If the articles of association of a company are silent on this matter, dividend must be paid according to Regulations 85 and 94 of table A schedule 1 appended to the companies act.
2. Dividends should not be paid at the cost of creditors or debenture holders of the company.

BASIC CONSIDERATIONS FOR DIVISIBLE PROFITS:

There are many factors involved in calculation the divisible profits. However, the following basic considerations must be followed for an amount to be legally distributed as dividends. They are:

1. **Memorandum and Articles of association of the company.**

If the provisions contained all the articles and memorandum of association of the company are silent about this (that is determination of divisible profits) then schedule 1, clause 85 to 94 will apply. These are as follows:

Clause 85: this clause says, the company in general meeting may declare dividend, but no individual shall exceed the amount recommended by the board.

This means that the authority to recommend dividend is the board of directors, but the declaration as to final dividend is within the jurisdiction of the general meeting of the shareholders. However, the general meeting cannot increase the amount of dividend as recommended by the board. If the board doesn't recommend any dividend in any year, the shareholders in general meetings can't on their own declare it. Declaration of final dividend constitutes an enforceable debt against the company and it cannot be revoked.

Clause 86: this states that the board may from time to time pay to the members such interim dividends as it appears to be justified by the profits of the company.

But unlike final dividend doesn't not create a debt against the company, and the board may subsequently revoke the resolution and cancel the announcement.

Clause 87:

1. The board may before recommending any dividend set aside out of the profits of the company, such sums as it thinks proper, as reserve or reserves which at the discretion of eh board be applicable for any purpose t which profits of the company may be properly applied, including provisions of the meeting contingencies or for equalization of dividends, an pending such application may at the like discretion either be employed in the business of the company or be invested in such investments as the board may from time to time think fit.
2. The board may also carry forward any profit which it may think prudent not to divide without setting them aside as reserve. The meaning of this clause is that the company has the right to create any reserve or reserves before recommending any dividend.

Clause 88: according to this clause a company may pay dividend in proportion to the amount paid up on each share. If unequal amounts have been paid up on some shares, the dividend may be unequal among different shareholders. However in the absence of such a clause in the articles of a company, members will be entitled to dividend in proportion to the nominal value of the shares and not in proportion to the amount paid in respect of each share.

Clause 89: the board may deduct from any dividend payable to any member, all sums of money if any presently payable by him to the company on account of calls or otherwise in relation to shares of the company.

Clause 90:

1. Any dividend, interest or other money payable in cash in respect of shares may be paid by cheque or warrant sent through the post directly to the registered address of the holders and in the case of joint holders, to the registered address of that one of the joint

holders who is first named on the register of members, or such person and to such address as the holders or joint holders may in writing direct.

2. Every such cheque or warrant shall be made payable to the order of the person to whom it is sent.

Clause 91:
Any one of two or more joint holders of a hare may give effectual receipts for any dividends bonuses or other money payable in respect of such share.

Clause 92: notice of any dividend that may have been declared shall be given to the persons entitled to share therein, the manner mentioned in the act.

Clause 93: no dividend shall bear interest against the company.

2. **Provisions of the Company's Act.**

Out of current profits: depreciation must be provided by the company, before declaring any dividend out of the current profits. It is also important that in respect of financial year ending after 28th December 1960, the arrears of depreciation must also be provided for before declaration or payment of dividend.

Company's amendment act 1974 says that the company should also transfer the prescribed percentage of profits (that is not exceeding 10%) to its reserves before declaring dividends. The company can also transfer a higher percentage of its profits in accordance with the rules framed by the central govt., in this regard. However, no amount needs to be transferred to the reserves where the rate of dividend is 10% or less.

Out of past Reserves: section 205 A(3) of the companies act, provides that in the event of inadequacy or absence of profits in any year, dividend may be declared by the company for that year out of the accumulated profits earned by the company in the previous year and transferred to reserves, if the following conditions are satisfied:

1. The rate of dividend declared by the company shall not exceed the average rate at which dividend was declared by it in 5years immediate.
2. The balance of the reserves which may remain after declaring such dividend shall not fall below 15% of its paid up share capital.

   Amount provided by the Central Government.

   A company may also declare dividend out of the amount provided by the central govt., or a state govt., for he payment of dividends in pursuance of a guarantee thereof.

<u>Provisions for Depreciation.</u>

The position as to depreciation which is compulsorily required to be provided before declaration or payment of dividend for any financial year may be summed up as follows:

1. For declaration of payment of dividend in respect of the current financial year, depreciation must be provided.
2. In respect of financial year ending after 28th December 1960, the arrears of depreciation must be provided before declaration or payment of dividend.
3. Under section 205(1) (c), the central govt., may if it thinks necessary to do so in public interests, exempt any company from the requirement of providing depreciation before declaring of paying dividend for that year.

