Bachelor of Commerce

BC - 505

AUDITING

Directorate of Distance Education

Guru Jambheshwar University of Science & Technology, HISAR-125001

Contents

Subject: Auditing	
Course Code: BC-505	**Author:** Mr. Kapil Singh
Lesson No.: 01	**Vetter:** Prof. M.C. Garg
INTRODUCTION TO AUDITING	

Structure

1.0 Learning Objectives

After reading this lesson, you will be able:

- To know evolution of auditing
- To understand auditing and its objectives
- To explain the utility and types of audit
- To know the main principles and postulates
- To understand the techniques of auditing

1.1 Introduction

The word 'auditing' has been derived from Latin word 'audire' which means to hear. Traditionally auditing can be understood as an examination of accounting records undertaken with a view to establishing whether they completely reflect the transactions correctly for the related purpose. In addition the auditor also expresses his opinion on the character of the statements of accounts prepared from the accounting records so examined as to whether they portray a true and fair picture. Auditing is a vital part of accounting. Traditionally, audits were mainly associated with gaining information about financial systems and the financial records of a company or a business.

In the field of auditing, first revolution came about in the year 1844 when in England, through the Companies Act, the preparation of a balance sheet by companies and getting the same audited was given legal recognition. In India, the history of auditing begins from 1st April, 1914 when Companies Act, 1913 came into force. This act made it compulsory for every company to get its yearly accounts audited and also spelt out the qualifications of a person to become an auditor. It also empowered all the State Governments to issue certificates of eligibility for appointment as auditors to persons who possessed complete knowledge of the double entry system. In 1949 on the recommendation of 'Accountancy Expert Committee' government passed Chartered Accountants Act, 1949. Under this act, the Institute of Chartered Accountants of India was formed. Thereafter, in order to become an auditor, a person had to be a member of the Institute and could get a certificate of Chartered Accountant only after clearing the examination conducted by the Institute.

Financial audits are performed to ascertain the validity and reliability of information, as well as to provide an assessment of a system's internal control. The goal of an audit is to express an opinion, under evaluation based on work done on a test basis. An audit must adhere to generally accepted standards established by governing bodies. These standards assure third parties or external users that they can rely upon the auditor's opinion on the fairness of financial statements, or other subjects on which the auditor expresses an opinion.

1.2 Evolution of Auditing

During the 18th century industrial revolution brought in large scale production, steam power, improved facilities and better means of communication. This resulted in the origin of Joint stock form of organizations. Shareholders contribute capital of these companies but do not have control over the day to day working of the organization. The shareholders who have invested their money would naturally be interested in knowing the financial position of the company. This originated the need of an independent person who would check the accounts and report the shareholders on the accuracy of the accounts and the safety of their investment.

The **Indian Companies Act, 1913** defined the qualification, power, duties and procedure of appointment of the Auditor. The audit of Joint Stock Company made compulsory by this Act. In the year **1949, Chartered Accountants Act** was passed. Companies' act 1956 further elaborated the provisions related to the auditing and accounts of the companies. Now a person to do the auditing must be qualified as per the standards of the Institute of Chartered Accountants of India. The concept and technique of audit has undergone a major change during the last fifty years. Before India became independent, the government audit was mostly confined to check against provision of funds, rules and orders and competence of authority concerned to sanction expenditure. With the launching of the Five Year Plans for economic and social development there has been change in the pattern of government expenditure necessitating shift in the emphasis, concept and practice of audit as scrutiny of individual transactions became inadequate as it tended to mistake woods for the trees.

Factors such as the volume of transactions, information technology, globalization and the constant increase in the complexity and number of laws, regulations and standards governing entities and their auditors have all impacted drastically on the evolving role of the registered auditing profession. The corporate collapses, business failures and fraudulent financial reporting scandals of the late 1990s and early 2000s led to a very turbulent time and resulted in a credibility crisis for the auditing profession. The period 2000 through 2006 has been a very unstable time for the auditing profession due to various scams and frauds. Long-held attitudes and customary practices have been challenged and found to be deficient by the media, the investing public, and those charged with regulating financial reporting and auditing. Issues of auditor independence, the role of corporate governance, the responsibilities of management, the appropriateness of consulting services, and the overall professional obligations of auditors have all been discussed and debated by a broad array of interested groups and individuals. As a result, this period has probably resulted in more substantive changes to the auditing profession than any other period in modern day business history.

Many of the business failures were also seen as audit failures, and the auditing profession stood accused of not performing its 'watchdog function' effectively and with objectivity. The response by governments and regulators to the corporate collapses and perceived audit failures gave rise to various new statutory requirements, regulations and standards that were aimed at strengthening the auditors' independence and improving the quality of their work. The As a result, the International Federation of Accountants (IFAC) issued new auditing standards that introduced a new risk-based audit methodology and more stringent documentation and reporting requirements. Over the past few years, much attention has been paid to the issue of global harmonization of generally accepted accounting principles while, at the same time, a much quieter revolution has been taking place in Generally Accepted Auditing Standards (GAAS). Indian Accounting Standards, (abbreviated as India AS) are a set of accounting standards notified by the Ministry of Corporate Affairs which are converged with International Financial Reporting Standards (IFRS). These accounting standards are formulated by Accounting Standards Board of Institute of Chartered Accountants of India. Now India will have two sets of accounting standards viz. existing accounting standards under Companies (Accounting Standard) Rules, 2006 and IFRS converged Indian Accounting Standards (Ind AS). The Ind AS are named and numbered in the same way as the corresponding IFRS. National Advisory Committee on Accounting Standards (NACAS) recommends these standards to the Ministry of Corporate Affairs. The Ministry of Corporate Affairs has to spell out the accounting standards applicable for companies in India. As on date the Ministry of Corporate Affairs notified 35 Indian Accounting Standards (Ind AS). But it has not notified the date of implementation of the same.

1.2.1 Auditing

The simple meaning of an **audit** is an evaluation of a person, organization, system, process, enterprise, project or product. An examination and verification of a company's financial and accounting records and supporting documents by a professional, such as a Certified Public Accountant is called auditing.

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

According to **Institute of Chartered Accountants of India (ICAI)**, "Auditing is the independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon".

Speicer 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".

1.2.2 Who is an auditor?

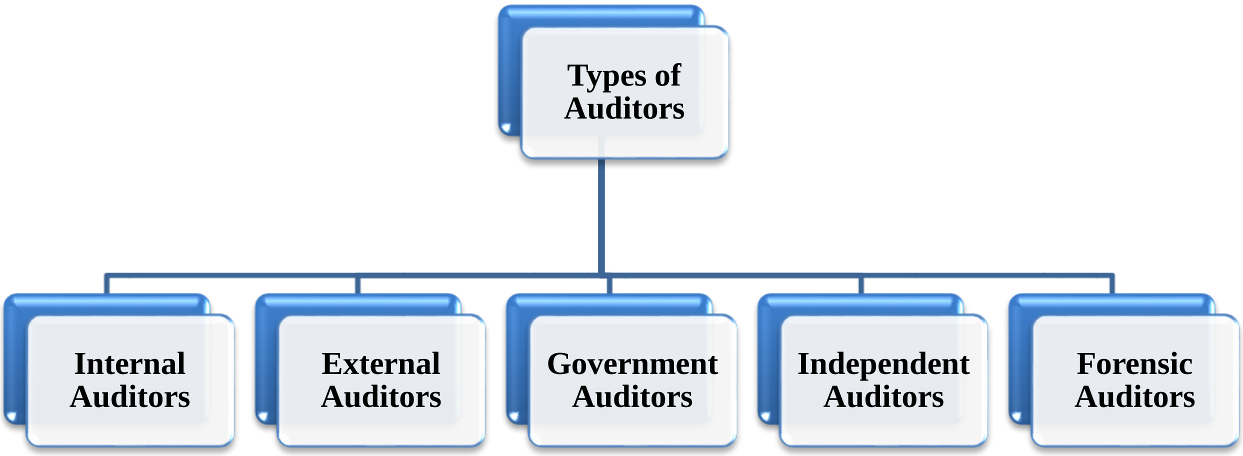
An official whose job it is to carefully check the accuracy of business records is called an auditor. An auditor can be either an independent auditor unaffiliated with the company being audited or a captive auditor, and some are elected public officials. The term is sometimes synonymous with "comptroller." Auditors are used to ensure that organizations are maintaining accurate and honest financial records and statements.

1.2.3 Qualities of an Auditor : The followings are the main qualities of an Auditor:

- **Required Qualification-**The first quality of an Auditor is the qualification. He/she must possess the required qualification as decided by The Institute of Chartered Accountants of India (ICAI) or Central Government time to time.
- **Complete Knowledge of Nature and Objectives of a Business-**An Auditor must have the complete and comprehensive knowledge of nature and objectives of all the aspects of the business, whose accounts has to be audited. It will help in the commencement of audit and during the audit process.
- **Knowledge of Accountancy-**Accountancy provide the complete rules and regulations/techniques about how the accounts of business concern will be prepared. So Auditor have the knowledge of these techniques. In the absence of these techniques auditor will be unable to find out the true and fair view of the business.
- **Knowledge of Various Law-**An Auditor must have complete knowledge of various law prevailing in the country. Some of them are as follows:
    - The Companies Act, 2013
    - The Partnership Act, 1932
    - The Income Tax Act, 1961
    - Goods & Services Act, 2017
    - The Contract Act, 1872
    - The Negotiable Instrument Act, 1881
- **Expert in the field of Auditing-**Auditor must have the required expertize in the field of auditing. It will be achieved through complete knowledge and actual practice of the knowledge in the businesses.
- **Diligent and Vigilant-**While doing their work of auditing an Auditor should be hard worker. Errors and frauds can be in any transaction so he must be vigilant and clever to detect the errors and how to rectify all the errors.
- **Unbiased and honest-**An Auditor must perform their duties as per the law, he should not be influenced by any person. He must be honest to their duties and state all matters in true and fair spirit. He should give the true view of the business to the owner of the business.
- **Fearless-**Auditor have to do their duties in a fearless manner. He should not hide any error and fraud in the pressure. So he must be fearless.

1.2.4 Types of Auditors

Auditors may be classified into the following categories:



- **Internal Auditors-**Internal auditors are employed by the organizations they audit. These auditors may review employee performance, compliance with company regulations and financial and accounting systems. Internal auditors allow company leaders to be informed of what is happening within the company and to address issues or concerns early.
- **External Auditors-**External audit is the inspection of the books of accounts of an organisation by an independent and qualified chartered accountant or a certified auditor. The auditor is not related personally in any manner to the organisation and is free to define the procedures and work independently, and is paid a free determined fee for his services. They give their report to the concerned management. This audit is also known as 'independent audit'.
- **Government Auditors-**Government auditors review the finances and practices of federal agencies. These auditors work for the U.S. Government Accountability Office. Auditors in this office report their findings to Congress, which uses them to create and manage policies and budgets. In addition, most state governments have similar departments to audit state and municipal agencies.
- **Independent Auditors-**Independent auditors do not work for the government or the organization being audited. These auditors review the financial statements of a company, municipality, agency or district to determine if the statements and reports are accurate and fair. Independent auditors help prevent organizations from releasing misleading financial information.

- **Forensic Auditors**-Forensic auditors specialize in crimes and are used by law enforcement organizations when financial documents are involved in a crime. This does not necessarily mean the crime was financial (although this can be the case) but rather that the law enforcement organization needs to track money used to find out where it began or ended up.

1.2.4 Difference between Accounting and Auditing

The following are the main differences between accounting and auditing:

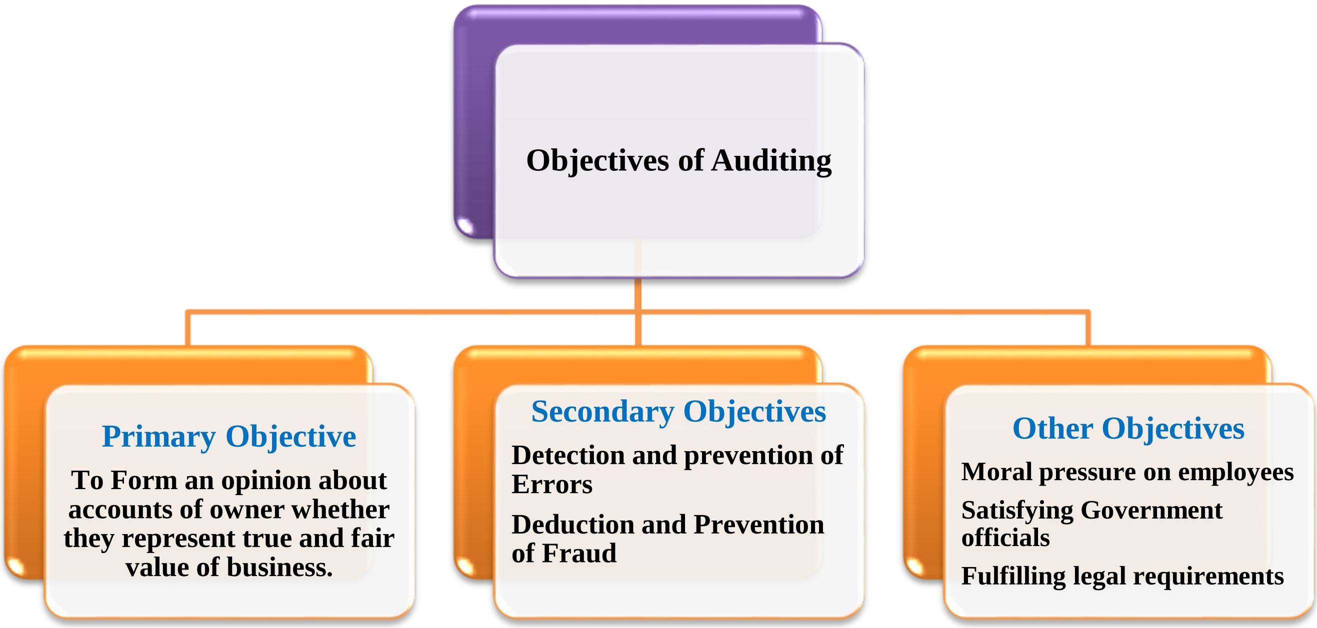
Sr. No.	Basis of Difference	Accounting	Auditing
1	**Meaning**	Accounting means the maintaining of the books of accounts such as Trading & P& L A/c and Balance Sheet.	Auditing means examining the books of accounts and to report about their accuracy.
2	**Object**	Accounting has an object of finding out the results of the business and to explain the financial position of the business.	The object of accounting is to explain the correctness and truthfulness of the accounts and balance sheet.
3	**Start and ends**	Accounting starts where book keeping ends.	Auditing starts where accounting ends.
4	**Job performance**	Accounting job is performed by the Accountant.	Auditing job is performed by the Auditor.
5	**Qualification**	For the accountant no specific qualification is required.	For the auditor specific qualification is required.
6	**Responsibility**	Accountant responsibility is fixed by the management.	Auditor responsibility is fixed by law.
7	**Record/Data**	Accounting is related with the present record.	Auditing is related with the past record.
8	**Evaluation**	The accountant cannot determine	Auditor also cannot determine

		the efficiency of its own function.	the efficiency of its own function but he can determine the efficiency of all the business.
9	**Methods**	Accounts use the method of valuation and depreciation.	The auditor uses manual and computerized method.
10	**Knowledge**	Accountant must have the knowledge of accountancy.	Auditor must have the knowledge of accounting as well as auditing.

1.2.5 Objectives of Auditing

The following are the objectives of auditing:

- **Primary Objectives-**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 Objectives-**The following objectives are incidental to the main objective of auditing.
  - **Detection and prevention of errors:** errors are mistakes committed unintentionally because of ignorance, carelessness. Errors are of many types:
    - **Errors of Omission:** These are the errors which arise on account of transaction into being recorded in the books of accounts either wholly or 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.



- **Errors of Commission:** When incorrect entries are made in the books of accounts either wholly or partially such errors are known as errors of commission. Wrong entries, wrong calculations, postings, carry forwards etc. can be located while verifying.
- **Compensating Errors:** When two/more mistakes are committed which counter balances each other are compensating errors. . If the amount is wrongly debited by Rs 100 less and Wrongly Credited by Rs 100 such a mistake is known as compensating error.
- **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. Example, Revenue expenditure may be treated as Capital Expenditure.
- **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.

- Check the trial balance.

- Compare list of debtors and creditors with the trial balance.
- Compare the names of account appearing in the ledger with the names of accounting in the trial balance.
- Check the total and balances of all accounts and see that they have been properly shown in the trial balance.
- Check the posting of entries from various books into ledger.

- **Detection 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 three types.

- **Misappropriation of Cash:** This is one of the major fraud 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. Cash can also be misappropriated by showing fewer receipts. 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.

- **Misappropriation of Goods:** Here records may be made for the goods not purchased or 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.
- **Manipulation of Accounts:** this is finalizing accounts with the intention of misleading others. This is also known as "Window Dressing". It is very difficult to locate because it is usually committed by higher level management such as directors. The objective of window dressing may be to evade tax, to borrow money from bank, to increase the share price etc. To conclude, it can 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 probe it to the full.

➢ **Other objectives**

- **Moral pressure on employees:** When the employees are aware of the fact that their work shall be examined by an independent person, it works as an indirect pressure on them and hence they work with much greater regularity, efficiency and caution. They don't do any wrong deed or commit negligence in their work. As a result possibility of frauds and errors is reduced by itself.
- **Satisfying Government officials:** Legally, it is not mandatory for a sole proprietorship concern and a partnership firm to get their books of accounts audited, with the main aim of preventing arbitrary assessment of tax by the tax authorities.
- **Fulfilling legal requirements:** It has been made legally mandatory for certain kinds of organisations to get their books of accounts audited, such as public trusts, companies, insurance companies etc. For such organisations it is necessary to comply with the requirements in relation to audit as specified in the relevant legal enactment.

1.2.6 Scope of Auditing

The scope and procedures of audit for a particular organization will be determined by the auditor on the basis of the terms of engagement, the requirement of relevant legal formalities and the pronouncement of the Institute. The term of engagement cannot, however, in any way reduce the scope and procedures of audit which are prescribed by the legal provisions or by the pronouncement of the Institute. To express an opinion on the financial statements of an organization, the auditor should satisfy himself first whether the information contained in the given accounting records is authentic, reliable and adequate as a basis for the preparation of the financial statements. The audit procedure should be designed in such a manner to cover sufficiently all aspects of the organization as far as they are relevant to the financial statements. In forming his opinion, the auditor should also decide whether the relevant information is properly disclosed in the financial statements on the basis of its statutory requirements. The principal areas to be covered in an audit include the following:

- **Accounting and internal control:** An examination of the system of accounting and internal control to ascertain whether it is adequate and appropriate for the concerned organization or not.
- **Arithmetical accuracy:** An overall checking of the arithmetical accuracy of the books of accounts by the method of posting, casting and balancing procedures.
- **Authenticity of transactions:** A proper verification of the validity and authenticity of the transactions entered into by checking the entries with the supporting documents.