<u>Past Losses:</u>

Under section 205(1) (b) of the companies act if a company has incurred a loss in any financial year or years after the companies amendment act 1960, then either the amount of loss or the amount equal to the amount of depreciation whichever is less shall be set off against the profits of the company before dividends can be declared. That is, that amount of depreciation forming part of past losses shall be allowed to set off against the future profits first.

3. **Provisions of the Income Tax Act:**
   Section 104 to 109 of the Income Tax Act provides that in the case of a company in which public are not substantially interested, has to distribute a specified amount of dividend as prescribed by the income tax act. The company would have to pay additional income tax on the undistributed part of its income if the actual dividends fall short of the amount so prescribed.
   Provisions of the banking regulation act also affect divisible profits section 17 of the act provides that a banking company incorporated in India must transfer 20% of its annual profits to a reserve fund before payment of dividend. However, the bank may obtain exemption from the central govt., in this regard.
4. **Principles of Accountancy.**
   Divisible profits are calculated as surplus of income over expenditure for a given period. For this purpose all transactions are distinguished as capital and revenue, and such a distinction is necessary from the accountancy point of view. But a modified basis is now adopted to calculate divisible profits, that are the differences between assets and liabilities plus capital at the commencement of the year (i.e. net worth at the beginning0is found out. If assets are more, there is surplus, otherwise there will be deficiency. Similarly the deficiency or surplus at the end of the year is calculated after considering the increase of decrease of the capital etc. if there is surplus it is profit and if its is deficiency there is loss. This is now well recognized principle for determining profits.
   According to the principles of accountancy it is not proper to distribute capital profits as dividends and it is also not advisable to distribute the profits of the current year without providing for the losses of the previous year. Principles of accountancy also advocate that proper reserve should be created among the shareholders by way of dividends.
5. **Legal Decisions:**
   The provisions regarding declaring dividends is made clear with certain legal decision, they are:

Distribution of capital profits and legal decisions:

Capital profits are not profits in the normal course of business. If a company sells a part of the property at a cost higher than the original cost of such assets the profits thus earned is capital profit. Similarly, premium received on issue of shares, profits made on the re-sale of forfeited shares etc are examples of capital profits, and thus it is clear that capital profits do not arise in the course of business. As per the company law, such profits should not be distributed amongst the shareholders as dividends. But the below mentioned case decisions provides that under certain circumstances, capital profits can also be distributed among the shareholders of the company.
Based on the tow legal decisions regarding the distribution of capital profits, it can be concluded that capital profits cant be distributed as dividends, unless:

a. All the other assets have been revalued.
b. Such profits had been actually realized.
c. That the Articles of Association of the company had permitted such a distribution and
d. Working capitals of the company should also be sufficient for the company to carry out the business because it is always good from the financial point of view of the company.

Auditor’s duties with regard to payment of Dividend.

1. The auditor should examine the Memorandum and Articles of Association of the company to determine the rights of different classes of shareholders to whom dividend has been paid.

2. Dividend can only be distributed out of profits and capital of eh shareholders cannot be used for the purpose.
3. The auditor should ascertain whether profits set aside for the purpose of dividend have been computed in accordance with the requirements of section 205 of the companies act.
4. The auditor should ascertain whether the rate of dividend has been recommended properly in the meeting of the board of directors.
5. The auditor should examine the list of shareholders with the register of shareholders to see that the total amount of dividend payable agrees with the dividend account.
6. The amount of unclaimed dividend should be verified with the dividend account bank passbook and dividend warrants if any returned undelivered.
7. The auditor should check whether the income tax has been deducted at source.
8. The auditor should see that the dividend has been paid within the terms of clause 88 of Table A i.e in proportion to the amount paid for shares, if the same is incorporated in the articles of the company.
9. In case of issue of bonus share it should be ascertained that whether the articles of eh company authorized it.
10. It should be seen that the depreciation in respect of fixed assets and also floating assets has been provided before computation of divisible profit.
11. It should be seen that security available to the creditors of the company is in no way affected by the distribution of dividends.

SECRET RESERVES.

Some time a company creates a reserve, which is not shown in the balance sheet. Such a reserve is called secret reserve. It has been defined as "any reserve that is not apparent in the face of the balance sheet/" this is also called Hidden Reserve or Internal Reserve or Inner Reserve.