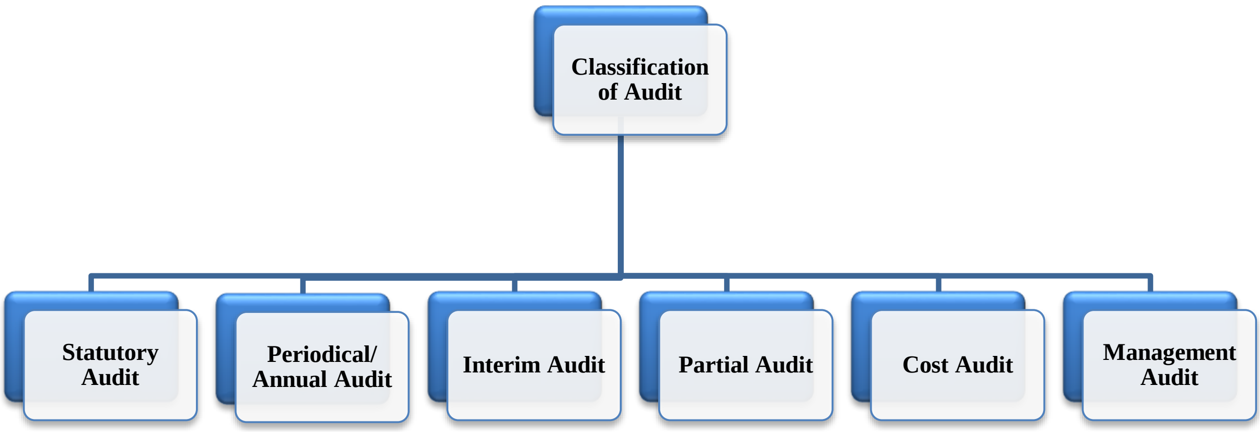
- **Distinction between capital and revenue items:** An effective scrutiny over the distinction between the items of capital and of revenue nature of income and expenditure correspond to the accounting period.
- **Verification of assets:** A detailed verification of the ownership, existence and value of the assets appearing in the balance sheet.
- **Verification of liabilities:** A proper verification of the liabilities of the organization as stated in the balance sheet.
- **Comparison of the financial statements:** A comparison of the Balance Sheet and Profit and Loss Account or other statements with the available records in order to see that they are in accordance therewith.
- **Truth and fairness of financial statements:** An effective checking of the results as shown by the profit and loss account to see that the results shown are true and fair.
- **Statutory requirements:** A concrete confirmation about the fulfillment of the statutory requirements and legal formalities in recording the financial transactions and in preparing the financial statements.
- **Appropriate reporting:** An appropriate reporting to the concerned persons to explain whether the statements of accounts examined do reveal a true and fair view of the state of affairs and of the profit and loss of the organization.

1.2.7 Classification of Audit

The classification of the audit is as under:

- **Statutory Audit:** Any audit carried on as per the requirement of law is called as a statutory audit. It is legally mandatory for such organisations established under various acts. In such audit, the scope of the audit, qualifications and disqualifications, rights and responsibilities are usually specified in that particular act. All joint stock companies have to get their accounts audited as per the provision of the Companies Act of 1956.

- **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.
- **Interim Audit:** It is an audit conducted in the middle of the accounting year before the accounts are closed. In other words any audit conducted between two financial audits is known as interim audit. The objective is to get periodical results, to declare interim dividend, to make decisions about the expansion of the business.



- **Partial Audit:** When an auditor is asked to audit only a part of the account system. It's called partial audit. When auditor is asked to audit only the payment side of cash book. It is resorted to achieve a particular target.
- **Balance Sheet Audit:** It is 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. In fact while verifying Balance Sheet items the auditor verifies/ checks all related items/accounts.
- **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 in case of specifies companies.
- **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 management are fulfilled. It aims to ascertain whether sound mgt prevails throughout the organisation and evaluates its efficiency in the system of its operation.

- **Continuous Audit:** A continuous audit is one in which the auditor visits his client's office at regular intervals throughout the year to verify the account. It starts at the beginning of the financial year and goes on till the end of the year. The objective of continuous audit may be-
  - To get final account audited immediately after the closure of accounting year.
  - When the business is very large.
  - When interval control system is into effective.
  - When regular final accounts are required.

1.2.8 Utility of Auditing

- Audited accounts are detected as an authentic record of transaction.
- Errors and frauds are detected and rectified.
- It increases the morale of the staff and thus it prevents frauds and errors.
- Because of his expertise the auditor may advise on various matters to his clients.
- An auditor acts as a trustee of his shareholders. Hence he safeguards their financial interest.
- For taxation purpose auditing of account is a must.
- In case of any claim is to be made from the insurance company only audited account should be submitted.
- Even in case of partnership firm auditing of accounts helps in the settlement of claim at the time of retirement/death of a partner.
- Auditor account helps in managerial decisions.
- Useful to secure loan at the time of amalgamation, absorption, reconstruction etc.
- Auditing safeguards the interest of owners, creditors, investors, and workers.
- It is useful to take certain financial decisions like issuing of shares, payment of dividend etc.
- To determine the value of the business in the event of purchase or sales of the business, audited account will be the treated as the base for the evaluation.
- If the accounts have been audited by an independent person, disputes between the management and labour unions on payment of bonus and higher wages can be settled amicably.

- In case of joint Stock Company where ownership is separated from management, audit of accounts ensure the shareholders that accounts have been properly maintained, funds are utilized for the right purpose and the management have not taken any undue advantage of their position.

1.2.9 Limitations of Auditing

Truly speaking, an audit should have no limitations of its own. It is designed to protect the interest of all parties who are interested in the affairs of the business. If there be any shortcoming arising there from, it may be due to its narrow scope of application in its related field of operation and unexpended definition of the concept. Auditing suffers from the following shortcomings:

- **Want of complete picture:** The audit may not give complete picture. If the accounts are prepared with the intention to defraud others, auditor may not be able to detect them.
- **Problems of dependence:** Sometimes the auditor has to depend on explanations, clarification and information from staff and the client. He may or may not get correct or complete information.
- **Post-mortem examination:** Auditing is a post-mortem examination. There is no use of such examination when events have already been occurred.
- **Existence of errors in the audited accounts:** It is not possible for the auditor in all cases, to check each and every transaction of an organisation. As a result, there may be error in the audited accounts even after the checking by the auditor.
- **Lack of expertise:** Auditor has to seek opinion of experts on certain matters on which he may not have expert's knowledge. The auditor has to depend upon such reports which may not always be correct.
- **Diversified situations:** Auditing is considered to be a mechanical work. Auditors may not be in a position to frame audit programme, which can be followed in all situations.
- **Quality of the auditor:** Success of audit depends on the sincerity with which the auditor has performed his duties. The same audit work can be done by two different auditors with difference in sincerity.

- **Existence of defective policies:** The auditor can only report on the truth and fairness of the financial statements. But other defects, i.e. defects relating to management and control may not be possible to be covered by the auditor.

1.3 Postulates of Auditing

Auditing postulates are matters which are assumed to be true and are taken for granted. It is often considered that it is useful to examine a discipline and to see what, if any, are its postulates. This was done by Mautz and Sharaf in their book *The Philosophy of Auditing* in 1961. Their eight postulates are given below:

- **Financial Statements and Financial Data are Verifiable**
- **There is no Conflict of Interest between the Auditor and the Management of the Entity**
- **The Financial Statements are free from Collusive and other Unusual Irregularities**
- **The Existence of a Satisfactory System of internal Control Eliminates the Probability of Irregularities**
- **Consistent application of generally accepted accounting principles results in fair presentation of the results and positions**
- **In absence of clear evidence to the contrary, what has held true in the past for the entity will hold true in the future**
- **When Examining Financial data, the Auditor acts exclusively in the Capacity of Auditor**
- **The Professional Status of an Independent Auditor Imposes Commensurate Professional obligations**

- **Financial Statements and Financial Data are Verifiable-**This is an unspoken assumption by all auditors who otherwise would not attempt to verify the assertions in the accounts they are auditing. Sometimes facts are not strictly verifiable and auditors content themselves with statements of the circumstances, which can be verified.

- **There is no Conflict of Interest between the Auditor and the Management of the Entity-**If this was not so, auditors would not believe the answers given to their questions and, given the complexity of modern businesses, would find conducting an audit impossible. It is this basic assumption which leads auditors to consider whether they should accept a new client where the integrity of the client is suspected.
- **The Financial Statements are free from Collusive and other Unusual Irregularities-**Auditors are expected to uncover material mis-statements in financial statements caused by fraud or other irregularities but collusive fraud is often impossible to discover by auditing procedures. If there were a requirement to uncover such frauds the audit would become impossible or, at the least, require many more detailed and expensive procedures than are currently performed.
- **The Existence of a Satisfactory System of internal Control Eliminates the Probability of Irregularities-**Auditors are entitled to rely on satisfactory internal controls as evidence of many assertions. If this postulate was not a fundamental principle of auditing they would not do so. Regardless of the assessed level of risk, auditors should perform some substantive procedures for financial statements assertions of material account balances and transaction classes.
- **Consistent application of generally accepted accounting principles results in fair presentation of the results and positions-**Auditors need some criterion for their assessment of the fairness of the view given by financial statements and the GAAPs supply it. Otherwise there would be no standard by which fairness could be judged.
- **In absence of clear evidence to the contrary, what has held true in the past for the entity will hold true in the future-**If this were not so the auditor would be unable to accept the value of debts, the value of fixed assets, and the salability of stock, the effectiveness of internal controls, the integrity of management and many other matters.
- **When Examining Financial data, the Auditor acts exclusively in the Capacity of Auditor-**This is tied up with notions like independence, useful economic function and social responsibility to the public. This postulate is fundamental and yet the necessary independence of mind is still a difficult problem for many auditors.
- **The Professional Status of an Independent Auditor Imposes Commensurate Professional obligations-**This means that members of the professions have higher duties than economic self-

interest. However, it is not always clear to whom professional duties are owed. Are they to the public at large, to the client company or the shareholders? However, it is certain that the professional accounting bodies impose very onerous duties on their members.

1.3.1 Basic Principle Governing an Audit

Fundamental principles are those according to which the books of business accounts are audited. These principles can be changed according the desire of the auditor.

- **Ethical Conduct:** Ethical Conduct is foundation of professionalism, which flows from the trust, integrity, confidentiality, and discretion of the auditor.
- **Fair Presentation**: It is the obligation of the auditor to report truthfully and accurately the audit findings, audit conclusions and audit reports. He should also correctly report significant obstacles encountered during the audit; as well as, unresolved or diverging opinions between the audit team and auditee.
- **Due Professional Care:** An auditor should use due professional care by the application of diligence and judgment while auditing. Auditors should exercise care in accordance with the importance of the task and confidence placed in them by the audit clients; having necessary competence is an important prerequisite.
- **Independence:** Independence is the basis for the impartiality and objectivity of the audit conclusions. Auditors must therefore be independent of the activity being audited, and be free from bias and conflict of interest. Auditors must maintain an objective state of mind throughout the audit process, to ensure that the findings and conclusions will be based only on evidence.
- **Evidence**: Evidence is the rational basis for reaching reliable and reproducible audit conclusions. Audit evidence must be verifiable. It must be based on the sample of information available. Samples should therefore be appropriately representative, since confidence that can be placed in the audit conclusions is closely related to the samples.
- **Working Paper Presentation**: The auditor collect documents providing evidence that audit was carried out according the principles. The auditor prepares the working paper and kept in this custody as a proof.
- **Systematic and Qualitative:** An activity can be systematic only if it is performed in a formal way. Audit should therefore be planned and carried out in accordance with defined and documented

procedures, using a check list and complete with formal reports and records. Quality audits must be carried out by people who are independent of the activity or process being audited so as to reduce the bias. Auditors therefore should not audit their own work, and as for as possible the area / department in which they are working.

- **Submission of Report:** According the principle of auditing a report will be prepared by the auditor at the end. It may be conditional or unconditional. The auditor can draw conclusion and disclose the facts and figures about the business for general information.

1.3.2 Techniques of Auditing

Auditing technique is defined as any technique used by auditors to determine deviations from actual accounting and controls established by a business or organization as well as uncovering problems in established processes and controls. Auditing techniques can be used to aid organizations by uncovering errors in business practices and providing a means of correction. Some businesses have used irregular accounting methods to hide certain monetary transactions and non-compliant behavior which has been uncovered by the use of varied auditing techniques. Other businesses have found new ways to save money and streamline business practices through various auditing techniques which have found waste in certain processes. Auditing techniques can be used to uncover these issues in order to ensure ethical business practices and to minimize waste or possible oversights within an organization. The applied techniques can determine if any income is hidden or improperly categorized or reported; transactions are being completed between the organization and regulated or prohibited persons, groups, or countries; uncovering of environmental waste discrepancies; finding of data inconsistencies; or any other business practice that can be considered as a process error, oversight, or violation of ethics, regulations, and laws.

- **Examination of Record:** This technique is commonly used by the auditors; the inspection of books and documents is made to verify the validity of data.

- **Inquiry:** The auditor can also use the technique of inquiry. He can get the information from resource persons inside or outside the enterprise.

- **Sampling:** Auditor can select few items from whole accounting information. This technique enables the auditor to obtain and evaluate the evidence of some characteristics of the whole class. It is helpful in forming the conclusion.

- **Confirmation:** To ensure the accuracy of the data auditor can collect the information from the debtor. Confirmation is response to an inquiry to prove certain data recorded in the books.
- **Compliance:** To check the arithmetical accuracy of accounting record, the balancing accounts can be compared with the vouchers to test the reliability of data.
- **Compliance Test:** These tests are designed to check the effectiveness and compliance of internal control. In obtaining the audit evidence, auditor is concerned with the existence of effective internal control.
- **Use of Computer Techniques:** There are large numbers of audit techniques like audit software, test packs and mapping which can be used by the auditor to test the accuracy of the data.
- **Substantive Test:** There are designed to obtain evidence that data produced by accounting system is accurate or not. It has two kinds :
  - Test of detail transaction.
  - Test of significant ratios and trends.
- **Dependence on Experts and Auditors:** The auditor has to rely on the internal and other auditors to complete his work. He has also to rely on other experts like lawyers, engineers and doctors for their expert opinion about the business.
- **Analytical Review:** It consists of studying significant ratios, trends and investigating different changes. This review procedure is based on the expectations of relationship among the past and present data.

1.4 Check Your Progress

1. The word 'auditing' has been derived from Latin word………?
   (a) Audio
   (b) Audire
   (c) Both a & b
   (d) None of the above
2. Which one not included in the scope of Auditing?
   (a) Accounting and internal control

(b) **Authenticity of transactions**

(c) **Verification of assets** and liabilities

(d) None of the above

3. Which one is the primary objective of an auditor ……..?

(a) To express the opinion whether account exhibits true and fair view of the state of affairs of the business.

(b) Detection and prevention of errors,

(c) Deduction and Prevention of Fraud

(d) All of the above

4. Auditing suffers from which one of shortcoming?

(a) **Post-mortem examination**

(b) **Problems of dependence**

(c) **Lack of expertise**

(d) All of the above

5. Basic principle governing an audit includes:

(a) Ethical Conduct.

(b) Fair Presentation.

(c) Due Professional Care.

(d) All of the above

6. Auditing postulates includes:

(a) **The Financial Statements are free from Collusive and other Unusual Irregularities**.

(b) **There is no Conflict of Interest between the Auditor and the Management of the Entity**.

(c) **Financial Statements and Financial Data are Verifiable**.

(d) All of the above

1.5 Summary

The word 'auditing' has been derived from Latin word 'audire' which means to hear. Traditionally auditing can be understood as an examination of accounting records undertaken with a view to establishing whether they completely reflect the transactions correctly for the related purpose. In addition the auditor also expresses his opinion on the character of the statements of accounts prepared from the accounting records so examined as to whether they portray a true and fair picture. Auditing is a vital part of accounting. The goal of an audit is to express an opinion, under evaluation based on work done on a test basis. An audit must adhere to generally accepted standards established by governing bodies. It is important that during an audit all necessary information is relayed through the financial statements and footnotes. Accounting principles refer to the alternative ways of relaying this information. There are a number of ethical matters that are extremely important for auditors to consider when performing their work. It is vital to the public image and credibility of the profession that the auditor is seen to be behaving in an acceptable manner in addition to actually complying with the ethical requirements. It is important to recognize that many groups in society rely on accountant's work, not just the shareholders on whose behalf the accountant is working. The accountant therefore has a public accountability. On the other hand, auditing techniques can be used to uncover these issues in order to ensure ethical business practices and to minimize waste or possible oversights within an organization.

1.6 Keywords

- **External Audit**: It is the inspection of books of account of an organization by an independent and qualified chartered accountant.
- **Partial Audit:** When an auditor is asked to audit only a part of the account system. It’s called partial audit.
- **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.
- **Generally Accepted Auditing Standards (GAA**S)-These are set of systematic guidelines/rules used by auditors when they audit the records of a company.
- **International Financial Reporting Standards (IFRS)-**These are the rules through which consistency, transparency and reliability comes in the financial statement in the whole world.
- **Forensic Auditors**-Forensic auditors specialize in crimes and are used by law enforcement organizations when financial documents are involved in a crime.
- **Auditing Postulates**: These are matters which are assumed to be true and are taken for granted.

- **Audit Program**: A detailed plan of work prepared by the auditor for the supervision and control of his assistant.
- **Compliance Test**: It is designed to check the effectiveness and compliance of internal control.

1.7 Self-Assessment Test

Q.1 What do you understand by the term auditing? Explain objectives of auditing.

Q.2 What are the principles of auditing? Explain the different postulates of auditing.

Q.3 Explain the different techniques of auditing.

Q.4 Who is an auditor? Explain the different types of auditors.

Q.5 What are different types of audit? Discuss the basic principles of auditing.

Q.6 Write Notes on

a) Utility of auditing

b) Evolution of Auditing in India

c) Audit techniques

d) Statutory and Continuous audit

e) Limitations of auditing

f) Qualities of an Auditor

1.8 Answers to Check Your Progress

1(b), 2 (d), 3(a), 4 (d), 5(d), 6 (d)

1.9 References/Suggested Readings

- **Basu, S.K**., "Fundamental of Auditing" Pearson Publication, New Delhi.
- **Tandon, B. N., S. Sudharsanam, and S. Sundharabahu**, "*A Handbook of Practical Auditing",* S. Chand and Co. Ltd., New Delhi.
- **Pagare, Dinkar**, "*Principles and Practice of Auditing",* Sultan Chand and Sons, New Delhi.

- **Institute of Chartered Accountants of India**, ‘‘*Auditing and Assurance Standards*’’, ICAI, New Delhi.
- **Gupta Kamal, and Ashok Arora**, “*Fundamentals of Auditing*,” Tata Mc-Graw Hill Publishing Co. Ltd., New Delhi.

Subject: Auditing	
Course Code: BC-505	**Author:** Mr. Kapil Singh
Lesson No.: 02	**Vetter:** Prof. M.C. Garg
AUDIT PLANNING AND AUDIT PROCESS	

Structure

2.0 Learning Objectives

After reading this lesson, you will be able

- To know about audit planning and its objectives
- To explain the process of audit planning
- To know about audit memorandum and steps in audit process
- To explain the meaning of audit programme and audit notebook
- To know about arrangements with client

2.1 Introduction

Initial audit planning takes place before the detailed audit work begins, and in planning for a specific audit assignment an auditor must adopt a strategy with regard to the nature, timing and extent of the audit work to be carried out. The detailed audit work is commonly carried out by a team of audit staff with varying degrees of skill and experience. It is therefore imperative at the planning stage that careful consideration is given to the assignment of work to the members of the team so that individuals are not required to carry out audit tasks which are beyond their level of competence. Similarly, at the planning stage, due consideration should be given to the co-ordination of work to be carried out by experts or other auditors if appropriate.

Whilst the plan for each audit assignment is unique most audit firms adopt a common method of approach on each assignment with standard documentation and check lists to ensure a comprehensive audit plan. In formulating a documented plan the following matters need to be considered:

- Knowledge of the entity's business;
- Risk and materiality;
- Nature, timing and extent of audit procedures;
- Co-ordination, direction, supervision and review of the audit.

An audit plan should be viewed as a structured plan of action mapping out the audit procedures to be carried out with the aim of reporting on whether a specified set of accounts show a true and fair view. However, the fact that the audit assignment is the commercial activity of the audit firm should be recognized, and if the costs of carrying out the planned procedures are likely to exceed the client entities budgeted fee then this imbalance should be addressed at the planning stage by consultation with the management of the entity.