Objections to creating secret reserves:

1. The balance sheet prepared at the end of the year will not show a true and fair view of the state of affairs of the company as is required under the companies act.
2. The creation of secret reserve causes loss to the shareholders who are the real owners as they do not get their due share of profit.
3. Secret reserves might be used by dishonest directors for improper purposes i.e., to cover up losses upon ultra vires transactions or for indulging in speculation I the shares of the company or fraudulent activities. All such activities may turn out to be ruinous to the company.
4. When secret reserves are created by under valuing an asset the balance sheet will show the value of this asset at a lower figure than its real value, then the company cannot claim from the insurance company the full value of that asset if it is destroyed by fire. It would be a loss to the company.
5. According to the companies act creation of secret reserves is prohibited. Only banking companies, insurance companies and finance companies can create secret reserves.

Auditor's duty.

The position of the auditor in connection with the secret reserves is very clear. He will have to disclose to the shareholders if the company has created secret reserves. If he fails to do so, he will expose himself to risk. At the same time he can't certify the balance sheet of a limited company as true and fair which is very important part of his statutory duties.

In case of financial companies such as banking companies and insurance companies where the creation of secret reserves is not prohibited legally, he should try to find out the necessity of creating such a reserve. He should discuss the whole matter with the board of directors and should also satisfy himself about the method and procedure of creating such a reserve. If he finds that the intention of the directors is honest and the amount is also reasonable then he should not qualify his report. He should also study the articles of association to ascertain the legal implication of creating such a reserve. In short, he must review the whole situation very carefully and must ascertain the object of their creation. If he is fully satisfied he should not object to such a creation otherwise he should disclose the facts in his report.

AUDIT OF EDUCATIONAL INSTITUTIONS.

(Schools and Colleges or Universities)

Generally educational institutions are run by the registered societies or the public trusts registered under the relevant act. The audit objective of such institutions is to determine whether financial statements give true and fair view or the auditor may be asked to report on certain other aspects like whether the institution has complied with requirements as to accounting and financial records.

PRELIMINARY:

The auditor should study the following aspects:

1. Whether his letter of appointment is in order as well as any additional work assigned to him.
2. Legal status of the institution like the society or a trust or a statutory body under some law.
3. Study important provisions relating to accounts and audit under the relevant law.
4. Study code of state govt., and regard to the ground-in-aid. In case of colleges, University Grant Commission also provides grants subject to certain conditions. The auditor should study various conditions and procedures for such grants.
5. Examine charter, Trust Deed, or Regulations and not the provisions particularly relating to accounts and audit.
6. In case of important decisions like delegation of financial powers, transactions regarding fixed assets and investments etc minutes book of various meetings of the Board of Trustees or Governing Body or managing Committee or finance committee should be examined.
7. The auditor should obtain the various lists of books of accounts registers and other records as well as the persons authorized to sanction and execute financial decisions.
8. Last year's audit report should be examined with regard to various observations on qualifications.

INTERNAL CONTROL SYSTEM

It includes division of duties and their rotation, authorization procedures, adequate record maintenance, responsibility for safeguarding of assets etc. independent checks should be applied by using proper systems and procedures. The auditor should assess various aspects of internal control systems.

1. Are various assets like fixed assets, consumable stores and cash verified at the regular interval of time and reconciled with the recorded balances.
2. Whether proper system is followed for sale and purchase of assets and investments of the institutions like proper sanctions from the appropriate authority, obtaining quotations for fixed assets, maintain proper registers and records etc.
3. Whether bank reconciliation statements are prepared regularly and difference in cash book and pass book investigated?
4. Whether there is adequate internal check and internal audit system?
5. Whether the fee structures of changes therein have been approved by the proper authority? Some time grant-in-aid is received by the institution, in such cases the fee structure has to be in accordance with the conditions prescribed by grant-in-aid issuing authority.
6. Whether rules regarding concession in fees and other charges are followed, like concession allowed only after proper authorization?
7. Whether fines or charges are waived or reduced on the basis of proper sanction?

8. They system regarding receiving fees from students, issuing fee receipts, serial numbering of receipts, preserving counterfoils should be verified.
9. The person receiving fees should not have any control over the cash book.
10. The fees received daily should be deposited in the bank and no payments should be made from such receipts.
11. All fees received should be entered in the fee register daily.
12. There should be a proper system of receiving donations. All such receipts should be by cheque only, if not crossed, these should be crossed immediately on the receipt thereof. When the donations are received in kind there should be the proper system of receiving such donations and safe custody thereof. Receipts should be issued for all donations.
13. There should be proper procedure for the purpose of various items like sanction and authority for purchases, inviting quotations, approval of purchase order etc.
14. Whether a list of approved suppliers is kept ready for gods which are to be purchased frequently like sports materials, books stationery and laboratory equipments.
15. Whether system of making payment for purchases has been established.
16. There should be an adequate system for recording purchases like the register of assets and accounting records.

    On the basis of strength of internal control system, the auditor will determine audit procedures to be applied.

AUDIT OF INCOME AND EXPENDITURE.

1. The auditor should verify the counterfoil of fee receipts issued with entered made into the fees register. The details of fees and charges should also be examined like tuition fees, admission fees, like the fees, examination fess, sports fees etc. the fees charged should be as per fees structure sanctioned by the appropriate authorities.
2. Entries made the cash book should be verified with the fees register. Any concessions have been granted these should be verified as per the rules.
3. The statement of reconciliation of fees received and total fees receivable should be verifies.
4. In case of hotel accommodation, the charges received for accommodation, mess, fines etc should be examined. The counterfoils of receipt book should be compared with hostel charges register and cash book.
5. For donations received the receipt book should be compared with the cash book entries. The donations received should be accounted for under an appropriate head like specific purpose (building fund etc) or Corpus Fund or General Purpose.
6. Grants in aid have to be accounted for properly under the head capital receipts and revenue receipts depending on the purpose for which it has been received.
7. It should be verified that grants received has been utilized for the purpose it was allowed.
8. Rent received for the facilities let out temporarily should be verifies from receipt book, cash book, sanction by authorized person, rates charged as per rules.
9. Income from investments in approved educational institutions is not taxable. The auditor should examine it tax deducted at source, refund thereof has been claimed and received.
10. The interest/dividend received on investment during the year should be verified from investment register as well as cash book. Any interest due but not received has been duly recognized.
11. In regard to payment of salaries and allowances, it should be verified that payments on as per terms and conditions of appointments, computation of gross amount and deductions here from. (Income tax, provident fund, life insurance premium, loan installment etc). The payments of net amount should be verified from bank statement.
12. The amount of income tax and provident fund deducted from salaries and employees own contribution to provident fund is to be verified as being deposited with the appropriate authorities from receipts challan/ acknowledgments.

13. The auditor should verify payments made out of the grants by comparing minutes of governing body, vouchers, cash book entries and utilization certificates. The grants must be utilized as per terms and condition specified by the state govt., UGC. Any grant which remains unutilized must have been returned back to the authority.
14. The payments of scholarships should be verified by comparing terms and conditions stipulated, vouchers, cash book entries acknowledgment from students.
15. Expenditure on hostel facilities should be examined like purchases of food grains, other provisions, stocks, repairs, water charges, electricity charges, maintenance etc.

AUDIT OF ASSETS AND LIABILITIES.

1. Fixed assets purchase should be verified. If state govt., has allowed grant for he acquisition of fixed assets, the auditor should examine the terms and conditions of grants being complied with.
2. The auditor should examine that separate account of fixed assets are maintained when these on acquired out of specific grants.
3. Depreciation should be properly charged on all the fixed assets. The rate of depreciation is decided by the management on the basis of useful life of fixed assets. Sometimes it may be decided to charge depreciation as per the provision of Companies Act.
4. The auditor should physically verify investments. The documents related to sale and purchase of investments should be examined. As per the Indian Public Trust Act in case of public trusts, investments can be made only in specified securities. All such requirement for the acquisition of investment should be complied with. The correspondence with the donor should be examined when investments are received as a donation.
5. The security deposits received from the students should be examined. The refund of security deposit should be examined from the acknowledgment received from the students.
6. The financial statement should be examined form the view point that separate statement of accounts for provident fund, building fund, sports fund etc.
7. The stock of stationery equipments and furniture should be carefully verified.
8. The staff provident fund should be verified and it should be seen that it is invested as per rules.
9. All the assets and liabilities should be properly exhibited in the balance sheet.

SUMMARY OF AUDITING AND ASSURANCE STANDARDS

AAS = Accounting Assurance Standards.

AAS 1: Basic principles governing an Audit:

Govern the auditor's professional responsibilities, which should be complied with for all audits. Compliance with the basic principles requires the application of auditing procedures and reporting practices appropriate to the particular circumstances.

The standard enunciates the following principles as integral part of any audit carried out by a member of the ICAI. They are: Integrity, Objectivity and Independence, Confidentiality, Skills and Competence, Work Performed by Others, Documentation, Audit Evidence, Accounting System and Internal Control, Audit Conclusions and Reporting,

AAS 2: Objective and scope of the audit of financial statements

Objective of an audit of financial statements is to enable an auditor to express an opinion. Responsibility for the preparation of financial statements is that of the management of the enterprise.