By its very nature the plan must be flexible and subject to change, dependent on the findings and events occurring during the audit process. Examples of findings or events which might lead to a revision to an audit plan include:

- Significant errors found in the processing of invoices through a sales accounting system. This could lead to a revision of the extent of testing and audit resources to be applied to the sales area of the accounts.
- Notification from the management of an entity that audited accounts are required at a date earlier than previously notified. This could lead to revision of the timing of audit procedures with a consequent increase in audit resources being allocated to the assignment.
- The revelation during the audit of the bank and cash area, of the existence of an additional bank account held by the entity but not previously notified to the auditor. This would lead to additional audit procedures being carried out in this area.

Planning is an integral part of the audit process. Whilst the audit procedures carried out on specified audits will vary depending on the nature, size and complexity of an entity's operations, good audit planning is crucial if an auditor wishes to ensure that an audit is carried out in an effective, efficient and timely manner.

2.2 Audit Planning

An audit plan is the specific guideline to be followed when conducting an internal or external audit. Internal audits are usually conducted by a company’s accounting staff and are primarily used for a management review of accounting processes. External audits are conducted by external public accounting firms or private certified public accountants (CPA) to ensure outside stakeholders that the company’s financial information is prepared in accordance with that jurisdiction's accepted accounting principles. External audits usually use a formal plan for auditors to follow.

Audit planning is defined as the process in which the strategy is designed to conduct the expected result which also defines the scope of audit inside the company. The size, nature and the time for the audit plan may vary. It depends on the size of the business. If the business is spread to the large scale, the strategy making and its implementation will take more time and also the overall scope of Audit plan may also increase. It is basically the step by step methodology where the audit in control reviews the financial process and the internal environment along with the engagement preparation.

We can also say the audit plan as the designing of processes which will help to review the financial events. The aim of doing audit planning primarily to make the financial statement error free and secondly the time for reviewing or cross checking the financial events should be done in less time. Planning in audit facilitates the overall business and the most hectic job for rectifying the accounts will now be done in lesser time. Auditing is extremely important to any organization. It is critical to uncovering issues within business operations and defines a procedure for quality improvement within the departments and the whole organization. Benefits of Audit Planning include:

- Reduced time required to plan, conduct and document audits
- Confirmation that all stages of an audit are completed
- Scheduling of regular audits and alerting department or whole business
- Trends can be identified by studying historical performance
- Standardized checklists and worksheets can be printed off and used during audit
- Status reports of issues
- Helps to meet requirements of regulatory audits e.g. ISO 9000, ISO 14000, H&S etc.

2.2.1 Objectives of Audit Planning

Audit objectives are to be carefully considered and clearly stated. As a general rule, there should be a limited number of clear objectives for an audit. They must be defined in a way that will allow the audit team to reach conclusions about each objective. As audit efforts will be directed toward answering the questions raised in the objectives, they should be defined as precisely as possible to avoid unnecessary and expensive audit work. Any changes to the audit objectives, as well as the major considerations and rationale for such changes, should be brought to the attention of the top management.

The main objective of audit planning is to ensure appropriate attention is given to all areas of the audit. More attention should be devoted in auditing high risk of the entity. Low risk areas should be given less time to conserve resources.

Secondly planning is done to pick potential problems during audit such as weaknesses in the internal control system and may have material effects on the financial statements.

Finally planning is useful in ensuring proper coordination and allocation of financial resources during the audit by assigning highly and experienced staff to high risk and most important areas.

Proper planning facilitates efficient use of audit resources and effective carrying out of the audit. When planning is correctly done, audit team is likely to identify events, transactions and practices which may have material effects on the financial statements and subsequently the auditor's opinion.

2.2.2 Process of Audit Planning

The best way to plan for an audit is to understand the factors the auditors will examine. They include management control, risk exposure, compliance with regulations, internal and external reporting, organizational change and growth. An audit is an opportunity to organize the business and create procedures. A due diligence book, prepared for your audit, can be a good tool to obtain financing or for use in legal proceedings.

- **Management Control-**The board of directors and senior management must take full responsibility for the veracity and transparency of their corporate governance and financial reporting. This requires increased oversight by management that is supported by documentation. A good way to meet this requirement is through the use of board and management intranets and enterprise resource planning systems that track and organize all documents and written communication across the organization.
- **Risk Factors-**Examine the strengths, weaknesses, opportunities and threats inherent in your business activities and management to identify, explain and mitigate any risks you find. Document the entire process for the audit. If you produce a product that might cause health concerns through environmental pollution or faulty ingredients, that is a risk factor. A risk factor is anything your company does that can result in a lawsuit, bad publicity from attacks by special interest groups, business interruption by natural disasters or potential disruption through the death of a key employee.
- **Compliance and Reporting-**Detailed financial records, supported by cross-referencing to contracts or events, is a primary compliance requirement and one of the first things an auditor will request. Compliance also involves financial and regulatory reporting, including reports to the board of

directors, shareholders or other stakeholders, quarterly and annual tax reports and reports to governmental and licensing agencies.

- **Change and Growth-**Gather all your business planning documents, project management documents and marketing materials to substantiate any financial changes or new contracts. Auditors look for off-budget expenses or alternative sets of financial information, so it is important to keep your financials as transparent as possible with a strong paper trail of planning and implementation.

2.2.3 Arrangements with the Client

Public Company Accounting Oversight Board (PCAOB) rule says an accounting firm is not independent if, during the audit and professional engagement period, the firm or any affiliate of the firm provides any product or service to the audit client for a commission or contingent fee, or receives a commission or contingent fee from the audit client either directly or indirectly. Contingent fees often are associated with tax services. In a contingent fee arrangement, the client pays a fee only if a specific finding or result is attained, or the fee otherwise depends on the findings or results of the services. Because the parties both stand to gain in the “success” of the product or service, the PCAOB considers these types of fee arrangements to create inappropriate relationships between firms and their audit clients.

The rule prohibits both direct and indirect fee arrangements. When the client pays the auditor, it is a direct fee. A fee paid by anyone other than the client is an indirect fee. Currently, the rule exempts fees fixed by public authority acting in the public interest if the fees do not relate to findings or results of an accounting firm’s services. For example, a bankruptcy court may set the amount of the firm’s fees. The fees are not considered to be contingent because the court is acting in the public’s interest by prescribing the fees and the fees are not conditioned on any findings or results relating to the accountant’s services. As the firm has no influence in the determination of its fees, such an arrangement removes any mutuality of interests between the firm and the client.

2.3 Audit Memorandum

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

Audit memorandum is very useful in case of first time audit by the concerned auditor in an organization. While conducting his auditing work, the auditor requires certain information, which may be directly related with the method of operation of the business. If the auditor is not informed about the method of operation as well the operational activities of the organization, he will not be in a position to conduct his audit effectively. Hence audit memorandum is useful to the auditor while the auditor wants to relate the financial transactions with the business activities, with the condition of the business in which the transactions being activated.

Conducting an in-house audit or an independent audit for another company requires you to deal into the finances and physical assets of the business to in order to balance the tangible with the existing records. The final step in the audit process is the audit memorandum which summarizes each phase of the audit and gives your reader recommendations for changes that will improve the accuracy of the records and profitability of the company. Writing an audit memorandum requires in-depth knowledge of the business and the attention to detail required comparing records with reality. Audit memqorandum includes the following steps:

- Outline the financial results of the audit in your introduction. Explain to the reader whether the audit showed a higher or lower financial standing than the existing records.
- Write a summary of the physical audit of the inventory of the company. List the details of the inventory audit. Explain to the reader whether items were physically missing or whether there were more items than expected.
- Draft an outline of the existing book inventory recorded by the company and how it compares to your physical count. Refer back to your comparison between the books and the physical count. Explain where the bookkeeping needs improvement.
- Explain the financial difference between the physical and book inventories. A shortage on the physical count would mean that the company has fewer assets than previously thought. Excess goods mean a surplus that needs to be tracked in order to learn its origins to make sure it has been paid in full.
- Outline your audit of the ongoing contracts in which the company is currently engaged. Explain the financial ramifications of the outcome of each contract.

- Detail the labor audit with an explanation of work hours and productivity. Review the output of the company in relation to the workforce on a daily, weekly, monthly, quarterly and yearly basis for a complete look at productivity.
- Summarize the audit with a statement outlining the company's finances along with your recommendations for improvement. Explain to the reader where he can make improvements, which systems function perfectly and where massive overhauls must take place.

2.3.1 Audit Programme

An Auditing program is a detailed plan of work prepared by the auditor for the supervision and control of his assistant, before actually beginning audit. Hence, an audit programme is a systematic, detailed and written plan of the audit techniques to be adopted on the basis of which the auditor and his staff proceed with their auditing work.

2.3.1.1 Objectives of audit programme

An audit program is prepared with the following objectives:

- To complete the audit work within the specified time periods.
- Division of work among the assistants so that each person is aware of what he is supposed to do.
- Being aware of the progress of work done by employees.
- Removing the possibility of any work being left out.
- Firing the responsibility of employees.

2.3.1.2 Types of Audit Programs

Audit programme are of the following two kinds;

- **Standard Programme**: An audit programme based on a standard format is known as a standard auditing programme. This document is used uniformly in all audits, and there is no need for the auditor to prepare a separate audit programme for each audit. Such a programme is also referred to as a fined or predetermined or a planned programme. Such a programme may be suitably modifies in order to accommodate the specific problems of a particular business.
- **Tailor made Programme**: A tailor made programme is one which is prepared separately for each organization keeping in mind the nature of business nature of transactions, method of accounting,

efficiency of internal control etc. such a programme is more practical and flexible as compared to standard programme.

2.3.1.3 Essentials of a Good Audit Programme

The success of an efficient auditor depends lamely upon the audit programme; hence the auditor should formulate the audit programme very carefully. While preparing an audit programme the following things must be kept in mind;

- **Written:** The Auditing programme should always be in writing in order to avoid any misunderstandings between the auditor and his employees in the future. When there is a written audit programme the auditor’s staff need not enquire again and again about the work to be performed by them.
- **Clear:** While drafting the audit programme it should be ensured that it is simple and clear, so that every person concerned with the programme can understand it easily. Ambiguity in the programme results in hindrances in the audit work and waste of the time and efforts
- **Division of Work:** The audit programme should be in accordance with the departments in the organization so that work may be assigned and responsibility may be fixed among the staff on the same basis. While dividing the work the auditor should be completely aware of the level of competence of his staff, since only then will be able to assign work in accordance with the capabilities of the person. The division of work should be done keeping the business of the organization and various other aspects of the work to be done in mind, so that the work may be completed successfully and no part of the work escapes examination by the auditor.
- **Flexibility:** An audit programme should be flexible, so that in case of a change in circumstances. There is no problem in altering the programme. During the course of the audit some circumstances do arise due to which work cannot proceed according to the plan and minor deviation have to be made Hence the programme should be such that minor alternations can be made in it.
- **Object Oriented:** The audit programme should be in accordance with the objectives of the organization so as to maintain co-ordination in the work of the organization and complete the audit smoothly and within specified time. Unless the audit programme has these qualities, it is of no practical use.

- **Previous Reports:** While drafting the audit Programme the final accounts and auditors reports of past years should be looked into, since by doing so many facts which are important from the point of view of the audit will come to light.
- **Department – wise:** A separate audit programme should be prepared for each department and sub-department of the organization. A part from this different audit program should also be prepared depending upon the nature of work. For example, different audit programmes should be prepared for cash, purchases, sales, etc. By doing so one can obtain important information and explanations from the employees of the organization in a smooth manner.

2.3.1.4 Importance of an Audit Programme

The following are the advantages of having an audit program.

- **Distribution of work:** By making an audit programme , the auditor assigns work to his staff according to their abilities so that the work can be completed fast and well since a person who is adapt in his work does the work very quickly.
- **Fixation of Responsibility:** The responsibility of each employee is determined on the basis of the programme. Hence, every person does his work with a lot of caution and diligence since in case of there being an error, he shall be held responsible.
- **Evaluation of Progress:** The audit programme also functions as a kind of a progress chart. Due to there being a written programme, the auditor can assess the progress of the work being done by his employees from time to time. He can find out what all has been done and what still remains to be done.
- **Uniformity in Work**: The audit programme for a year can be prepared very easily by looking into the audit programme prepared for the past years. This has two benefits it ensures uniformity in the audit work, and it prevents unnecessary waste of time in formulating an audit programme from scratch.
- **Time Saving:** By working according to a predetermined plan, many of the problems that may crop up while doing the work are solved automatically. Hence, the unnecessary loss of time in thinking and understanding things can be saved.
- **Simultaneous Work in Different Business:** Many organizations can be audited simultaneously and efficiently since the audit programme makes it clear that what is to be done and how many people

and how much time is required for doing the same. This information makes it possible for the audit of several organizations simultaneously.

- **Complete Checking Possible:** By having a prior written programme, for the audit work, no field of examination remains untouched and hence the auditor is satisfied that a complete examination has been conducted.
- **Facilitate Control:** Having an audit Programme facilitates control over the audit work since the division of work and responsibilities are specified beforehand. This increases the efficiency of the audit staff and reduces the chance of negligence and error.

2.3.1.5 Disadvantage of an Audit Programme

The following are the main disadvantage of having an audit programme:

- As work of the audit is done completely according to the audit programme, the staff does the work mechanically which leads to monotony and the staff become negligent and inefficient in doing their work.
- The employees of the auditor have to work according to the audit programme. As a result, capable employees also lose their enthusiasm in doing the work.
- The detection of frauds even more difficult since doing so requires a very imaginative and through examination.
- Since the audit programme is formulated in advance, it becomes very difficult to make changes in it in accordance with changes in circumstances.
- The same kind of program cannot be applied to every business. It becomes necessary to change the audit programme in accordance with the structure of the business. Hence, the same audit programme cannot be used for every organization all the time.

2.3.1.6 Specimen of an Audit Programme

Type of Books	**Assistant's Sign**	**Time**	**Auditor's cost at hourly rate of the employee**
Cash Book • Cashing • Posting			

• Vouching • Bank Reconciliation Statement			
Sales Book • Costing • Posting • Vouching			
Purchase Book • Costing • Posting • Vouching			
Bill Register • Casting • Posting • Vouching			
Journal • Casting • Posting • Vouching			
Verification of Final Accounts			
Verification of Schedules			

2.3.2 Audit Note Book and Audit Working Papers

2.3.2.1 Audit Notebook

During the audit the auditor comes across a number of points on which clarifications may be required in the future or which may be useful in the future. The auditor cannot always remember all these things an hence, every auditor while conducting the audit , keep a notebook, known as the audit notebook for his personal use in which he records important information relating to the audit. Sometimes, the auditor records the important information on plain papers, and these are referred to as auditors. However, it is always better to maintain the information in a notebook. The auditor maintains a separate notebook for each organization, in which he records important fact about the organization and his comment on the same. This notebook is also helpful while auditing the same organization again.

2.3.2.2 Contents of Audit Notebook

It is very difficult to say anything conclusive about the contents of the audit notebook. It is prepared according to the requirements of the particular audit. However, the audit note book normally contains the following information.

- A brief description of all legal documents such as in the case of a company the ‘memorandum and articles of association, Minute books, contract etc.
- A Copy of the audit programme.
- An appropriate description of the actual work done during the audit.
- A description of all technical aspects and terminology use in the business.
- All suspicious which need to be solved or explained in the future.
- A list of the books of accounts being maintained.
- The name of all principal officers along with their duties and responsibilities.
- A list of vouchers, bills and other documents which have been lost.
- A brief description of all known frauds and errors.
- The total of all important amounts balances of important accounts.
- A brief description about guarantees and other important facts.
- All other important facts which may come in use in the future.
- The dates of the commencement and completion of the audit and the work assigned to the chief assistant and other subordinates.

- The dates of the commencement and completion of the audit and the work assigned to the chief assistant and other subordinates.
- Description of amounts which have been corporate with third parties.
- The description of the person giving certificates about the loans received depreciation etc.

2.3.2.3 Importance or Advantage of Audit Notebook

The audit notebook is a very important record for the auditor. The following are the main advantages from maintaining an audit notebook;

- In case of any dispute between the auditor and the client and changes of negligence being levied on the auditor, the auditor can produce the audit notebook as evidence in his defence.
- By analysing the notebook once can assess the intelligence, competence and dedication towards his work of the auditor.
- It facilities the audit work since all important points are noted at one place. The work is not disrupted even if there is a change in employees.
- The progress of the audit work can be clearly assessed. The notebook is very useful as it tells the auditor how much of the audit work has been completed and what still remains to be done.
- All important facts relating to the business are assimilated in the audit notebook, and hence it proves to be very helpful in preparing audit programme in the future.
- After the completion of the audit the auditor has to submit his report in which he has to include all important facts observed by him during the course of the audit.
- The notes made by him in the audit notebook concerning important information, explanations, faults and irregularities are very helpful to him in preparing his audit report.

2.3.2.4 Audit Working Papers

While conducting the audit, all such notebooks, documents, lists correspondence, etc. use by the auditor, which are retained by him even after the completion of the audit and which it is not necessary to return to the client are known as the auditor's working papers.

Audit working papers usually include the following; -

- Audit Programme

- Audit notebook
- Audit appointment letter.
- Correspondence done in relation to the audit programme.
- Lists of debtors and creditors.
- Opening and closing trail balance.
- A copy of the audit report.
- Copies of other correspondence done in relation to the audit, such as correspondence debtors, creditor, bank etc.
- Rules of the organization, memorandum of association, articles of association, prospectus etc.
- List of cost vouchers.
- Certificate received from the management in relation of valuation of closing stock.
- Adjustment Journal Entries.
- List of Investments.
- Explanation received during the course of the audit.
- Summary of minute books.
- Documents relating to depreciation.
- Copies of documents, which the auditor thinks necessary to retain etc., have made observations and other important calculations.

2.3.3 Factors to be considered before Audit Process

Before starting audit process the auditor has to clarify some basic facts:

- **Scope and Nature of work Assigned:** Before commencing the audit work, the auditor should determine the scope of the audit, i.e. whether only a part of the books of accounts is to be audited or the complete books of accounts are to be audited. The Scope of the audit depends upon the contract between the auditor and his appointer and the terms and conditions in his appointment letter. However, in case of a statutory audit the scope of the audit is specified by law and it can only be enhanced by the appointer and the auditor, and cannot be reduced. If the auditor is also entrusted with the work of preparing the Trial Balance, Profit and Loss Account, etc. than he does such work in the capacity of an accountant and he is entitled to get additional remuneration for the same.

- **Objectives of the Audit:** Before commencing the audit he auditor should find out as to what the objective of the appointer in getting the books of account audited. Such information is very necessary when the audit is being conducted for the first time. If the books are being audit by the same auditor over a number of years , then there is no special need for the auditor to enquire about the objectives every time.
- **Nature and Technical Features of Business:** Before commencing the audit, the auditor should obtain complete knowledge about the nature of business of the organization and other technical details – goods being traded; from whom and purchase and sale attributes of goods; income and expenditure sources; and hence the auditor should have knowledge of all facts which are specific to organization. The nature and quantum of such specific information depends upon the nature of the organization.
- **List of Books of Accounts:** The auditor should obtain a list of all the books accounts being maintained by the organization as well as the names of the people who are maintaining the same. A part from this he should also obtain a list of all legal and other important books of record being maintained by the organization.
- **Study of System of Internal Check:** Before commencing his work the auditor should conduct an in-depth examination of the internal check system of the organization. He should assess how effective the system of check actually is. Internal system is a system on the basis of which the total work in the organization is divided in such a manner, that the work is examined simultaneously as it is being done. If the division of work is faulty, the occurrence of frauds and errors in the accounts increase. Hence, the auditor should assess whether the internal Check System is satisfactory or not, and if not then he should keep the same in while determining the scope of his audit techniques.
- **Knowledge of Previous year's Final Accounts:** If the organization has been in existence over the last few years, then the auditor should examine the Profit and Loss Account, Balance sheet, the report on the accounts and other related documents. He should examine as to whether or not any adverse fact was brought to light in the same. If the previous auditor has pointed out any deficiencies or defects in his report, then the auditor should lay special emphasis on those points while doing his work.