The scope of an audit will be determined by the terms of the engagement, the requirements of relevant legislation and the pronouncements of the Institute.

1. The terms of engagement cannot restrict the scope of an audit in relation to matters which are prescribed by legislation or by the pronouncements of the Institute.
2. The audit should cover all relevant aspects of the enterprise; ensure sufficiency and reliability of the information contained in the underlying accounting records/source data and proper disclosure.
3. It recognizes the test nature of audit, exercise of judgment in deciding extent and nature of audit procedures, and judgment nature of audit opinion.
4. Constraints on the scope of the audit should form part of his report, and a qualified/disclaimer of opinion be considered.

AAS 3: Audit documentation

Requires an auditor to prepare sufficient and appropriate audit documentation that provides a record of the basis for the auditor's report and to demonstrate that the audit was performed in accordance with AASs and applicable legal and regulatory requirements

Audit documentation implies record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached.

It includes working papers (on paper or on electronic media), audit programmes, analyses, issues memoranda, letters of confirmation and representation, checklists, extracts of important documents, correspondence concerning significant matters, and schedules of work the auditor performed.

The nature of the Audit Documentation should be such that, an experienced auditor, having no connection with the audit should be able understand nature, timing, extent and results of the audit procedures, the audit evidence obtained, conclusions reached on significant matters, etc..

If the auditor has identified audit evidence that contradicts or is inconsistent with the auditor's final conclusion regarding a significant matter, the auditor should document how the auditor addressed the contradiction or inconsistency in forming the final conclusion.

Nature, timing and extent of audit procedures performed should include:

Who performed the audit work and the date of such work; and who reviewed specific audit documentation and the date of such review. Documentation of nature, timing and extent of audit procedures performed, should contain the identifying characteristics of the specific items tested. Reasons for Departure from a basic principle or essential procedure in an AAS to achieve audit objective more effectively.

In case of change of documentation subsequent to the date of audit report, it should record new audit procedures carried out, new conclusions reached, when and by whom such changes were made, and reviewed, the specific reasons for the changes; and the effect, if any, of the changes on the auditor's conclusions. Assembling of the audit file be finally completed not more than 90 days after the date of the auditor's report

Any changes to the documentation after file assembling should be recorded.

The auditor should have set procedures to maintain its confidentiality, safe custody, protect its integrity, enable its accessibility and retrievability; and enable its retention for a period sufficient to meet the needs of the firm, and legal and professional requirements.

Scanning of original documentation allowed for practical reasons so far as its identical in all respects as it would have been in a physical form.

AAS 4: The auditor's responsibility to consider fraud and error in an audit of financial statements

Audit planning must involve risk of material misstatements due to fraud and errors.

"Error" refers to an unintentional misstatement in the financial statements, including the omission of an amount or a disclosure.

"Fraud" refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. Fraud misstatements may include fraudulent financial reporting and misstatements resulting from misappropriation of assets. Refer the annexure to the AAS for circumstances indicating possibility of fraud.

Primary responsibility for prevention and detection of fraud and errors rests with the management. Audit cannot guarantee an absolute assurance about absence of material misstatements due to fraud and errors.

Auditor must plan and perform an audit with an attitude of professional skepticism.

When planning the audit, the auditor should make inquiries of management about management's assessment of misstatements resulting from fraud and error and internal controls placed to address such risk and any known fraud or error detected/suspected/investigated by management.

The auditor must consider factors stated in AAS 6, AAS 29 and AAS 13 while analyzing a misstatement to be indicative of fraud. He must document the procedures carried out and finding thereof.

A misstatement resulting from fraud/suspected fraud/error should be communicated to management/regulatory authorities as appropriate.

If the auditor unable to continue performing the audit as a result of a misstatement then he must follow guidance in the AAS.

AAS 5: Audit evidence

Auditor should evaluate whether he has obtained sufficient appropriate audit evidence before drawing conclusions.

Judgment as to what is sufficient appropriate audit evidence should be evaluated by considerations such as risk of misstatement, internal controls, materiality, trends and ratios, and so on.

Audit evidence from compliance procedures reasonably assure the auditor in respect of existence, effectiveness and continuity of controls.

Audit evidence from compliance procedures reasonably assures the auditor in respect of Existence – Valuation of assets/liability, Occurrence - Completeness – Measurement of transaction, appropriate presentation and disclosure of items.