- **Period of Audit:** The auditor should also find out the period pertaining to which the books of accounts are to be audited. Normally, audit is conducted once in a year's however in special circumstances the books pertaining to a much larger or smaller period may be audited.
- **Instructions to Employer:** After obtaining the above information the auditor should issue instructions to his appointer, in respect of the following matters:
  - The books should be totalled and the Trial Balance and final accounts be prepared.
  - All the vouchers should be arranged serially.
  - Lists of debtors and creditors are prepared.
  - Lists of bad and doubtfully debts are prepared.
  - Lists of outstanding expenses, prepaid expenses and accrued incomes be prepared
  - List of stocks be prepared and the method of valuation be specified.
  - List of investments be prepared and their costs also be specified.
  - A list of vouchers relating to transactions and goods returned by various branches, agents other related organizations be prepared.
  - A complete detail of permanent capital expenditure is prepared.
  - A list of deferred revenue expenditure is prepared.
  - A list of all directors containing their names and addresses is prepared.

  The auditor gets information on all of the above matters from employer. This information is needed by him from time to time during the continuations of his audit. Hence, it becomes necessary for the auditor to prepare an Audit Memorandum Notebook, in which all useful information and explanations should be recorded. A major advantage of such notebook is that, the auditor saved from the nuisance of approaching the management again and again for information.

- **Division of Distribution of Audit work**: An Auditor audits of a number organization. Hence, in order to complete the entire work within the specified time the division and distribution of work becomes necessary. Every Chartered Accountant has certain assistants for training known as Articled Clerks. Among these assistant, those who are experienced are known as seniors and those who are not so adept and experienced are known as seniors and those who are not so adept and experienced are known as juniors. It is only through the distribution of work between the senior and junior assistants that the completion of work becomes possible.

- **Auditing Program:** An Auditing program is a detailed plan of work prepared by the auditor for the supervision and control of his assistant, before actually beginning audit. Hence, an audit programme is a systematic, detailed and written plan of the audit techniques to be adopted on the basis of which the auditor and his staff proceed with their auditing work.

2.3.3.1 Key Steps in Audit Process

The implementation of continuous auditing consists of six procedural steps, which are usually administered by a continuous audit manager.

Knowing about these steps will enable auditors to better monitor the continuous audit process and provide recommendations for its improvement, if needed. These steps include:

- Establishing priority areas.
- Identifying monitoring and continuous audit rules.
- Determining the process' frequency.
- Configuring continuous audit parameters.
- Following up.
- Communicating results.

- **Establishing Priority Areas:** The activity of choosing which organizational areas to audit should be integrated as part of the internal audit annual plan and the company's risk management program. Many internal audit departments also integrate and coordinate with other compliance plans and activities, if applicable. Typically, when deciding priority areas to continuously audit, internal auditors and managers should:

  - Identify the critical business processes that need to be audited by breaking down and rating risk areas.
  - Understand the availability of continuous audit data for those risk areas.
  - Evaluate the costs and benefits of implementing a continuous audit process for a particular risk area.
  - Consider the corporate ramifications of continuously auditing the particular area or function.

- Choose early applications to audit where rapid demonstration of results might be of great value to the organization. Long extended efforts tend to decrease support for continuous auditing.
- Once a demonstration project is successfully completed, negotiate with different auditee and internal audit areas, if needed, so that a longer term implementation plan is implemented.

When performing the actions listed above, auditors need to consider the key objectives from each audit procedure. Objectives can be classified as one of four types: detective, deterrent (also known as preventive), financial, and compliance. A particular audit priority area may satisfy any one of these four objectives. For instance, it is not uncommon for an audit procedure that is put in place for preventive purposes to be reconfigured as a detective control once the audited activity's incidence of compliance failure decreases.

➢ **Monitoring and Continuous Audit Rules:** The second step consists of determining the rules or analytics that will guide the continuous audit activity, which need to be programmed, repeated frequently, and reconfigured when needed. For example, banks can monitor all checking accounts nightly by extracting files that meet the criterion of having a debt balance that is 20 percent larger than the loan threshold and in which the balance is more than Rs 100000.

In addition, monitoring and audit rules must take into consideration legal and environmental issues, as well as the objectives of the particular process. For instance, how quickly a management response is provided once an activity is flagged may depend on the speed of the clearance process (i.e., the environment) while the activity's overall monitoring approach may depend on the enforceability of legal actions and existing compliance requirements.

➢ **Determining the Process' Frequency:** Although the process is called continuous auditing, the word continuous is in the eye of the beholder. Auditors need to consider the natural rhythm of the process being audited, including the timing of computer and business processes as well as the timing and availability of auditors trained or with experience in continuous auditing. For instance, although increased testing frequency has substantial benefits, extracting, processing, and following up on testing results might increase the costs of the continuous audit activity. Therefore, the cost-benefit ratio of continuously auditing a particular area must be considered prior to its monitoring.

Furthermore, other tools used by the manager of the continuous audit function include an audit control panel in which frequency and parameter variations can be activated. Hence, the nature of other continuous audit objectives, such as deterrence or prevention, may determine their frequency and variation.

- **Configuring Continuous Audit Parameters:** Rules used in each audit area need to be configured before the Continuous Audit Procedure (CAP) is implemented. In addition, the frequency of each parameter might need to be changed after its initial setup based on change stemming from the activity being audited. Hence, rules, initial parameters, and the activity's frequency — also a special type of parameter — should be defined before the continuous audit process begins and reconfigured based on the activity's monitoring results.

  When defining a CAP, auditors should consider the cost benefits of error detection and audit and management follow-up activities. For instance, in the example of the bank described earlier, the excess threshold of Rs100000 could lead to a number of false negatives (e.g., values that were ignored when the balance was smaller than Rs 100000 but were identified as representing a problem) and a number of false positives (e.g., values with balances above Rs100000 that were flagged but were accurate). If the threshold is increased to Rs 200000, there will be an increase in false negatives and a decrease in false positives. Because follow up costs would go up as the number of false positives increases and the presence of false negatives may lead to high operational costs for the organization, internal auditors should regularly reevaluate if error detection and follow-up activities need to be continued, reconfigured, temporarily halted, or used on an ad hoc basis.

  Furthermore, the stratification of audited data into sub-groups allows organizations to better monitor the activity and reconfigure any parameters (e.g., auditors will be notified when balances larger than 20 percent of the debt remains that are also larger than US $5,000). However, the more complex the rule and its conditional components, the more parameters that must be examined, monitored, and sometimes reconfigured.

- **Following Up:** Another type of parameter relates to the treatment of alarms and detected errors. Questions such as who will receive the alarm (e.g., line managers, internal auditors, or both usually the alarm is sent to the process manager, the manager's immediate supervisor, or the auditor in charge of that CAP) and when the follow-up activity must be completed, need to be addressed when establishing the continuous audit process.

Additional follow-up procedures that should be performed as part of the continuous audit activity include reconciling the alarm prior to following up by looking at alternate sources of data and waiting for similar alarms to occur before following up or performing established escalation guidelines. For instance, the person receiving the alarm might wait to follow up on the issue if the alarm is purely educational (i.e., the alarm verifies compliance but has no adverse economic implications), there are no resources available for evaluation, or the area identified is a low benefit area that is mainly targeted for deterrence.

- **Communicating Results:** A final item to be considered is how to communicate with auditee. When informing auditee of continuous audit activity results, it is important for the exchange to be independent and consistent. For instance, if multiple system alarms are issued and distributed to several auditees, it is crucial that steps 1-5 take place prior to the communication exchange and that detailed guidelines for individual factor considerations exist. In addition, the development and implementation of communication guidelines and follow-up procedures must consider the risk of collusion. Much of the work on fraud indicates that the majority of fraud is collusive and can be performed by an internal or external party. For example, in the case of dormant accounts, both the clerk that moves money and the manager that receives the follow-up money may be in collusion since the manager's key may have to be used for certain transactions.

1.4 Check Your Progress

1. In formulating a documented plan the following matters need to be considered ………

   (a) Knowledge of the entity's business;

   (b) Risk and materiality;

   (c) Nature, timing and extent of audit procedures;

   (d) All of the above

2. "Audit planning is defined as the process in which the strategy is designed to conduct the expected result which also defines the scope of audit inside the company". Is the statement true or false.

   a) True

   b) **False**

c) **Both the above**

d) None of the above

3. An audit memorandum is a statement containing.....

a) All useful information regarding the business of the client

b) It indicates the method of operation, policies with regard to different aspects of the business,

c) Both of the above

d) None of the above

4. An Auditing program is a……....

a) detailed plan of work prepared by the auditor for the supervision

b) systematic and written plan of the audit techniques

c) Both of the above

d) None of the above

5. Contents of audit notebook includes:

a) A brief description of all legal documents of a company.

b) A Copy of the audit programme.

c) All suspicious which need to be solved or explained in the future.

d) All of the above

6. Factors to be considered before Audit Process includes:

a) **Scope and Nature of work assigned.**

b) **Objectives of the audit.**

c) **Study of system of Internal check**

d) All of the above

1.5 Summary

Initial audit planning takes place before the detailed audit work begins, and in planning for a specific audit assignment an auditor must adopt a strategy with regard to the nature, timing and extent of the audit work to be carried out. The detailed audit work is commonly carried out by a team of audit staff with varying degrees of skill and experience. Planning is an integral part of the audit process. Whilst the audit procedures carried out on specified audits will vary depending on the nature, size and complexity of an entity's operations, good audit planning is crucial if an auditor wishes to ensure that an audit is carried out in an effective, efficient and timely manner. An Auditing program is a detailed plan of work prepared by the auditor for the supervision and control of his assistant, before actually beginning audit. Hence, an audit programme is a systematic, detailed and written plan of the audit techniques to be adopted on the basis of which the auditor and his staff proceed with their auditing work. The auditor cannot always remember all these things an hence every auditor , while conducting the audit , keep a notebook, known as the audit Notebook for his personal use in which he records important information relating to the audit. Sometimes, the auditor records the important information on plain papers, and these are referred to as auditors. While conducting the audit, all such notebooks, documents, lists correspondence, etc. use by the auditor, which are retained by him even after the completion of the audit and which it is not necessary to return to the client are known as the auditor's working papers.

2.6 Keywords

- **Audit Memorandum**: A statement containing all useful information regarding the business of the client.
- **Audit notebook-** The auditor while conducting the audit, keep a notebook, known as the audit notebook for his personal use in which he records important information relating to the audit.
- **Audit working papers-** While conducting the audit, all such notebooks, documents, lists correspondence, etc. use by the auditor are known as the auditor's working papers.
- **Audit Programme-** An auditing program is a detailed plan of work prepared by the auditor for the supervision and control of his assistant, before actually beginning audit.
- **Standard Programme**: An audit programme based on a standard format is known as a standard auditing programme.
- **Tailor made Programme**: A tailor made programme is one which is prepared separately for each organization. Such a programme is more practical and flexible as compared to standard programme.

2.7 Self-Assessment Test

Q.1 What is audit planning? Explain the process of audit planning.

Q.2 Define audit programme. What are the essential of a good audit programme?

Q.3 Explain the main steps involved in audit process.

Q.4 What are the important content of an audit notebook? Explain its importance in audit work.

Q.5 Write notes on:

a. Audit working papers
b. Arrangement with client
c. Types of audit programme
d. Advantages of working papers

2.8 Answers to Check Your Progress

1(d), 2 (a), 3(c), 4 (c), 5(d), 6 (d)

2.9 References/Suggested Readings

- **Basu, S.K**., "Fundamental of Auditing" Pearson Publication, New Delhi.
- **Tandon, B. N., S. Sudharsanam, and S. Sundharabahu**, "*A Handbook of Practical Auditing",* S. Chand and Co. Ltd., New Delhi.
- **Pagare, Dinkar**, "*Principles and Practice of Auditing",* Sultan Chand and Sons, New Delhi.
- **Institute of Chartered Accountants of India**, ''*Auditing and Assurance Standards*'', ICAI, New Delhi.
- **Gupta Kamal, and Ashok Arora**, "*Fundamentals of Auditing,*" Tata Mc-Graw Hill Publishing Co. Ltd., New Delhi.

Subject: Auditing	
Course Code: BC-505	**Author:** Mr. Kapil Singh
Lesson No.: 03	**Vetter:** Prof. M.C. Garg
AUDIT OF E-COMMERCE TRANSACTIONS	

Structure

3.0 Learning Objectives

After reading this lesson, you will be able:

- To define E-commerce and know the evolution of E-Commerce.
- To describe the type of E-commerce and its advantages and disadvantages.
- To understand the difference between traditional commerce and E-commerce.
- To know the process of audit in e-commerce environment.

3.1 Introduction

E-commerce plays a significant role in the marketplace, both nationally and internationally. With more people making purchases online rather than at traditional retail stores, it is becoming a fast-growing area of business and one to strongly consider as you plan your own career. E-commerce is a huge part of the economy and is vital to businesses that sell their products or services online. E-commerce gives businesses the ability to reach more customers than traditional retail reaches. With so many people making their purchases online, it is the fastest-growing retail market. It offers consumers a more convenient way to shop for the products or services they need without having to visit a retailer's physical location to make a purchase. It includes activities of promoting and selling a product or service and obtaining payment for the same. The purchase of products and services may be made using the Internet, such as in the cases of movie tickets, airline tickets, and downloadable software, or physically, as in the cases of electronic gadgets, books, fashion accessories, and so forth. The payment may be online using a credit card or integrated with a banking application for transfer of funds from a bank account. In some cases, the payment is also accepted upon physical delivery of the product. In case of banking applications, the activities include accessing financial information, making payments, and transferring funds from one account to another, opening new accounts, using an electronic bill payment service, and so forth.

3.2 Meaning and Definition of Electronic Commerce (E-Commerce)

Electronic commerce or e-commerce (sometimes written as e-Commerce) is a business model that lets firms and individuals buy and sell things over the internet. E-commerce, also known as electronic commerce, is the buying and selling of goods (or services) electronically on the internet. It can also refer to other online activities like online auctions, ticketing and banking. E-commerce is an essential part of many businesses that rely on the sale of physical products or services online.

In addition to retail, e-commerce also includes wholesale transactions, where someone buys a large amount of product and then resells it, as well as drop-shipping, where the product is sold by one company, shipped to a second company and then assembled and sent to the consumer. Some e-commerce transactions also include subscriptions, where a consumer agrees to buy a product on a set schedule.

Definition of E-Commerce

In common parlance, e-commerce is the buying and selling of goods and services on the Internet, especially the World Wide Web. Generally, e-commerce may be comprised of:

- E-tailing or "virtual storefronts" on web sites with online catalogues, sometimes gathered into a "virtual mail";
- Gathering and use of demographic data through Web contacts;
- Electronic Data Interchange (EDI), the business-to-business exchange of data;
- E-mail and e-fax and their use as media for reaching prospective and established customers (for example, with newsletters) including internet telephony;
- Business-to-business buying and selling;
- The security of business transactions services;
- Any other activity of similar nature.

Information Systems Audit and Control Association (ISACA) defines e-commerce as the process by which organizations conduct business electronically with their customers, suppliers and other external business partners, using the internet as an enabling technology. Therefore, it encompasses both business-to-business (B2B) and business-to-consumer (B2C) e-commerce models, but does not include existing non-internet e-commerce methods based on private networks, such as EDI and SWIFT.

Organization for Economic Co-operation and Development (OECD) defines e-commerce as commercial transactions, involving both organizations and individuals, that are based upon the processing and transmission of digitized data, including text, sound and visual images and that are carried out over open networks (like, the internet) or closed networks (like, AOL or Minitel) that have a gateway onto an open network.

3.2.1 Types of E-commerce

There are six different kinds of e-commerce. These include:

(a) **Business-to-consumer (B2C)**-This is the most common kind of e-commerce. When shoppers get online and buy something from an online store, they are involved in business-to-consumer e-commerce.

(b) **Business-to-business (B2B)**-Many businesses sell raw goods or parts through e-commerce to other companies that will then use those materials to create their products.

(c) **Consumer-to-consumer (C2C)**-This kind of e-commerce refers to when consumers sell to other consumers. Sites like eBay and Craigslist are examples of this kind of e-commerce.

(d) **Consumer-to-business (C2B)**-This type of e-commerce is when consumers sell their products or services to businesses.

(e) **Business-to-administration (B2A)**-This category of e-commerce refers to transactions between businesses and public administration, which includes areas such as social security, employment and legal.

(f) **Consumer-to-administration (C2A)**. This includes transactions between consumers and public administration, where consumers pay for services like taxes and legal document preparation.

3.2.2 History of E-Commerce in India

The origin of commerce by exchanging goods occurred before recorded history. Now commerce is a basic activity of goods trading and buying in everyday life. Entering into the electronic era, the way individuals and organizations do business and undertake commercial transactions have been changed. The emergence of large business organizations in the late 1800s and early 1900s triggered the need to create and maintain formal records of business transactions. The process of using a person or a computer to generate a paper form, mailing that form, and then having another person enter the data into the trading partner's computer was slow, inefficient, expensive, redundant and unreliable. The history of e-commerce is how information technology has transformed business processes. The meaning of electronic commerce has changed over the last 30 years. Originally, electronic commerce meant the facilitation of commercial transactions electronically, using technology such as Electronic Data Interchange (EDI) and Electronic Funds Transfer (EFT). These were both introduced in the late 1970s, allowing businesses to send commercial documents like, purchase orders or invoices electronically. The growth and acceptance of credit cards, Automated Teller Machines (ATMs) and telephone banking in the 1980s were also forms of electronic commerce. From the 1990s onwards, electronic commerce would additionally include Enterprise Resource Planning systems (ERP), data mining and data warehousing.

The concept of e-commerce first formally came forth in 1991, a time when internet practically did not even exist in India. Even worldwide, very few could fathom that the act of buying and selling goods and services over the internet, would be as widely accepted a practice, as it is today. By the late ’90s, people became aware of this thing called the internet, but for a majority of them, it remained a luxury they did not particularly need. In a truly Indian manner, it was only in 2002, when the IRCTC introduced an online reservation system that the public widely accepted the internet as something fruitful, by which time a company named Amazon, was already beginning to create a few murmurs in the US. The first real stepping stone towards setting off the e-commerce juggernaut, was perhaps the creation of Flipkart, when two engineers from IIT Delhi decided to sell books online from an apartment in Koramangala area of Bengaluru. A business idea not too dissimilar to that of Amazon. Little did they know that a decade later, US retail giants, Walmart, would acquire their business in a US$ 16 billion-dollar deal, after a fierce bidding war with none other than Amazon.

3.2.3 Advantages of Electronic Commerce

E-commerce offers consumers the following advantages:

- **Convenience.** E-commerce can occur 24 hours a day, seven days a week.
- **Increased selection**. Many stores offer a wider array of products online than they carry in their brick-and-mortar counterparts. And many stores that solely exist online may offer consumers exclusive inventory that is unavailable elsewhere.
- **Increasing reach**. E-commerce allows small businesses to reach a broad range of consumers. It allows all sellers to be a part of a global marketplace.
- **More jobs**. As these small e-commerce businesses grow, they employ more people.
- **Lower operational costs**. E-commerce also helps small businesses to grow because it can have fewer operational costs. Without having to pay rent on a shop, many small business owners can afford to run their e-commerce shops.
- **Easier and more convenient shopping.** One of the major advantages of e-commerce is that it allows customers to quickly find and get what they are looking to buy. It also offers consumers the convenience of not needing to leave their homes to get what they need, which saves time.
- **Allows comparison shopping**. Consumers also gain power through the experience of online shopping. They can research and compare products and companies easily. Websites can offer things

like detailed product descriptions and consumer reviews that can help consumers make decisions wisely.

3.2.4 Disadvantages of E-Commerce

E-commerce has the following disadvantages:

- **Limited customer service**-If you are shopping online for a computer, you cannot simply ask an employee to demonstrate a particular model's features in person. Although some websites let you chat online with a staff member, this is not a typical practice.
- **Lack of instant gratification**-When you buy an item online, you must wait for it to be shipped to your home or office. However, retailers like Amazon make the waiting game a little bit less painful by offering same day delivery as a premium option for select products.
- **Inability to touch products**-Online images do not necessarily convey the whole story about an item, and so e-commerce purchases can be unsatisfying when the products received do not match consumer expectations.
- **Case in point**-An item of clothing may be made from shoddier fabric than its online image indicates.
- **Limited face-to-face interaction with customers-**One of the disadvantages of e-commerce is that business owners have more limited relationships with their clients. Since their clients are typically on the other end of a computer, it can be more difficult to build meaningful relationships, something that is important to many business owners and customers.
- **Bandwidth challenges-**Bandwidth and reliability can vary from country to country, so it can be challenging if you are targeting or wanting to work in a particular region.
- **Shifting retail jobs-**Another disadvantage of e-commerce is that it can cause a shift in retail jobs. While the employers of small businesses that sell on the internet may be hiring as a result of their success with e-commerce, traditional department stores may experience some job loss as a result. Retailers have to sell online to stay competitive, but some have been more successful at that than others.
- **Rapidly changing trends-**This field is changing remarkably quickly. It can be challenging to keep up with trends and technology in such a rapidly changing field.

3.3 Difference between Traditional Commerce and E-commerce

Followings are the difference between traditional commerce and E-commerce:

Traditional commerce refers to the buying or selling product/services from person to person without use of internet. It is an older method of business style and comes under traditional business. Due to busy life of customers, they are not preferring this as it is time taking and needs physical way of doing business. E-commerce refers to the buying or selling product/services electronically with the help of internet. It is a newer concept of business style and comes under e-business. Now a day's people prefer this as it is less time taking and does not need physical way of doing business everything can be done with laptop or smartphone and internet.

Difference between Traditional Commerce and E-Commerce

Sr. No.	Basis of Difference	Traditional Commerce	E-Commerce
1	**Meaning**	Traditional commerce refers to the buying or selling goods and services from person to person without use of internet.	E-commerce refers to the buying or selling goods and services electronically with the help of internet.
2	**Concept**	Traditional commerce is a older method of business.	E-commerce is a newer concept of business.
3	**Scope**	Its scope of business is in a limited physical area.	Its business scope is in worldwide as it is done through digital medium.
4	**Use of Practices**	In traditional commerce, it is difficult to establish and maintain standard practices.	In e-commerce, it is easy to establish and maintain standard practices.
5	**Direct Interaction**	In traditional commerce, direct interaction through seller and buyer is present.	In e-commerce, indirect interaction through seller and buyer occurs using electronic medium and internet.

6	**Performed by**	Traditional commerce is carried out by face to face, telephone lines or mail systems.	E-commerce is carried out by internet or other network communication technology.
7	**Processing of transaction**	In traditional commerce, processing of transaction is manual.	In e-commerce, processing of transaction is automatic.
8	**Delivery of goods**	In traditional commerce, delivery of goods is instant.	In e-commerce, delivery of goods takes time.
9	**Accessibility**	Its accessibility is for limited time in a day.	Its accessibility depend on buyer means round the clock.
10	**Time and Money**	Traditional commerce is done where digital network is not reachable.	E-commerce is used to save valuable time and money.
11	**Resource focuses**	Its resource focuses on supply side.	Its resource focuses on demand side.
12	**Inspection of Products**	In traditional commerce customers can inspect products physically before purchase.	In e-commerce customers cannot inspect products physically before purchase.
13	**Customer support**	For customer support, information exchange there is no such uniform platform.	For customer support, information exchange there is exists uniform platform.

3.4 Audit in E-Commerce Environment/Transactions

First of all, the auditor need to understand that what business activities and processes have been replaced by e-commerce and also its impact on business operations. The approach to auditing of e-commerce transactions provides for the followings:

- **Skill and Competence**-Auditor should have sufficient knowledge of the business of the organization, industry and the computer information systems to plan, direct, control and review the work performed. The sufficiency of knowledge would depend on the nature and extent of e-commerce environment. This will help auditor to determine the extent and complexity of e-commerce activities in the organization; understand e-commerce strategy of the organization; determine nature, timing and extent of audit procedures. With the growing complexity of Information and Internet technology, e-commerce to date has created a basis for new markets and products, as well as customer empowerment. Developments in web technology have opened communication among platforms, networks, and end users, representing a major step forward from the more insular systems of the past. However, the same technology that enables this increased interconnectivity has also introduced numerous opportunities for control breaches. In such a scenario, organization's e-commerce activities may be operating in a more complex environment. To address key control issues, auditor may decide to use the work of an expert to obtain sufficient and appropriate audit evidence for the purpose of the audit. For example, the work of an expert may be used to understand the risks in e-commerce activities, to test technical controls, analysis of audit trails and key transactions, etc.
- **Legal Considerations**- Management needs to consider legal and regulatory issues related to the entity's e-commerce activities, for example, whether the entity has adequate mechanisms for recognition of taxation liabilities in various jurisdictions or documentation requirements for order processing and invoices to comply with tax legislation. Factors to be considered include the place where:
    - The entity is legally registered;
    - Its physical operations are based;
    - Its web server is located;
    - Goods and services are supplied from; and
    - Its customers are located or goods and services are delivered.

  These all may be in different jurisdictions. Without understanding the regulations and the law applied in different jurisdictions, organizations may be subject to fines and adverse judgments and may incur other costs, such as legal fees to defend themselves in case they inadvertently breach such laws. Legal or regulatory issues that may be particularly relevant in an e-commerce environment include:

- Adherence to national and international privacy requirements;
- Adherence to national and international requirements for regulated industries;
- The enforceability of contracts;
- The legality of particular activities, for example Internet gambling;
- The risk of money laundering; and
- Violation of intellectual property rights.

The auditor should obtain a general understanding of:

- The legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates; and
- How the entity is complying with that framework.

After obtaining the above general understanding, the auditor shall obtain sufficient appropriate audit evidence regarding compliance with those laws and regulations to have a direct effect on the determination of material amounts and disclosures in the financial statements. While an audit cannot be expected to detect non-compliance with all laws and regulations, the auditor is specifically required to perform procedures to help identify instances of non-compliance with those laws and regulations where non-compliance should be considered when preparing financial statements. When a legal or regulatory issue arises that, in the auditor's judgment, may result in a material misstatement of the financial statements or have a significant effect on the auditor's procedure or the auditor's report, the auditor considers management's response to the issue. In some cases, the advice of a lawyer with particular expertise in e-commerce issues may be necessary when considering legal and regulatory issues arising from an entity's e-commerce activity.

Auditor may consider provisions of Information Technology Act, 2000 including that related to following:

- Legal recognition of electronics records;
- Legal recognition of digital signatures;

- Use of electronic records and digital signatures in Government and its agencies;
- Retention of electronic records;
- Attribution, acknowledgement and despatch of Electronic records;
- Provision for certifying authorities and subscribers in connection with digital signature;
- Provision for penalties for cyber offences.

➢ **Audit Planning**-In an ecommerce environment, while establishing the overall audit strategy the auditor should consider the effect of information technology on the audit procedures, including the availability of data and the expected use of computer assisted audit techniques. In an e-commerce environment, the entries in accounting records are often initiated, recorded, processed and reported in electronic form. Accordingly, the auditor should consider the following points during the planning stage:

- Scope in e-commerce environment e.g., understanding of flow of accounting transactions, records and information, location where the related system are hosted, interfacing of accounting systems with other systems, reporting requirements, etc.
- Identification of key risk areas with respect to e-commerce environment and plan to address these areas to reduce the risk at acceptable low levels.
- Request for report of internal audit, if any, covering the ecommerce activities. The considerations in such report may be included in the audit plan by the auditor.
- Understanding of internal controls instituted by the management with respect to e-commerce activities.
- Develop and document an e-commerce audit plan as a part of overall audit plan.
- Keeping in view complexity and specific environment of information technology set up, audit plan should include deployment of appropriate experienced team members.
- Timing of audit e.g., interim reviews or final reviews with regard to e-commerce activities.

➢ **Risks and Control**-Wherever e-commerce transactions are used for key business processes, there is significant change in the manner in which some of the activities are performed as compared to traditional transactions. This change can introduce risk by:

- Eliminating or reducing efficacy of some traditional controls,
- Adding new elements like, technology, new activities, legal considerations, etc. which need to be appropriately considered during audit, and
- Speeding up transactions which can bring its own issues with cut-offs, period end procedures, etc.

In order to identify risks associated with e-commerce transactions, the auditor should analyze the e-commerce application by considering the following factors relating to the entity's e-commerce activities including:

- Loss of transaction integrity;
- Risk of business process failure;
- E-commerce security risks, including virus attacks, unauthorized access;
- Improper accounting policies related to, for example, capitalization of expenditures such as website development costs, misunderstanding of complex contractual arrangements, title transfer risks, translation of foreign currencies, allowances for warranties or returns, and revenue recognition issues.
- Non-compliance with taxation and other legal and regulatory requirements, particularly when internet e-commerce transactions are conducted across international boundaries;
- Failure to ensure that contracts evidenced only by electronic means are binding;
- Over reliance on e-commerce;
- Systems and infrastructure failures or crashes; and
- Financial risks e.g., foreign exchange risks, credit risk, etc.

From the auditor's perspective, controls over IT systems are effective when they maintain the integrity of information and the security of the data such systems processes, and includes effective general IT controls and application controls. General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. These include controls over the following:

- Data center and network operations

- System software acquisition, change and maintenance
- Program change
- Access security
- Application system acquisition, development and maintenance

Application controls are manual or automated procedures that typically operate at a business process level and apply to the processing of individual applications. Application controls can be preventive or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data.

Matters that may be relevant to the auditor when considering the entity’s e-commerce strategy in the context of the auditor’s understanding of the control environment include:

- Involvement of those charged with governance in considering the alignment of e-commerce activities with the entity’s overall business strategy;
- Whether e-commerce supports a new activity for the entity or whether it is intended to make existing activities more efficient to reach new markets for existing activities;
- Sources of revenue for the entity and how these are changing (for example, whether the entity will be acting as a principal or agent for goods or services sold);
- Management’s evaluation of how e-commerce affects the earnings of the entity and its financial requirements;
- Management’s attitude to risk and how this may affect the risk profile of the entity;
- The extent to which management has identified ecommerce opportunities and risks in a documented strategy that is supported by appropriate controls, or whether ecommerce is subject to ad hoc development responding to opportunities and risks as they arise; and
- Management’s commitment to relevant codes of best practice or web seal programs.

- **Outsourcing Arrangement**-Sometimes an entity may depend on service organizations such as Internet Service Providers (ISPs), Application Service Providers (ASPs) or data hosting companies to provide many or all of the IT requirements of e-commerce activities. The entity may also use service organizations for various other functions in relation to its e-commerce activities such as order fulfillment, delivery of goods, operation of call centers and certain accounting functions. Standard on Auditing (SA) 402, "Audit Considerations relating to Entities Using Service Organizations" lays down that when an entity uses service organization the auditor may consider how an entity's use of a service organization affects the entity's internal control systems so as to identify and assess the risks of material misstatement and to design and perform further audit procedures.

In obtaining an understanding of the entity and its environment, the auditor may determine the significance of service organization's activities to the entity and relevance to the audit. Auditor may use the report of the service organization auditor. While doing so, the auditor may consider the professional competence of that auditor in the context of the specific assignment undertaken by the service organization auditor. With respect to involvement of service organizations (third parties), the auditor may also consider the following points:

- The responsibility for negotiating should be delegated to levels of management and staff that are experienced in the area. Appropriate service-level agreements should be incorporated in the contract such as the performance of key control processes, compliance with statutory laws and regulations, non-disclosure agreement or provisions for audit rights.
- Third parties should have the necessary types and levels of insurance or provide appropriate levels of indemnification in the event of a problem.
- Involvement of legal department while signing the contracts with the service organizations.
- Service Organization should provide evidences of Business Continuity Plan / Disaster Recovery Plan and Risk Mitigation Plan in order to minimize business risk.

➢ **Going Concern**- E-commerce activities in an organization may be complementary to its traditional business. For example, a banking company may use e-commerce for some of its activities (e.g., pay order request, opening of fixed deposit accounts and transfer of funds) in addition to serving its customers by conventional methods. In contrast, e-commerce activities may be a new line of business in the organization or the organization may be carrying out all or significant amount of its business activities through e-commerce e.g., an on-line newspaper which is available free through the website and makes its revenue by selling advertising space on the website. In this context, the auditor should consider effect of entity's dependence on e-commerce activities and on its ability to continue as a going concern.

Indications of risk that continuance as a going concern may be questionable could come from the financial statements or from other sources. In an e-commerce environment, auditor's consideration may also include the following factors:

- Robustness of the business model, especially the revenue stream.
- Ability to attract continued funding from investors especially in the case of continued losses.
- Fundamental changes in market and/or in technology.
- Loss of key customers, increase in competitors, cultural differences, etc.
- Outsourcing arrangements for key e-commerce elements.
- Allocation of resources and capital.
- Changes in legislation or government policy.

➢ **Audit Evidence**- Electronic records and digital signatures are major shift in business processes. Today, electronic records and digital signatures have legal and commercial equivalence of paper records and written signatures. The Information Technology Act, 2000 gives recognition to electronic records and digital signatures. Therefore, electronic records can be used as audit evidence for the purpose of audit. However, electronic records may be more easily destroyed or altered than paper records without leaving evidence of such destruction or alteration. Electronic audit evidence may include screen print, electronic reports from the auditee's computer system, audit trails, access control list, etc.

For an auditor of financial statements, the objective of audit evidence in e-commerce environment remains same as in the case of non e-commerce environment. However, in an e-commerce environment, the audit evidence are mostly in electronic form and, therefore, the auditor should understand and evaluate the effect of electronic records on audit documentation. Audit evidence is cumulative in nature and, therefore, it may be noted that electronic evidence does not eliminate the need of paper evidence. In an e-commerce environment it is not necessary for an auditor to gather the audit evidences in electronic form only. Keeping in view the objectivity and availability of audit evidence, it may be gathered either in electronic form or in paper form. In this respect, an auditor may consider following:

- The scope, objectives, planning, methodology followed for audit and assumptions should be completely documented.
- Whether the entity's information security policies and security controls as implemented are adequate to prevent unauthorized changes to the accounting system or records, or to systems that provide data to the accounting system.
- Auditor should enquire and understand how management is gaining comfort on internal controls over financial reporting in an e-commerce environment. In case the auditor finds that internal controls identified by the management are sufficient for the purpose of audit and these internal controls are also operating effectively, auditor may decide to rely upon such internal controls and gather related audit evidence, including electronic audit evidence. In case the auditor finds that the internal controls identified by the management are not sufficient or not operating effectively for the purpose of audit of financial statements, he may decide to obtain additional audit evidence in order to form an opinion on the financial statements.
- Auditor may consider user of computers to gather, understand, analyze, examine and retain evidences for audit documentation purpose.
- Integrity of electronic information and records is must to ensure that audit evidence being documented is complete, accurate, valid, sufficient and reliable. Organizations are using increasingly complex software to process and store accounting and business transactions. Therefore, the auditor should consider, understand and evaluate risks and control system. This will help ensure the integrity of electronic evidence being documented by the auditor.
- If the evidence being gathered is in electronic form (i.e., reports, print screens, etc.) then the auditor should gather evidence directly after getting appropriate access to the computer system of the auditee. In case help is taken from the auditee personnel (say, IT or finance team) for gathering of electronic evidence such a process needs to be supervised by an expert possessing such skills, who may either be the auditor's staff or an outside professional engaged by the auditor in order to ensure completeness and accuracy of the evidence gathered.

- The auditor may test automated controls and control over changes to the electronic information, such as record integrity checks, electronic date stamps, digital signatures and version controls when considering the integrity of electronic evidence.
- While determining the sufficiency and reliability of electronic information, the auditor may also consider compensatory manual controls in place. For example, depending on the auditor's assessment of automated controls, the auditor may also consider the need to perform additional procedures such as confirming transaction details or account balances with third parties.

➢ **Audit Trails-** It means those records that enables a transaction to be traced from its source to a summarized total in a financial statement. Audit trails may be generated in a variety of systems and equipment. For example, every person who enters the organization's network with a user ID and password is logged and the transactions carried out by the person are recorded for later control. Similarly, an organization may log the customer's transaction from its initiation through collection of the receipt and delivery of the product. Integrity, confidentiality, efficiency, effectiveness and availability in an e-commerce environment are a prerequisite to ensure that financial records and accounts are sufficiently reliable for reporting. Auditor may use audit trails to:

- Follow the history of a transaction;
- Investigate the causes when a record is found to be erroneous;
- Analyze data after massive file destruction;
- Correctly interpret the file where data damage is program caused;
- Investigate false information that has been sent to system users; and
- Monitor procedural violations to highlight possible breaches of security, etc.

Auditor may adopt following strategy to understand the extent of availability and use of audit trails:

- Interview appropriate management and staff to gain an understanding of the types of audit trails being generated by the applications;
- Identify information requirements relevant for the business process;
- Identify inherent IT risks and the overall level of control;
- Select the audit trails to be reviewed; and

- Review of audit trails.

Examples of audit trails include failed access attempts, incorrect value assigned to data, attempts to change restricted data, excessive use of certain data and invalid entries in event logs and transaction logs. Auditor may use Computer Assisted Audit Techniques (CAATs) to assess the integrity, effectiveness and efficiency objectives of audit trails. The use of CAATs allows for the complete analysis of audit trails, focusing testing on subsets that appear with errors or irregularities and presenting them in a new format (file or paper).

In addition, the following should also be verified by an auditor to ensure integrity, completeness and sufficiency of audit trails:

- Analyze the security ACL (Access Control List) assigned to the resources (operating systems generally) where the logs are stored (on-line, off-line, on-site, off-site).
- Check for existence of policies and procedures about audit trails in applications and products.
- Review the audit trails towards recreating activity or error analysis as needed.
- Review the parameters installed in the equipment/software regarding activation/deactivation or deletion.
- Obtain and assess the risk assessment document for each audit trail generated.
- Check for the existence of controls over the audit trails considered as highly important with regard to their confidentiality and integrity (e.g., Electronic Fund Transfer systems and their equipment, network, procedures, etc.).
- Monitor routines to analyze audit trail availability.
- Review the access control audit trails on the security software or key management reports.

➢ **Accounting Policies**-Auditor should examine appropriateness of accounting policies adopted by the organization with respect to its e-commerce activities. These accounting policies may be related to conversion of foreign currencies, capitalization of development cost, revenue recognition, recognition and measurement of cost, disclosures in the financial statements, etc. Accounting Standard (AS) 26 “Intangible Assets” prescribes the accounting considerations for Audit of Financial Statements treatment for intangible assets. AS-26 also contains illustrative application of the Accounting Standard to website costs and to internal use computer software, which can be internally generated or acquired. “Guidance Note on Accounting by Dot Com Companies” deals with accounting by dot-com companies and other entities engaged in electronic commerce (e-commerce) in respect of certain issues relating to revenue recognition and expense recognition.

- **Audit Documentation**-It implies records of audit procedures performed, relevant audit evidence obtained, and the conclusions the auditor reached. It include the working papers, audit programs, analysis issues, checklist, correspondence, schedules of work, etc. For documentation of electronic records and evidence auditor should consider the following points:
  - The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form. For example, purchase, shipping, billing, cash receipt, and cash disbursement transactions are often consummated entirely by the exchange of electronic messages between the parties. Certain electronic information may exist only at a certain point of time. However, such information may not be retrievable after a specified period of time if files are changed and if backup files do not exist. An organization’s data retention policies may require the auditor to request retention of some information for the auditor’s review or to perform audit procedures at a time when the information is available.
  - Electronic evidence needs to be preserved electronically by the auditors on their computers for any further reference. Further, measures need to be taken to ensure confidentiality, integrity and availability of such evidence for a period similar to the paper records. In this respect, following may be considered by the auditor:
    - Enable the determination of when and by whom documentation was created, changed or reviewed;
    - Protect the integrity of the information at all stages of the engagement, especially when the information is shared within the engagement team;
    - Prevent unauthorized changes to the engagement documentation; and
    - Allow access to the engagement documentation by the engagement team and other authorized parties as necessary to properly discharge their responsibilities.