Reliability of audit evidence depends on its source – internal or external, and on its nature – visual, documentary or oral. Consistency amongst the sources and nature will give increased assurance.

Evidence can be obtained by performing compliance and substantive procedures through Inspection, Observation, Computation and Analytical review.

AAS 6 : Risk assessments and internal control

Obtain an understanding of the accounting and internal control systems to plan audit, assess audit risk and design procedures to ensure it is reduced to an acceptably low level.

"Audit risk" means the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. It has 3 components: inherent risk, control risk and detection risk.

"Inherent risk" is the susceptibility of an account balance or class of transactions to misstatement that could be material, either individually or when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.

"Control risk" is the risk that a misstatement that could occur in an account balance or class of transactions and that could be material, either individually or when aggregated with misstatements in other balances or classes, will not be prevented or detected and corrected on a timely basis by the accounting and internal control systems.

"Detection risk" is the risk that an auditor's substantive procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material, either individually or when aggregated with misstatements in other balances or classes.

Auditor should assess inherent risk at the level of financial statements.

The auditor should make a assessment of control risk, at the assertion level, for each material account balance or class of transactions. It means evaluating effectiveness of accounting and internal control systems in preventing or detecting and correcting material misstatements.

The auditor should also evaluate the control environment, control procedures, and assessment of control risk and test controls. He must make adopt suitable nature, timing and extent of substantive procedures.

There is an inverse relationship between detection risk and the combined level of inherent and control risks. Regardless of risks assessed the auditor must adopt suitable nature, timing and extent of substantive procedures for material account balances and classes of transactions.

For each of the above assessment/evaluations of risks and other items the auditor must document his conclusions and evidence for reaching them.

Auditor should communicate with management, at an appropriate level, of material weaknesses in the design or operation of the accounting and internal control systems, which have come to his attention.

Auditor's assessment of control risk is:
Auditor's assessment of inherent risk
High
Medium
Low

High
Lowest
Lower
Medium

Medium
Lower
Medium
Higher

Low
Medium

Higher
Highest

AAS 8: Audit planning

Plans should be made to cover at least

(a) acquiring knowledge of the client's accounting systems, policies and internal control procedures;
(b) establishing the expected degree of reliance to be placed on internal control;
(c) determining and programming the nature, timing, and extent of the audit procedures to be performed; and
(d) co-coordinating the work to be performed.

Planning should be continuous throughout the engagement. It must involve overall plan for the expected scope and conduct of the audit and nature, timing and extent of audit procedures.

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

Matters to be considered in developing the audit plan given in Para 11 of the AAS.

Auditor should document his overall plan based on size and complexity of the audit. A time budget, in which hours are budgeted for the various audit areas or procedures, can be effective planning tool.

Planning should consider factors such as complexity of the audit, the environment in which the entity operates, previous experience with the client, discussions with client and knowledge of the client's business.

A written audit programme should be made setting forth procedures needed to implement the audit plan. It may contain audit objectives for each area and should have sufficient details to serve as a set of instructions to the assistants involved and as a means to control.

AAS 13: Audit materiality

Information is material if its misstatement (omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information.

Materiality depends on the size and nature of the item, judged in the circumstances of its misstatement. The assessment of what is material is a matter of professional judgment. Materiality can be considered at individual account balances, classes of transaction, legal and regulatory requirements, cumulative impact of small misstatements.

Materiality should be considered while determining the nature, timing and extent of audit procedures, evaluating the effect of misstatements and degree of audit risk.

If the aggregate of the uncorrected misstatements that the auditor has identified approaches the materiality level, or if auditor determines that the aggregate of uncorrected misstatements causes the financial information to be materially misstated, he should consider requesting the management to adjust the financial information or extending his audit procedures.

AAS 14: Analytical procedures

"Analytical procedures" means the analysis of significant ratios and trends including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts.

Auditor should apply analytical procedures at the planning (in understanding business and potential risks) and overall review stages of the audit.

Analytical procedures include comparisons of the entity's financial information with comparable information – for prior periods, of budgets or forecasts, estimation of depreciation charge for the year etc., and similar industry data.

Analytical procedures also include consideration of relationships among elements of financial information that would be expected to conform to a predictable pattern, such as gross margin percentages and between financial information and relevant non-financial information, such as payroll costs to number of employees.
In case analytical procedure is used as substantive test then auditor must consider reliability, relevance and source of information, changes required to be made to make the information comparable.
When analytical procedures identify significant fluctuations or relationships that are inconsistent with other relevant information or that deviate from predicted amounts, the auditor should investigate and obtain adequate explanations and appropriate corroborative evidence.