- There need to be appropriate controls over access to such evidence and eventual destruction after the expiry of the retention period otherwise they could lead to unintentional destruction of evidence or a risk to confidentiality.
- Enable the retrieval of, and access to, the documentation during the retention period, particularly in the case of electronic documentation since the underlying technology may be upgraded or changed over time.

3.5 Check Your Progress

1 What is full form of e-commerce?

a) Electronic commerce
b) Commerce on Internet
c) Both a & b
d) None of the above

2 Which one is the advantage of e-commerce?

a) Convenience
b) Comparison shopping
c) **Both a & b**
d) None of the above

3 Which one is the disadvantage of e-commerce?

a) Limited customer service
b) Lower operational costs
c) More jobs
d) All of the above

4 "E-commerce provide face to face interaction between customer and seller." Is the statement true?

a) **Yes**
b) **No**
c) **Cannot say**
d) None of the above

5 Which one point will be considered by an Auditor during audit planning?

a) Scope in e-commerce environment
b) Identification of key risk areas
c) Understanding of internal controls
d) All of the above

6 Which one factor should analyze by an auditor in order to identify risks associated with e-commerce transactions?

a) Loss of transaction integrity;
b) Risk of business process failure
c) **Both a & b**
d) All of the above

3.6 Summary

E-commerce is a huge part of the economy and is vital to businesses that sell their products or services online. E-commerce gives businesses the ability to reach more customers than traditional retail reaches. Electronic commerce includes activities of promoting and selling a product or service and obtaining payment for the same. This may also include the payment of bills and government revenue services. Originally, electronic commerce meant the facilitation of commercial transactions electronically, using technology such as Electronic Data Interchange (EDI) and Electronic Funds Transfer (EFT). The concept of e-commerce first formally came forth in 1991, a time when internet practically did not even exist in India. Even worldwide, very few could fathom that the act of buying and selling goods and services over the internet, would be as widely accepted a practice, as it is today. It has many type such as B2B, B2C, B2A etc. It not only made the audit easy but create many threats to our life also. There are number of consideration during audit process of e-commerce transactions like skill and competences, legal consideration, risks, accounting policies, going concern, audit evidence and documentation etc.

3.7 Keywords

- **Commerce-** Commerce refers to the buying or selling goods and services from person to person without use of internet.

- **E-commerce-** E-commerce refers to the buying or selling goods and services electronically with the help of internet.
- **Audit trails-** *It means those records that enables a transaction to be traced from its source to a summarized total in a financial statement.*
- **Audit Planning**: Audit planning is a process of deciding in advance what is to be done, who is to do it, how it is to be done and when it is to be done by the auditor in order to have efficient and effective completion of work.
- **Accounting policies-** Accounting policies are the specific principles and procedures implemented by a company's management team that are used to prepare its financial statements.
- **Business-to-consumer (B2C)**-This is the most common kind of e-commerce. When shoppers get online and buy something from an online store, they are involved in business-to-consumer e-commerce.
- **Business-to-business (B2B)**-Many businesses sell raw goods or parts through e-commerce to other companies that will then use those materials to create their products.
- **Business-to-administration (B2A)**-This category of e-commerce refers to transactions between businesses and public administration, which includes areas such as social security, employment and legal.

3.8 Self-Assessment Test

Q.1 What is E-Commerce? Explain the evolution of E-commerce.

Q.2 Define E-Commerce. What are the various type of E-Commerce?

Q.3 Differentiate between Traditional Commerce and E-commerce.

Q.4 What is E-Commerce? Explain the advantages and disadvantages of E-Commerce?

Q.5 Explain the detailed note on Audit in E-commerce environment.

Q.6 Write short notes on the followings:

a) Legal Consideration in e-commerce transactions

b) Audit Planning

c) Audit Trails

d) Audit Documentation

3.9 Answers to Check Your Progress

1(c), 2 (c), 3(a), 4 (b), 5(d), 6 (c)

3.10 References/Suggested Readings

- **Tandon, B. N., S. Sudharsanam, and S. Sundharabahu**, "*A Handbook of Practical Auditing",* S. Chand and Co. Ltd., New Delhi.
- **Pagare, Dinkar**, "*Principles and Practice of Auditing",* Sultan Chand and Sons, New Delhi.
- **Institute of Chartered Accountants of India**, ''*Auditing and Assurance Standards*'', ICAI, New Delhi.
- **Gupta Kamal, and Ashok Arora**, "*Fundamentals of Auditing*," Tata Mc-Graw Hill Publishing Co. Ltd., New Delhi.
- **Ghatalia, S.V.**, "*Practical Auditing*," Allied Publishers Private Ltd., New Delhi.

Subject: Auditing	
Course Code: BC-505	**Author:** Mr. Kapil Singh
Lesson No.: 04	**Vetter:** Prof. M.C. Garg

INTERNAL CONTROL, INTERNAL AUDIT AND INTERNAL CHECK

Structure

4.0 Learning Objectives

After reading this lesson, you should be able:

- To know about internal control system and its objectives
- To explain stages in study and evaluation of internal control
- Explain the meaning and objectives of internal check
- To define elements of internal check
- To explain about internal audit

4.1 Introduction

Internal control is the process designed to ensure reliable financial reporting, effective and efficient operations, and compliance with applicable laws and regulations. Safeguarding assets against theft and unauthorized use, acquisition, or disposal is also part of internal control. In accounting and auditing, it is a process affected by an organization's structure, work and authority flows, people and management information systems, designed to help the organization accomplish specific goals or objectives. It is a means by which an organization's resources are directed, monitored, and measured. It plays an important role in preventing and detecting fraud and protecting the organization's resources, both physical (e.g., machinery and property) and intangible (e.g., reputation or intellectual property such as trademarks).

At the organizational level, internal control objectives relate to the reliability of financial reporting, timely feedback on the achievement of operational or strategic goals, and compliance with laws and regulations. At the specific transaction level, internal control refers to the actions taken to achieve a specific objective (e.g., how to ensure the organization's payments to third parties are for valid services rendered.) Internal control procedures reduce process variation, leading to more predictable outcomes. Internal controls within business entities are also referred to as operational controls. The system of internal control and its actual is decided by the management. It is the job of the management cadre to decide how the work is to be dividing and what is the amount of controlling each task requires. As far as the auditor is concerned he starts his work only after. Internal control can be divided into three parts:

- **Organisational control**-It includes the complete knowledge of objectives, organisational structure and the mutual relationship among various departments of the organisation.
- **Accounting control**-It includes Accounts control, Standard cost control, Budget Control etc.
- **Administrative control**-It includes Cost financial control, Control Accounts etc. in order to maintain the efficiency in the work done by office in any organisation.

4.2 Internal Control

The System of control of all aspects of the business and its transactions is known as internal control. Normally, internal control implies controlling the internal work of the business in such a manner that profit are maximized and the possibility of manipulation, frauds, forgery etc. are minimized. The system controls each aspect of the business in planned manner and through this system all activities of the business, whether economic or non-economic, are controlled. A part from control relating to research, personnel and administration all other controls relating to the accounts are included in internal control.

According to **Spicer and Pegler**, " Internal control is best regarded as indicating the whole system of control, financial and otherwise, established by the management in the conduct of business including internal check, internal audit and other forms of control.''

Howard Stettler defined that, "Internal check and internal audit comprise the principal means by which business management maintains internal control over the extensive activities and operations for which it is responsible.

4.2.1 Objectives of Internal Control

The following are the main objectives of internal control.

- **To Protect Business**: Internal control provides safety of the assets of the business by comparing the actual assets with those being shown in the books of accounts from time to time, and ensuring that only person duly authorized by the management have access to the assets.
- **To Verify Books of Accounts**: Examining the accuracy of the accounts and ensuring the transactions are being recorded correctly.
- **Fixation of Responsibility**: Under this control system responsibility centres are established and fixed the responsibility in relation to every activity for smooth running of business.

- **Facilitate Comparison**: Comparing the standards set by Internal Control with actual activities and establishing and removing the deviations therein.
- **Compliance with Management Policies**: It ensures compliance with the policies of the management and ensuring that transaction are being entered into in accordance with the methods prescribed by the management.
- **To Increase Efficiency of Business**: Internal control helps in increasing the efficiency of work, by increasing the efficiency of material, labour, plant, and capital and improving the running of the business.
- **Make Control over Stock**: Stock includes raw material, work in progress and finished goods. In relation to control stock policies of the organization may differ from one to another. There should be an appropriate system for controlling the receipt of goods, issue of goods and safety of the goods in stock. Internal control ensures all these.

4.2.2 Principles of Internal Control

Internal control is based on the following principles:

- **Principle of Separation-**Financial and accounting operations must be separated, i.e., handling of cash and the recording of the movement thereof should be done by different persons.

- **Principle of Responsibility-**Responsibility for the performance of the job must be clearly stated so that there may be no room for doubt or confusion subsequently.
- **Principle of Scepticisms-**Too much confidence should not be pinned on one individual. Nearly all frauds have been committed by trusted officials or employees.
- **Principle of Rotation-**The rotation principle relating to the transfer of an employee from one job to another should be the inflexible guiding rule.
- **Principle of Review-**The work should be so arranged that work done by one employee should be promptly checked by another independent employee.
- **Principle of Clarification-**Clear and well-defined rules should be laid down and practically followed, relating to dealing with cash, ordering, receiving and issuing goods, etc.
- **Principle of Documentation-**The arrangement of the work should be in such a manner that a written record of the part played by each employee should be maintained, and the work should pass through several hands in a well-defined manner.

4.2.3 Components of an Internal Control Structure

Committee of Sponsoring Organizations (COSO) identifies five interrelated internal control structure components as follows:

- **Control Environment-**The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Numerous factors comprise the control environment in an entity, among which are the following:
  - Integrity and ethical values
  - Commitment to competence
  - Board of directors and audit committee
  - Management philosophy and operating style
  - Organizational structure
  - Assignment of authority and responsibility
  - Human resource policies and practices
- **Risk Assessment-**Risk assessment for financial reporting purposes in an entity's identification, analysis, and management of risks relevant to the preparation of financial statements that are fairly presented in conformity with generally accepted accounting principles. Management's risk

assessment should include special consideration of the risks that can arise from changed circumstances, such as new areas of business or transactions, changes in accounting-standards, new laws or regulations, the rapid growth of the entity, and changes in personnel involved in the information processing and reporting functions.

- **Information and Communication-**The information system relevant to financial reporting, objectives, which includes the accounting system, consists of the methods and records established to identify, assemble, analyse, classify, record, and report entity transactions and to maintain accountability for the related assets and liabilities. Communication involves providing a clear understanding of individual roles and responsibilities about the internal control structure over financial reporting.
- **Control Activities-**Control activities are those policies and procedures that help ensure that management directives are carried out. They help ensure that necessary actions are taken to address risks to the achievement of the entity's objectives. Control activities have various objectives and are applied at various organizational and functional levels. Control activities relevant to a financial statement audit may be categorized in many different ways. One way is as follows:
    - Information processing controls
    - General controls
    - Application controls
    - Proper authorization
    - Documents and records
    - Independent checks
    - Segregation of duties
    - Physical controls
    - Performance reviews
- **Monitoring-**Monitoring is the process that assesses the quality of the internal control structure's performance over time. It involves assessment by appropriate personnel of the design and operation of controls on a suitably timely basis to determine that the ICS is operating as intended and that it is modified as appropriate for changes in conditions.

4.2.4 Stages in the Study and Evaluation of Internal Control

Auditors are required to understand internal controls in order to assess the risk of material misstatements. At the planning stage, generally accepted auditing standards require the auditor to understand the controls adequately enough to permit audit planning. When using a substantive approach (assessing control risk at maximum), the auditor must understand the control environment and the control systems that collect, record, and process data. The auditor must report the information found. When using a combined approach, the auditor must also understand the control systems that enhance the reliability of data and information. In addition, the auditor must test the controls relied upon to establish that they are operating as intended. Good control systems should include the following:

- Competent and trustworthy personnel
- Proper authorization of transactions and activities
- Adequate segregation of duties
- Design and use of adequate documents and records
- Controlled access to assets and records
- Periodic, independent comparison or verification
- Error-checking routines

Phases of Internal Control Evaluation

- Gaining an understanding of the internal controls stated to be in effect
- Assessing the preliminary control risk and determining the audit approach to be used
- Testing control audit procedures when assessing control risk below maximum (based on identified specific controls on which risk could be assessed low)

The auditor will usually want to rely on some internal controls to reduce substantive tests of balances. This requires that the auditor first understand the controls and then test compliance throughout the audit period. For a preliminary evaluation of internal control, the auditor looks at possible misstatements and the controls that exist to prevent or detect such misstatements. If the auditor intends to rely on internal controls as part of gathering sufficient appropriate evidence, tests of control need to be planned and executed. The decision to carry out tests of controls is dependent on the evaluation of the design of the system and the cost-benefit trade-offs of control testing, if appropriate. Auditors understand and evaluate internal control relevant to the audit in order to:

- Assess risks of material misstatement, identify types of potential misstatements, and determine the nature, timing, and extent of audit procedures
- Formulate constructive suggestions to management for improving internal controls
- Management's objectives with respect to internal control are to ensure the orderly and efficient conduct of the entity's business. It is management's responsibility to establish and maintain the entity's controls that provide reasonable assurance that its objectives of reliable financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations will be achieved.
- The auditor is concerned with management's control objectives as they relate to financial statement preparation in accordance with generally accepted accounting principles and the management of risk that may give rise to a material misstatement in the financial statements. It is the auditor's responsibility to gain a sufficient understanding of internal controls to enable the auditor to plan the audit.
- The objectives that are of interest to both management and the auditor include validity, completeness, authorization, accuracy, classification, accounting, and proper period, as they pertain to the financial statements.

The control environment is the foundation for effective internal control. It includes the governance, management philosophy, and operating style of an entity and communication of its values and standards. It includes the attitudes, awareness, and actions of management and those charged with governance relating to the entity's internal control. It sets the tone of an organization influencing the control consciousness of its people through appropriate human resource policies/practices and assignment of authority and responsibility.

4.2.5 Internal Check

Internal check is best regarded as indicating checks on the day-to-day transactions which operate continuously as a part of the routine systems whereby work of one person is proved independently or is complementary to the work of another, the object being the prevention of or early detection of errors and frauds. The main objective of internal check is prevention of errors and frauds and/or detection of errors and frauds at the earliest. Internal check is a continuous process and is part of the day-to-day routine. It relates to all the transactions that take place every day. Internal check is achieved by complementary allocation of duties and by independent verification of the work of one person by another.

Internal check is a part of internal control system. It ensures that all financial transactions are properly recorded. It also ensures efficiency of the accounting system followed by the organization and enables easy preparation of financial statements. It achieves its main object of minimizing errors and frauds. A sound system of internal check increases the reliability of financial statements. Internal check discourages fraud and collusion among employees by instilling a fear of detection in their minds. Internal check assigns responsibilities to persons and enables maintenance of records and documents properly and thereby ensures smooth flow of work.

Internal Check is a system in which all the transactions of the organization and the related accounting work is divide among the employees in such a manner that the work done by one employee is examined independently by another employee. According to this system, the work is divided among the employees to according their capabilities and in such a manner that no single employee does any task or transaction from the start to the end. In this manner, the complete accounting work in respect of any transaction is not allotted to any single person from the start to finish.

4.2.6 Objectives of Internal Checks

Following are the objectives of internal check:

- **To Prevent Frauds and Errors-**The main objective of internal check is to establish a system which makes frauds impossible or very difficult to commit and hence employees are dissuaded against committing frauds. In the same manner the prevention of errors is also one of its objectives since in this technique there is provision for compulsory examination of work done by one employee by another.
- **Determination of Responsibility-**The determination of responsibilities of employees is also one of the objectives of internal check. In this system work is divided in such a manner so that in case of frauds and errors the related officers can be held responsible.
- **To Prevent Omissions in Accounting-**The aim of this system is to bring about discipline in accounting so that no transaction is omitted from being recorded in the books of accounts.

- **To Increase the Efficiency of Employees-**The aim of the internal system is to divide the work into various parts and assigning it to those employees who are efficient in doing such work. In this manner, this system is also adopted in order to increase the efficiency of employees.
- **Quick Preparation of Final Accounts-**The aim of this technique to prepare an organization structure of the accounting department in such a way the accounting work can be done an efficient and errors free manner, and at the end of the financial year the final accounts can be prepared as quickly as possible.

4.2.7 Elements of Good Internal Check System

Certain qualities are needed to make an internal check system more effective and efficient. Such qualities are known as element/ features of internal check system which are as follows:

- **Division of Work:** Before applying test check it is necessary to divide the entire tasks among the staffs in such a way so that work can be checked automatically by the other staff. Like, when staff takes the responsibility of purchase, then another staff should make its payment.
- **Provision of Check:** An organization should set up such provision, so that work can be checked by the staff. An officer can check the work of one staff by transferring to the staffs and again.
- **Use of Devices:** In this modern world, various devices can be used to do various function like use of time record machine, wage determination machine etc. An organization should use such machines which help to make work of internal check easier.
- **Self-balancing System:** An organization can use self-balancing ledger accounts which help to make the work of internal check easier. Its effectiveness depends on its management.
- **Change in Work:** An organization needs to transfer the staffs from one place to another place so that the work of previous staffs can be checked by the later staff member which helps to make the internal check system effective.
- **Specialization:** Every staff may not have such specialized knowledge to maintain accounts properly. So, an organization should give training to increase their skill so that internal check can be made more effective.
- **Control:** There is more chance of frauds where there is direct contact of consumer or public. So, a manager can keep eyes in those works so that internal check system can be made more effectively.

4.3 Internal check and Auditor

The auditor has to take certain decision before commencing his work. He has to decide whether he has conducted his examination on the basis of overall checking or whether he may resort test checking and whether the checking should be routine or in depth. In large organization it is neither possible nor economically viable to check each and every transaction. The main aim of auditing is to certify the accuracy, fairness and regularity of the business transactions. Hence before deciding upon the actual structure of his audit programme it becomes necessary for him to study the internal check system of the organization. A good system of internal check makes his work more easy and smooth; however, if the system of internal check is weak then he may be deceived by the same. He should take the following steps in order to evaluate the system of internal check;

- The auditor should first of all obtain a written description of internal check system from the client, so that he can get a basic idea of the internal check system of internal check system of the organization.
- The auditor should check as to whether the internal control system is being practically implemented in the same manner as specified in the description or not.
- He should check what the activities are in relation to various types of transactions and how the work has been dividing among the various employees based on these activities. He should also study the work of each employee, work rotation, compulsory leave etc.
- He should find out the weak and undependable areas of the internal check system. He should also find out the weaknesses in the system as a whole, so that he can lay more emphasis on areas where the possibility of frauds and errors is greater.

4.3.1 Advantage of Internal Check

If the internal check system is devised in accordance with the nature of the business and after due thought, it has the following advantages for the organization.

- **Moral Influence on Employees:** The internal check system has a moral and psychological influence on the employees. The business activities are divided in such a way that each employee.
- **Ease in Audit:** The auditor also benefits greatly from this system. In organization where the internal check system is reliable, the auditor can resort to test checking instead of in depth examination and hence can complete the work in lesser time and with lesser efforts.

- **Early Preparation of Final Accounts:** All the accounts are examined continuously; hence there are no undetected errors in the books of accounts and the Trial Balance. Since both sides of the Trial Balance are tallied the final accounts can be prepared much earlier.
- **Benefit to Employer:** Internal check system increase the belief of the owner of the business in the books of accounts. He assured that the accountancy work is proceeding smoothly, and hence he can focus his attention in other areas, and work for the progress of the business.

4.3.2 Disadvantage of Internal Check

The main disadvantages of internal check are as follows:

- This facility involves division of work, so there can be requirement of extra staff members. Only big companies can avail this facility not possible for the small companies.
- In Internal check there can be grouping of the people for commits frauds within the organization for their self-interest. This can destroy the name and fame of organization.
- When a company follow the system of internal checks, the auditor much relies on the correctness of this system. Hence due to this type of negligence auditor doesn't give more efforts to check the accounts.
- Sometime employer is much assured with the internal check system of organisation. Every employee wants to do their work as soon as possible. But this type of mentality can be harmful for the organization.

4.3.3 Difference between Internal Control and Internal Check

The main points of distinction between Internal Control and Internal Check are as follows;

Sr. No.	Basis of Difference	Internal Control	Internal Check
1.	**Meaning**	The purpose of internal control is to ensure that the activities undertaken are as per predetermined plans, policies and procedures. so that any durations from the same can be	Internal check involves an arrangement in an organization in which the work of under taking and recording a transaction is distributed among various employees so that the work of one employee is verified

		verified and steps can be taken to prevent rectify and prevent the same in the future	and controlled by another.
2.	**Scope**	Internal control has wider verifications involving the control of the administration aspects or financial aspects or any other aspect of an organization	Internal check is limited to the verification of financial transactions undertaken in year.
3.	**Objects**	To ensure that the activities undertaken to achieve the goals of an organization as per predetermined plans and procedures. To achieve this, the work of subordinates should be overseen and modifications should be made where ever necessary.	The objective of internal check is to minimize the occurrence of fraud and errors in the process of book keeping an also if fraud or an error has occurred to find out the same as soon as possible.
4.	**Relation**	Internal control is exercised over all the activities /sub-activities undertaken by an organization.	Internal check is over employees exercised for recording all financial transactions.

4.3.4 Internal Audit

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. Internal auditing is a catalyst for improving an organization's governance, risk management and management controls by providing insight and recommendations based on analyses and assessments of data and business processes. With commitment to integrity and accountability, internal auditing provides value to governing bodies and senior management as an objective source of independent advice. Professionals called internal auditors are employed by organizations to perform the internal auditing activity.

The scope of internal auditing within an organization is broad and may involve topics such as an organization's governance, risk management and management controls over efficiency/effectiveness of operations including safeguarding of assets, the reliability of financial and management reporting, and compliance with laws and regulations. Internal auditing may also involve conducting proactive fraud audits to identify potentially fraudulent acts; participating in fraud investigations under the direction of fraud investigation professionals, and conducting post investigation fraud audits to identify control breakdowns and establish financial loss.

Internal auditors are not responsible for the execution of company activities; they advise management and the Board of Directors or similar oversight body, regarding how to better execute their responsibilities. As a result of their broad scope of involvement, internal auditors may have a variety of higher educational and professional background

4.3.5 Qualification of Internal Auditor

As per prevailing law internal audit is not mandatory for companies. It is the internal matter of the company and its management. They can appoint internal auditor as like external auditor. The qualification of internal auditor depends upon the company. They can appoint a Chartered Accountant (CA) or Cost Accountants (CS) as internal auditor or it is not essential to appoint CA or CS as internal auditor.

4.3.6 Efficient Internal Audit Department

Followings are the main requisites of an efficient internal audit department:

- **Adequate, qualified and experienced staff-**The first and foremost requisites of an efficient internal audit department is availability of adequate, qualified and experienced staff for the work of internal audit. Proper number of internal auditors with proper qualification and experience can do internal audit in the efficient and effective manner and chances of frauds and errors are also less in comparison to non-qualified.

- **Proper working conditions within the organization for the staff**-Proper working environment with all facilities within the organization for internal auditor boost the performance of staff.
- **Proper division of work within the staff of internal audit-**Proper division of work is the key to success in the internal audit. So right work should be assigned to the right person for the smooth functioning of the organization.
- **Freedom to work, plan and report**-Freedom to work and report is necessary for the internal auditors to make possible of true and fair valuation of organization. When they plan with their own conscious mind, they plan for the best of organization. Reports should be prepared unbiased by the internal auditor to give proper view of the organization. These type of freedom boost the morale of staff.

4.3.7 Procedure of internal audit

The following are the main steps in internal audit:

- **Define the objectives of the internal audit**-The first step in the internal audit procedure is to define the main objectives of internal audit. A clear plan of internal audit should be clear in the mind of internal auditors that have to be done in the organization.
- **Formulate the policy and techniques**- For controlling the internal audit certain policy and technique must be framed. These policy will ease the procedure of internal audit and guide the internal auditors time to time.
- **Select some representative transactions for the examination**-Next some representative transactions will be selected which have to be examined.
- **Complete examination of documents and vouchers-**The selected transaction should be completely examined from the beginning to end. This includes the examination of documents and vouchers, confirmation from the employees and third parties and relationship between parties.
- **Examine the errors and frauds**-During the procedure all the errors and frauds should be examined. Effects of these errors can cause of loss for the organization, so utmost care should be taken when examination is in the progress.

- **Report to the management**- At the end of the internal audit procedure a report of the examination should be submitted to the management which contain all the facts and figures that faced by internal auditors during the procedure.

4.3.8 Benefits of Internal Audit

Following are the benefits of internal audit:

- Internal audit feeds the managers with a perennial source of information for exercising effective control. By measuring performance, evaluating results and recommending suggestions for remedial actions, internal audit may be instrumental for forcing events to conform to plans.
- The plan itself may be put to a critical study under an internal auditing programme so as to find out its appropriateness and effectiveness in the organization. Particularly, policies and procedures are appraised to see their relevancy and continuation towards the attainment of enterprise objectives. Briefly, internal audit may be utilized as the keeper of managerial conscience in the organization.
- The introduction of an internal auditing programme tones up the morale and working efforts of all members of the organization. The risk of being exposed before the eyes of managers induces persons to keep within the track and to avoid errors of omission or commission.
- Internal audit scrutinizes accounting and financial data to screen facts from the heaps of figures and statistics. Thus accounting for management information can be made to prevail under a programme for internal audit.

4.3.9 Disadvantage of Internal Audit

The main disadvantages of internal audit are as follows:

- This facility involves high cost set up, so only big companies can avail this facility not the small companies.
- If the management of the organization are not in favor of employees, then their services can't be satisfactory.
- Internal auditor and management can commit any fraud in the organization.
- Internal auditors are the employees of the organization, so they have to do function as per directions/wishes of management.

- Sometimes company appoints unqualified employee as internal auditor, which can commits errors and frauds.

4.3.10 Difference between Internal Checks and Internal Audit

Sr. no.	Basis of difference	Internal Checks	Internal Audit
1.	Nature of work	It involves the verification of transactions recorded in the books of accounts.	It involves the verification of transactions recorded in the books of accounts and internal control.
2.	Objective	Prevent from frauds and errors.	Detection of frauds and errors and judge the effectiveness of internal check.
3.	Period	It starts when the transaction is being recorded and continues for whole year.	It starts when the transactions have already recorded.
4.	Scope	Verification and recording the transactions.	Verification of transactions and books of accounts.
5.	Staff	It is conducted by routine staff members.	It requires extra staff for internal audit.
6.	Function	It is operative function.	It is advisory function.
7.	Procedure	It involves verification of books by one person by another person during the recording of the transaction.	It has a specific procedure.
8.	Knowledge of errors frauds	Knowledge of errors and frauds during recording of the transaction in the books of	Knowledge of errors and frauds after recording of the transaction in the books of

		accounts.	accounts.

4.4 Check Your Progress

1. Internal Auditor is appointed by........

   (a) Management
   (b) Shareholders
   (c) Government
   (d) Statutory body

2. Internal check is a part of......

   (a) Internal audit
   (b) Internal accounting
   (c) External audit
   (d) Internal control

3. Internal check is carried on by......

   (a) Special staff
   (b) Internal auditor
   (c) Internal staff
   (d) None of the above

4. Internal Audit is..?

   a) **Voluntary for a company**
   b) **Not necessary for a company**
   c) **Compulsory for a company**
   d) All of the above

5. Internal control means…………

   a) Internal control is the process designed to ensure reliable financial reporting.
   b) Effective and efficient operations.
   c) Compliance with applicable laws and regulations.
   d) All of the above

6. Objective of Internal control is…

   a) To Protect Business
   b) To Verify Books of Accounts
   c) Fixation of Responsibility
   d) All of the above

4.5 Summary

Internal control is the process designed to ensure reliable financial reporting, effective and efficient operations, and compliance with applicable laws and regulations. Safeguarding assets against theft and unauthorized use, acquisition, or disposal is also part of internal control. In accounting and auditing, it is a process affected by an organization's structure, work and authority flows, people and management information systems, designed to help the organization accomplish specific goals or objectives. Internal Check is a system in which all the transactions of the organization and the related accounting work is divide among the employees in such a manner that the work done by one employee is examined independently by another employee. According to this system, the work is divided among the employees to according their capabilities and in such a manner that no single employee does any task or transaction from the start to the end. Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

4.6 Keywords

- **Internal control**: It includes the system of control of the business and its transactions.
- **Internal check**: An arrangement in an organization in which the work of undertaking and recording a transaction is distributed among different employees so that the work of one is verified and controlled by others.
- **Internal Audit**: An independent objective assurance and consulting activity designed to add value and improve organization objective.
- **Self-balancing System:** An organization can use self-balancing ledger accounts which help to make the work of internal check easier. Its effectiveness depends on its management.

- **Principle of Scepticisms-**Too much confidence should not be pinned on one individual. Nearly all frauds have been committed by trusted officials or employees.
- **Principle of Clarification-**Clear and well-defined rules should be laid down and practically followed, relating to dealing with cash, ordering, receiving and issuing goods, etc.
- **Control Environment**-The control environment sets the tone of an organization, influencing the control consciousness of its people.
- **Control Activities**-Control activities are those policies and procedures that help ensure that management directives are carried out.

4.7 Self-Assessment Test

Q.1 What is internal control system? Explain its objectives.

Q.2 Define internal control. Explain principal and components of an internal control structure.

Q.3 Define internal check. What are the objectives of internal check system?

Q.4 Differentiate between internal control and internal check.

Q.5 What is internal audit? Explain the benefits of internal audit.

Q.6 Explain the quality of good internal check system.

Q.7 Write short notes on:

a) Internal check and auditor

b) Advantages of internal check

c) Evaluation of internal check system

d) Procedure of internal audit

e) Difference between Internal Checks and Internal Audit

4.8 Answers to Check Your Progress

1(a), 2 (d), 3(c), 4 (a), 5(d), 6 (d)

4.9 References/Suggested Readings

- **Basu, S.K**., “Fundamental of Auditing” Pearson Publication, New Delhi.

- **Tandon, B. N., S. Sudharsanam, and S. Sundharabahu**, "*A Handbook of Practical Auditing",* S. Chand and Co. Ltd., New Delhi.
- **Pagare, Dinkar**, "*Principles and Practice of Auditing",* Sultan Chand and Sons, New Delhi.
- **Institute of Chartered Accountants of India**, ''*Auditing and Assurance Standards*'', ICAI, New Delhi.
- **Gupta Kamal, and Ashok Arora**, "*Fundamentals of Auditing,*" Tata Mc-Graw Hill Publishing Co. Ltd., New Delhi.

Subject: Auditing	
Course Code: BC-505	**Author:** Mr. Kapil Singh’
Lesson No.: 05	**Vetter:** Prof. M.C. Garg
VOUCHING	

Structure

5.0 Learning Objectives

After reading this lesson, you will be able:

- To know about audit procedure

- To explain how to make vouching of cash transaction
- To know about vouching of trading transaction
- Vouching of Personal and Impersonal Ledgers

5.1 Introduction

It is the practice in an audit, with the objective of establishing the authenticity of the transactions recorded in the primary books of account. It essentially consists of verifying a transaction recorded in the books of account with the relevant documentary evidence and the authority on the basis of which the entry has been made; also confirming that the amount mentioned in the voucher has been posted to an appropriate account which would disclose the nature of the transaction on its inclusion in the final statements of account. Vouching does not include valuation. Vouching can be described as the essence or backbone of auditing. The success of an audit depends on the thoroughness with which vouching is done. After entering in all vouchers, only then can auditing start.

The object of vouching is to establish that the transactions recorded in the books of accounts are (1) in order and have been properly authorized and (2) are correctly recorded. “Simple routine checking cannot establish the same accuracy that vouching can. In routine checking, entries recorded in the books only show what information the bookkeeper chooses to disclose, however these entries can be fictitious without any vouching or vouchers. By using a vouching or a voucher system a company will have concrete and solid documentation and evidence of expenses, capital, and written proof in audits. Vouching is the essence or backbone of auditing because when performing an audit, an auditor must have proof of all transactions. Without the proof provided by vouching, the claims provided by the auditor are just that, only claims. In most cases, hard to detect frauds can only be discovered through the use of vouching. This means that the auditor must conduct vouching with great importance, if not, he can be charged with negligence which happened in the case of Armitage v. Brewer and Knott. Through this case, the importance of vouching was realized. In this case, the auditors were found to be guilty on negligence, because the auditors did not display enough reasonable care and skill in vouching the wage sheets and ended up failing to detect fraud in manipulation of these wage records and cash vouchers. When delivering the decision the Judge stated that "It was clear that a good many documents were suspicious neither face nor called for Inquiry". It was declared that it was essential that due care and attention are to be given to vouching in auditing.

5.2 Vouching

Vouching is a procedure followed in the process of the audit to authorise the credibility of the entries entered in the books of accounts. In simple and easier words, it is a precise investigation of the presented documents of the firm by an auditor to check the correctness and accuracy of such documents. It is the foremost step of the auditing process based on which auditor performs his work and prepare an audit report.

Vouching involves not only the substantiating the entry in the books of account with any documentary evidence like assessments, receipts, counterfoils of receipt book or paying-in-book, contracts but also involves seeing that the transactions have been properly authorized, recorded and entered in the books of account. It tests the truth of items appearing in the books of original entry. In order to be a successful auditor, he should be an intelligent person, have common sense, and be tactful in handling his work. He should go to the source of a transaction and go beyond the books of account. He could discover clever frauds by proper vouching only. Hence he should vouch the items with great care and intelligence. He should thoroughly vouch and satisfy himself at each time as to the authenticity and completeness of transactions in the books of accounts.

Vouching is defined as the "verification of entries in the books of account by examination of documentary evidence or vouchers, such as invoices, debit and credit notes, statements, receipts, etc.

5.2.1 Characteristics of Vouching

Vouching has the following characteristics:

- **Scrutinizing of Entries with Vouchers**-In vouching, made in the books of accounts are scrutinized on the basis of relevant vouchers. Vouchers help in verifying the authenticity of the entries made in the relevant accounts of the business.
- **Documentary Evidence as the Basis of Vouching**-The main basis of vouching is documentary evidence. An auditor to examine the relevant vouchers to certify the authentic of the entries made in the books of accounts. The vouchers must be originals (not copies) and related of pertinent to the entries, and must be authentic.
- **Examination of Entries by going behind the Transaction**-The purpose of vouching is to ensure that:

- The transactions are related to the business of the enterprise.
- The transaction is duly and correctly and accurate.
- The transaction has been made by a duly authorized employee of the concern.

In other words, the auditor or the examiner does not confine himself to the entries in the books of accounts; he goes beyond to the source of the transaction to establish the authenticity of the vouchers.

- **Routine Checking as Par Vouching-**Routine checking is a part of vouching. In fact, vouching starts with routine checking, and one complements the other.
- **Vouching as the Backbone of Auditing-**Vouching is the backbone of auditing, and helps in uncovering serious malpractices or frauds. An auditor needs to be extra careful while he does vouching for a concern.

5.2.2 Objectives of Vouching

It is the technique used by the auditors to judge the authenticity of the entries appearing in the financial statement. Procedure and accuracy followed for performing vouching decide the success or failure of the auditing. Some major objectives behind the vouching process are as follows:

- To ensure that all the transactions took place during the financial year for the business purpose only (not for personal use), and are appropriately recorded in the books of accounts with true and fair evidences.
- To check the accuracy of the totalling and carrying forward amount recorded in the financial statements.
- To ensure that the person responsible for the business has verified his records or not.
- To make the financial records free from malpractices.
- To make sure that financial records are prepared in a lawful manner.

5.2.3 Importance of vouching

While performing an audit, the auditor is totally dependent on the documents presented to him by the responsible person for the business during the whole financial year. If any bill related to sales, purchase, electricity, telephone, that are not associated with the business is presented, it can only be detected with fair vouching. Various frauds can be detected while doing vouching if it is done in an intelligent manner. For preparing reliable profit and loss a/c, Balance sheet, the vouching should be done accurately. It's an ethical duty of an auditor to check the arithmetical accuracy of records and see its substantial accuracy because if the primary document is wrong, the whole financial statement will show the wrong and unfair result.

Vouching is the act of checking evidential documents to find out errors and frauds and to know the authenticity, accuracy and reliability of books of accounts. Thus, it is important for an auditor due to the following reasons:

- **Vouching is the backbone of auditing**-Main aim of auditing is to detect errors and frauds for proving the true and fairness of results presented by income statement and balance sheet. Vouching is only the way of detecting all sorts of errors and planned frauds. So, it is the backbone of auditing.
- **Vouching is the essence of auditing**-Auditing not only checks the accuracy of books of accounts but also checks whether the transactions are related to business or not. All the transactions are performed after the prior approval of concerned authority or not, transactions are real or not because an accountant may include fictitious transactions to commit frauds. All these facts can be found with the help of vouching. So, vouching is essential for auditing.
- **Vouching is important to see whether evidences are correct or not**-An auditor checks the books of accounts to detect errors and frauds. Frauds may be committed presenting duplicate vouchers. All the small and big amounts of frauds can be detected with the help of vouching. So, all the evidential documents and records are to be checked carefully and in detail by an auditor which is the scope of vouching.

Therefore, it can be said that vouching is the heart of auditing because without the work of vouching, the work of auditing cannot be performed.

5.2.4 Concept of voucher

The documentary pieces of evidence such as counterfoil, cash memo, receipts and pay-in-slips used for recording transactions in books of accounts is defined as a voucher. The transactions supposed to be recorded only if relevant evidences are available. For Example, Purchase transaction should have these supporting documents for preparing voucher:

- Invoice bill
- Quotation

- Purchase order
- Requisition slip
- Entry gate pass (while receiving goods)

5.2.4.1 Types of vouchers

In general, vouchers are of two types:

- **Primary Vouchers**: The bills or the documents that are available in the original copy are known as primary vouchers.
- **Secondary Vouchers**: These are the bills which are available in a duplicate copy.

5.2.4.2 Sources of Vouchers

There are two sources of vouchers:

- **Internal vouchers**: The vouchers prepared by the company inside its premises are termed as internal vouchers, such as sales invoice.
- **External vouchers**: The vouchers created outside the organisation are termed as external vouchers, such as bank statement.

5.3 Examination of vouchers

While vouching the transactions, the auditor should first of all examine the various vouchers keeping the following points in mind:

- **Made in the Name of the Employer**: The auditor should see whether the voucher is made in the name of the employer of the concern.
- **Printed Form**: He should see whether the voucher is on a printed form.
- **Serial Number**: He should see whether all vouchers are consecutively numbered and filed in order of the entries in the various books.
- **Date, Name, Amount, etc.**: The auditor should check date, name of the party to whom the voucher is issued, the name of the party issuing the voucher, and the amounts, etc.
- **Cancelled by Stamp**: The vouchers, which are inspected by the auditor, should be cancelled by a stamp so that it cannot be produced again.
- **Related to the Firm**: The auditor should also see that all the vouchers are related with the business or not and see whether the payments made by the concern relate to the business or not. The auditor

should pay special attention to those vouchers, which are in the personal name of one of the partners, directors, manager or officers of the company.