AAS 16: Going concern

Appropriateness of the going concern assumption underlying the preparation of the financial statements should be considered while planning, performing and reviewing results of audit.
Auditor must critically evaluate financial, operating and other indicators that question the going concern assumption. (Refer AAS Para 6)
When going concern assumption is in question, the auditor should gather audit evidence to attempt to resolve, the question regarding the entity's ability to continue in operation for the foreseeable future and document that same.
Where going concern assumption is appropriate because of mitigating factors, the auditor should consider whether management's plans or other factors need to be disclosed in the financial statements.
Where the going concern question is not satisfactorily resolved, the financial statements should disclose adequately:
The principal conditions that raise substantial doubt about the entity's ability to continue in operation for the foreseeable future.
State that there is significant uncertainty that the entity will be able to continue as a going concern and, therefore, may be unable to realize its assets and discharge its liabilities in the normal course of business; and State that the financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts, or to amounts and classification of liabilities that may be necessary if the entity is unable to continue as a going concern.
Where disclosure is inadequate the auditor should express a qualified or adverse opinion, as appropriate. Where disclosure is adequate audit report should highlight the going concern problem by drawing attention to the note giving disclosure.

AAS 20: Knowledge of the business

Auditor should have or obtain knowledge of the business to enable him to identify and understand the events, transactions and practices that, in his judgment, may have a significant effect on the financial statements or on the examination or audit report.
Knowledge of business, which is a continuous and cumulative process, should be used by the auditor in assessing inherent and control risks planning and performing the audit effectively and efficiently, in determining the nature, timing and extent of audit procedures, evaluating audit evidence and providing better service to the client.
For continuing engagements, the auditor would update and re-evaluate information gathered previously, including information in the prior year's working papers. He must document all his finding.
Auditor should ensure that his staff also is communicated with this knowledge. Refer the AAS appendix for matters for a illustrative list of matters to consider.

AAS 21: Consolidation of laws and regulations in an audit of financial statements

The Standard deals with Auditor's consideration of compliance with laws and regulations and the audit procedures where non-compliance is observed. Management is responsible for ensuring that entity's operations are as per the relevant laws and regulations; i.e., Responsibility for prevention and detection rests with management.

Auditor must obtain:
A general understanding of the legal and regulatory framework applicable to the entity and the procedures adopted by entity to comply with such framework. A written representation from management that management has disclosed all known or possible non-compliances of laws and regulations.
Sufficient appropriate audit evidences of the compliances with laws and regulations affecting determination of material amounts and disclosures in financial statements.
Appropriate planning and performing of such audit tests are required to identify non-compliance with applicable laws and regulations. Sufficient evidences should be obtained of such non-compliances and they be considered while preparing financial statements.

AAS 23: Audit considerations relating to entities using Service organizations
The Standard is prescribed for an auditor whose client uses service organizations. Service organizations undertake activities such as information processing, maintenance of accounting records, facilities management etc.
Auditor of the client should determine the significance of activities of service organizations and their relevance to the audit. Instances of factors to be to be considered are the nature of services, terms of contract, material financial statements affected by use of service organizations and their inherent risks, client accounting and internal control interactions with those of service organizations, financial strength and capabilities of service organizations etc.
Auditor of the client who is using a service organization auditor's ("other auditor") report should consider the nature, scope of and content of his report. The service organization's auditor report shall be any one of the following: Type A or Type B reports.
Type A Reports are on suitability of design that provides an understanding of the service organization's accounting and internal control systems and the service organizations auditors' opinion on the same. Such report would not be used as a basis for reducing the assessment of control risk
Type B Reports are on suitability of design and operating effectiveness that covers besides matters stated in Part A, the details of tests of controls identified and performed by the other auditor and their related results. The client auditor uses such reports as evidences to support a lower control risk assessment.
The service organization's auditor may be engaged to perform substantive procedures that are of use to the client's auditor.

AAS 26: Terms of audit engagement
The Standard deals with agreeing to terms of engagement and the auditor's response to changes in the terms of an engagement to one that gives a lower level of assurance.
Auditor and Client must agree on the terms of engagement that is recorded in a contract or any other suitable form of contract. To avoid misunderstandings the engagement letter must be sent to client before the commencement of the engagement.
Audit engagement letter must be clear and precise and must include the scope of assignment, declaration that the audit process are subjected to peer review, the objectives of financial statements, communicating matters of conflicts of interest, and the responsibilities of the management.
Management responsibilities are the selection and implementation of accounting standards and their departures, records maintenance, efficient internal controls for safeguarding assets and prevention of frauds and other irregularities

The changes in terms of engagement letter must be agreed between the client and auditor. If in a situation the auditor is not in agreement with suggested changes than he should withdraw from the engagement. Subsequently on withdrawal, the auditor will need to consider whether there is any contractual obligation or otherwise to report the circumstances necessitating his withdrawal to parties like the board of directors or shareholders.

AAS 27: Communication of audit matters with those charged with governance

This Standard deals with establishing standards on communications of audit matters arising from the audit of financial statements between the auditor and those charged with governance of an entity. The Standard does not provide guidance on communication by the auditors to outside agencies like the external regulator or supervising agencies.

The Standard also includes guidance on confidentiality requirements, laws and regulations.

"Governance" refers to the role of persons who are entrusted with the supervision, control and direction of an entity. Auditors to determine the relevant persons who are charged with Governance and with whom audit matters of Governance are required to be communicated.

The structure of Governance may be different for very entity. Example in case of companies the board, audit committee, corporate governance committee; in case of trusts the trustees or the management etc.

The communications of matters of Governance are required to be reported on a timely basis. This may be either orally or in writing. In case of oral communications, the auditor must document such facts and responses of the entity in his working papers.

Instances of Matters of Governance of Interest are limitations in the scope of audit, changes in accounting polices which are having a material effect, modification in the auditor’s report, continuity of the entity as a going concern, disclosures of significant risks and exposures in financial statements, any other matters agreed in the audit engagement letter.

Auditors are not required to design procedures for specific purposes of identifying the matters of Governance.

AAS 29: Auditing in a computer information systems environment

This AAS sets the standards on procedures to be followed when an audit is conducted in a computer information systems (CIS) environment.

Auditor to have sufficient knowledge of the computer information systems to plan, direct, supervise, control and review the work performed.

In planning audit in a CIS environment, the auditor should obtain an understanding of the significance and complexity of the CIS activities and the availability of the data for use in the audit.

When the CIS are significant, the auditor should also obtain an understanding of the CIS environment and how it may influence the assessment of inherent and control risks.

He must evaluate risks and controls in the light of the following – Lack of transaction trails, Uniform processing of transactions, Lack of segregation of functions, Potential for errors and irregularities, Initiation or execution of transactions, Dependence of other controls over computer processing, Potential for increased management supervision, Potential for the use of computer-assisted audit techniques.

Auditor should consider whether CIS:

Ensure that authorized, correct and complete data is made available for processing;

Provide for timely detection and correction of errors;

ensure that in case of interruption in the working of the CIS environment due to power, mechanical or processing failures, the system restarts without distorting the completion of the entries and records;

Ensure the accuracy and completeness of output;

Provide adequate data security against fire and other calamities, wrong processing, frauds etc.;

Prevent unauthorized amendments to the programmes and

Provide for safe custody of source code of application software and data files.
Auditor should document his audit plan and also assessment of risks as per AAS 6 and design audit procedures to reduce the audit risk.

Notes:

Only selected AAS are covered here considering their pervasive importance and applicability.
All AAS should be read with reference to the "Preface to the Statements on Standard Auditing Practices". AAS are mandatory with respect to all attest engagements carried out by the members. Any audit not done in accordance with the AAS, the auditor draws attention to material departures there from in his report.
Points covered in one AAS but are otherwise covered in detail in another AAS are ignored in the first one.
Detailed definitions should be read from the AAS.
Subjects of AAS that are covered by an AS are not produced here.
For a detailed illustrative check lists on AAS and AS refer the Society's publication Audit Checklists for Companies.

AAS 33: Engagements to review financial statements

This Standard provides guidance to the auditor's professional responsibilities, the formats and contents for a review of financial statements.
Auditor needs to comply with the code of ethics prescribed by the Institute of Chartered Accountants of India.
The procedures for a review shall be governed by the requirements of this Standard, the relevant laws and regulations governing the entity and where appropriate the terms of the review engagement and its reporting requirements.
The auditor must plan the work for an effective review by way of obtaining or updating knowledge of the client businesses, accounting and operating systems etc. Important matters of review should be documented including making inquiries on matters subsequent the balance sheet dates that may require adjustment or disclosures in the financial statements.
Review reports wherever possible to quantify the matters that impair the true and fair view with either express a negative assurances or adverse statements on the financial statements. Limitation of scope must be specified by way of qualification or negative assurances when such limitations are significant in nature. The date of review report must not be a date when the financial statements are signed or approved by the management. Review reports must include performing procedures relating to events occurring up to date of signing of the report.