- **Special Mark in case of Detailed Checking**: In case of vouchers, which require detailed checking, the auditor should put special mark on them. He should check such vouchers carefully.
- **Passing of Vouchers**: The auditor should see that a responsible senior officer of the concern passes every voucher correctly and the rubber stamps are affixed. He should also see whether the responsible official signs them.
- **Stamped**: If the amount of voucher exceeds Rs.500 it must be stamped. The auditor should note whether the vouchers are stamped too.
- **Not to take the Help of the Employees**: The auditor should not take the help of the employees of the concern while checking the vouchers.
- **Type of Account**: The auditor should see whether the payment is made to a capital account or revenue account.
- **Related to the Year under Audit**: The auditor should see that the vouchers are related to the year for which the auditing is going on.
- **Amount in Words and Figures**: The auditor should also see that the figures and words of the amount in the vouchers are the same.
- **Points Regarding Further Verification**: If any transaction requires further verification of any other evidence such as Memorandum of Association, Articles of Association, Prospectus, Partnership Deed, etc. they shall be noted.
- **Not to Accept Invoice as a Voucher**: The invoice should not be accepted as voucher because there are a lot of chances of double payment i.e., once in the form of credit purchase and second time in the form of cash purchase.
- **Not to Accept the Mutilated Vouchers as such**: In case if any voucher is mutilated or the amount therein is cut then the auditor should not accept such vouchers as such. They should be made signed by any senior responsible officer of the concern before they are accepted.
- **Pad Paper is not Voucher**: Pad papers should not be accepted as vouchers because in such case chances of fraud are more.

- **Time of Payment**: The vouchers for insurances, rates, and taxes, etc. should be checked by the auditor with reference to the period for which the payment has been made. In case of payments in advance, the auditor should see whether correct adjustments have been made.

5.3.1 Audit Procedure

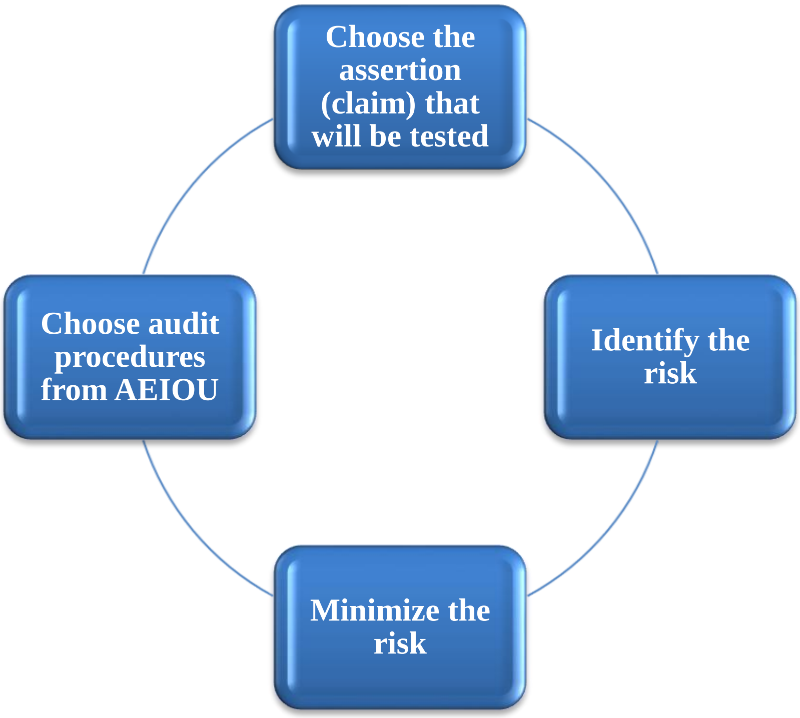
The audit procedure is as follows:

- **Identify the Statement Tested-**Audit procedures are performed in order to test financial statement assertions. Therefore, the first step in explaining an audit procedure is to identify the assertion that needs to be tested. The assertions embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur, may take the different forms. A brief explanation of the various assertions is as follows:
  - **Completeness:** This means that all transactions have been recorded in the financial statements i.e. all assets, liabilities, equity interests (capital and reserves) and other disclosures have been included in the financial statements.
  - **Occurrence:** This assertion means that transactions and events and other matters that have been recorded actually took place and relate to this organisation.
  - **Valuation and allocation:** This means that all items have been included in the financial statements at appropriate amounts according to company policy and the relevant financial reporting framework. Furthermore, any allocations or valuation adjustments required (like impairment) have been made and financial and other information is disclosed fairly and at appropriate amounts.
  - **Classification and understand ability:** Financial information is appropriately presented and disclosed, and disclosures are clearly expressed so as to make them understandable to the users. For this, the disclosures should use simple language and state matters clearly and concisely.
  - **Accuracy:** Accuracy means that amount and other data relating to transactions and events have been recorded at the correct amount –i.e. at the amounts appearing in the source documents.
  - **Rights and obligations:** This means that the entity has a right to its assets .i.e. it is free to use or dispose of the assets as it sees fit. Furthermore, the entity is obliged to pay off the liabilities that are shown in the statement of financial position.
  - **Existence:** This means that assets, liabilities and equity interests (capital and reserves) are physically present/belong to the entity on the reporting date.

- **Cut off:** This means that transactions and events have been recorded in the correct accounting period–for example, if goods are delivered prior to year-end, they are included in the cost of goods sold, not inventory.

➢ **Identify the audit procedure-**The following audit procedure will be followed:

- **Choose the assertion (claim) that will be tested:** Choose an assertion from Completeness, valuation and allocation, Rights and obligations and Existence if you are testing the period-end balance of property, plant and equipment (PPE); valuation of noncurrent assets is the assertion tested.
- **Identify the risk:** Identify the risk that will cause a material misstatement in the financial statements–the audit risk is the total value of property, plant and equipment (PPE), that may be misstated due to over-valuation/ undervaluation of property, plant and equipment (PPE).



- **Minimize the risk:** The auditor will check the availability of a revaluation report (a source document for the revaluation) and confirm that the value mentioned in the valuation report matches the amount at which the property, plant and equipment (PPE) is revalued and shown in the financial statements. There are many other procedures that will apply to this risk.
- **Choose audit procedures from AEIOU**

A: Analytical Procedure, **E**: Enquiry and confirmation directly from a third party, **I**: Inspection of records and assets and liabilities, **O**: Observation and **U**: recalc**U**lation and performance

- **Note the following while writing down the audit procedure**
  - **Write it clearly:** Audit procedures should be written in such a way that even a junior auditor will be able to understand what is to be done. For example, avoid vague procedures like 'check goods received notes'. This is vague as it does not explain what is to be examined in the goods received notes. Is it the description of items received, the quantity received or the name of the vendor?
  - **Write down the reason for adopting audit procedure:** The audit procedure 'check goods received notes' does not mention why the goods received notes are to be checked. Instead, write the audit procedure as: 'agree the description of items and the quantities ordered mentioned on the goods received note with the descriptions on the purchase orders raised on the vendor'. This confirms that the entity has procured goods based on an authorised purchase order.
  - **Use audit terminology-**Use terminology relating to audit like 'cast', 'agrees', 'trace', etc. Use the word 'cast' to mean totalling up a list–for example, 'cast the trial balance'. Use the words 'agree' or 'trace' to mean matching information from two documents/records–for example, 'agree the total sales of the sales day book to the general ledger account'; or 'trace the total amount from the delivery note to the purchase order to confirm correct valuation of the invoice'.
  - **Common errors must be avoided-**The different common errors must be located and improved by the auditor. It must be mentioned what is to be checked and why it is checked.

5.3.2 Vouching of Cash Transaction

Most errors and frauds are the result of misappropriation of cash which is done by manipulating the receipts and payments. The auditor, therefore, must be extra careful in checking the items of cash and ensure that no receipt or payment of cash unrecorded in the cash book and that no fictitious payment has been entered in it.

There are two columns in a cash book (a) Cash Receipt and (b) Cash payments.

- **Vouching of Receipt Side of Cash Book-**Vouching of the receipt side of a cash book is more complicated the vouching the payments side because the evidence of receipt is not direct since the payment of such receipts is made by other parties and the entries in the cash book are made internally. In case of receipts side the auditor has to depend upon the internal checks and external documentary evidence and pay special attention on the weak points of the internal check system.

- **Compare Counter Foil With Cash Book:** The auditor check the received cash with the counter foil. He should also verify that unused receipt books are kept under, lock and key or not.
- **Sales of Assets:** The auditor should check the money received from the sale of assets and vouch it with reference to the correspondence of contract and other reliable evidence.
- **Terms of Discount:** Auditor should verify about the terms and conditions on which discounts are given to the debtors. He should also test a few items on their base.
- **Receipt of Interest:** Auditor should also verify that all the due interests on loan have been received or not. If, received than up to how much extent they have been received.
- **Receipt of Rent:** Rent received should be vouched with the rent agreement and counter foil receipts.
- **Cash Sale:** In this regard auditor should compare the daily sale statement of cashier and salesman with the bank statement and must watch the prepared cash vouchers regarding sale.
- **Verify Commissions:** Auditor should check the account of commission with the accounts of the parties from whom commission has been received. The rate of commission must be checked.
- **Profit from Investment:** Auditor should touch the profit from the investment with the counter of dividend warrants, financial journals and type of investment with nature of invested company.

➢ **Vouching of Payment (Credit) Side of Cash Book-**While examining the authenticity and correctness of any payment made, it is essential to have evidence of the payment having been made. In vouching payments, the auditor should not merely seek proof that the money has been paid away; he also has to examine that the amount paid is reasonable, is paid to an authorized person and is duly and correctly recorded in the cash book. Besides this, he should make sure that the accepted norms have been adhered to.

  - **Checking of Internal System:** With reference to cash payments, auditor should examine the internal check system and keep in view the weak points while auditing
  - **Inspection of Wages:** The auditor should inspect the certified wage sheet and also test a few items for his satisfaction. He should also compare the appointment order and contract with the salaries.

- **Petty Cash Checking:** Auditor should check the petty cash in hand and verify the balance of petty cash with cash book on the basis of various related statements and transactions.
- **Checking of Payable Bill:** The auditor should examine these bills with the returns. If these are paid through bank then pass book should be checked from time to time.
- **Checking of Revenue and Expenditure:** The auditor should verify that proper allocation has been made between capital and revenue expenditure with proper documentary evidence.
- **Creditor's Payments:** Auditor should also examine the record and documentary evidence about the payments made to the creditors with name, date of purchase and date of payment.
- **Detection of Any Missing Entry:** Auditor should very careful in examining the various payments. He should detect the missing or irregular entry by proper checking of vouchers.
- **Checking of Names and Dates:** Auditor should check the name of the payees in the cash book against their entries. He should also note that dates on vouchers.
- **Purchase of property and Investment:** The auditor should check the relevant deed and the authority letter in (in case the sale is made by a person authorized by the owner) to vouch the purchase of property. In case of investment, it should be seen that the expenditure has been properly apportioned between capital and revenue.
- **Checking of other Payments:** Various other payments such as director's fee, commission and travelling allowances must be checked carefully by two auditors with cross verification of evidences.

5.3.3 Vouching of Trading Transaction

Trading transactions include, purchases, sales, purchase return, sales return, on the basis of consignment, hire purchase, sale or return, etc. Before commencing vouching and verification of the trading transactions, the auditor has to examine the effectiveness of the internal control systems in book keeping, compliance of accounting principles; and maintenance of stock records etc.

- **Vouching of Purchase Book-**In case the internal check system is satisfactory, the auditor should adopt the following technique for vouching the Purchase Book.
  - Each entry in the purchase book must be vouched on the basis of the relevant invoice. An invoice is deemed to be the original Voucher. It is therefore important to check the invoice for its authenticity and correctness.

- In case any invoices are not available while vouching the relevant entries can be authenticated by asking for duplicate invoice from the supplier. Any invoice which has been lost and for which no duplicate is available must be written in a note book by the auditor.
- The auditor must check the goods inward book and the good received note with the Purchase book.
- After checking the invoice entered in the Purchase Book, the auditor should check the totals and balances and ensures that the calculations made are correct. The posting to the respective ledger accounts also need to be checked.
- Invoice of goods received on consignment and goods received on approval also need to be examined to ensure that the same have not been entered as purchases in the books of accounts.

➢ **Vouching of Purchase Returns Book-**In case of vouching of purchase return book an auditor should check the following:

- The auditor should check to confirm whether or not a credit Note has been received in response from the seller and whether the amounts of the two notes are the same.
- The auditor should check the Credit Note entries in the purchases return book to ensure that the entries are correct.
- In case of any doubt about the goods having been returned, the auditors can correspondence with the creditors to confirm the same.
- Usually, frauds are committed for goods returned at the beginning or the close of the financial year. The accounts relating to these should, therefore, be thoroughly examined.

➢ **Vouching of Sales Book-**In case of vouching of sale book an auditor should check the following:

- The order copy of different parties which has been received by the business
- The entries must be matched with dispatch book or store outward book at the main gate of store.
- Debtors account statement must be checked by the auditor
- To ensure that goods sent on consignment basis or approval basis should not be recorded as actual sale
- The trade discount provided to different customers must be checked on rate and time basis.
- The current financial year sale should not be recorded in the new financial year or vice versa.

- **Vouching of Sales Return Book-**The following points must be kept in mind while vouching the sales returns.
  - The auditor also needs to check whether or not the credit notes have been duly received and that they bear the receipts' signatures.
  - When the returned goods are received an entry is made in goods Inwards Book by the gate-keeper, the auditor therefore, needs to examine the goods inwards book.
  - He also needs to check the castings of the sales returns Books and the postings in the Ledger Accounts.
  - The auditor should especially check some random entries made in the beginning or at the close of the financial year as these may involve some manipulation of accounts.
- **Vouching of Bills Receivable Book-**The auditor should proceed as follows while vouching the bill receivable books.
  - Check the matured bills for which payments have been received.
  - Compare the bills received by the due date with the entries in the Cash Book.
  - Check the Cash book and the Bank Pass Book for the bills that have been discounted.
  - For the Bills that have been dishonoured, the relevant entries in the financial books need to be examined.
- **Vouching of Bills Payable Book-**The following procedure should be adopted while vouching the bills Payable book.
  - Entries in the bill payable book should be checked with the accounts of the creditors.
  - The Evidence of the bills for which the payment has been made on maturity can be verified by examining the Cash Book and the Pass Book.
  - In case the payment has been made in cash, the receipt for such payment needs to be examined.
  - The costing of the bills Payable Book and their posting in the Ledger Account also need to checked.

5.3.4 Vouching of Personal and Impersonal Ledgers

This mainly includes vouching of debtors, creditors and general ledgers which are explain below:

- **Vouching of Creditors Ledger**
  - The opening balance of the various accounts must be matched with the closing balance of various accounts as shown in the ledger accounts of previous year.
  - All the supporting books and documents must be checked carefully
  - There should be correspondence with the creditors if possible
  - All entries which are checked must be tick marked.
  - The reason for non-payment of any creditor for a long time must be investigated
  - Additions and calculations should be checked properly.
- **Vouching of Debtors ledger**
  - The opening balance of the various accounts must be matched with the closing balance of various accounts as shown in the ledger accounts of previous year.
  - The totalling and balances of various accounts should be checked.
  - Entries from subsidiaries ledgers must be cross checked.
  - The list of debtors should be matched with balances in their personal account.
  - The provision for bad debts and amount of bad debts should be cross checked.
- **Vouching of General Ledger**
  - Each posting in this ledger must be vouched
  - The totalling and balances of various accounts should be checked and must ensure that totals are correctly brought forward of these accounts.
  - The balances of different accounts must be matched with profit and loss account and balance sheet.

5.3.5 Vouching of Petty Cash Book

It is usually kept on the imp rest system. The auditor should ascertain that the system of petty cash is maintained on the imp rest system and note the amount of imp rest should be consistent and in line with the requirements of the company although it should not necessarily be rigid. After examining the adequacy or otherwise of the system of internal check, the following should be performed for vouching the petty cash book.

- **Checking of amount drawn**-Checking the amount drawn for petty cash with reference to cash book or bank statement.
- **Casts & carry forward**-Check the cast, cross forwards of the petty cash book.
- **Check of vouchers-**Tests check the petty cash vouchers with the supporting evidence.
- **Signature**-It should be seen that the petty cash book has been signed by cashier at the end of the month.
- **Pasting-**Pasting should be checked in to the general ledger.
- **Surprise/physically counting**-A surprise count of the cash kept with the petty cashier is also suggested. At the end of financial closing the cash in hand must be physically counted.
- **Allocation**-Expenditure Allocation should be properly verified.
- **Authorization of payment**-It should be seen that payment vouchers are properly authorized.

5.4 Check Your Progress

1. Which of the following is an importance of vouching?

    (a) Ensures all items are disclosed in the financial statement as per Schedule VI provisions

    (b) It helps to verify whether entries are passed as per acceptable accounting principles.

    (c) Helps in detection and prevention of errors & frauds

    (d) All the above

2. Which of the point is not to be considered while checking a voucher?

    (a) Name of party

    (b) Serial number of voucher

    (c) Credit period of payment

    (d) Accounting entry

3. Which of the following can be accepted as a supporting document?

    (a) Invoice/Challan

    (b) Debit note/Credit note.

    (c) Emails/letters.

(d) All of the above.

4. Checking the date of voucher on the voucher during vouching mainly helps the auditor to obtain evidence that.

(a) The transaction relates to current year.

(b) The transaction has taken place.

(c) The transaction is genuine.

(d) The transaction is legal.

5. Checking the date of entry of voucher in the books mainly helps auditor to obtain evidence that:

(a) Entry was made on the same day as that of the voucher.

(b) Entries are passed on a daily basis

(c) The vouchers are filled every day.

(d) No vouchers are missing

6. In order to audit petty cash expenses, the auditor has to check

(a) Petty cash register

(b) Internal controls

(c) Reconciliation of petty cash register and cash book

(d) All of the above.

5.5 Summary

It is the practice followed in an audit, with an objective of establishing the authenticity of the transactions recorded in the primary books of account. It essentially consists of verifying a transaction recorded in the books of account with the relevant documentary evidence and the authority on the basis of which the entry has been made; also confirming that the amount mentioned in the voucher has been posted to an appropriate account which would disclose the nature of the transaction on its inclusion in the final statements of account. The documentary pieces of evidence such as counterfoil, cash memo, receipts and pay-in-slips used for recording transactions in books of accounts is defined as a voucher. These can be the bills or the documents that are available in the original copy are known as primary vouchers and the bills which are available in a duplicate copy known as secondary voucher. The vouchers prepared by the company inside its premises are termed as internal vouchers, such as sales invoice and the vouchers created outside the organisation are termed as external vouchers, such as bank statement. Vouching does not include valuation. Vouching can be described as the essence or backbone of auditing. Audit procedures are performed in order to test financial statement assertions. Therefore, the first step in explaining an audit procedure is to identify the assertion that needs to be tested. The assertions embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur, may take the different forms. Verification is a technique of auditing in which the auditor certifies the assets and liabilities as shown in the Balance Sheet by actual checking or any other technique. The owner or owners of an organization need to know whether the profit or loss as shows by the books is correct or not, and also whether. The assets and liabilities as described in the balance sheet are present in the organization or not.

5.6 Keywords

- **Invoice**: It is deemed to be original voucher.
- **Vouching**: Verification of entries in the books of account by examination of documentary evidence.
- **Voucher**-The documentary pieces of evidence such as counterfoil, cash memo, receipts and pay-in-slips used for recording transactions in books of accounts is defined as a voucher.
- **Quotation**- A formal statement setting out the estimated cost for a particular job or service.
- **Cash Book-** A cash book is a financial journal that contains all cash receipts and disbursements, including bank deposits and withdrawals.
- **Petty Expenses-** Petty cash is a small amount of cash that is kept on a business or company's premises to pay for minor expenses and needs.
- **Primary Vouchers**: The bills or the documents that are available in the original copy are known as primary vouchers.
- **Secondary Vouchers**: These are the bills which are available in a duplicate copy.
- **Internal vouchers**: The vouchers prepared by the company inside its premises are termed as internal vouchers, such as sales invoice.
- **External vouchers**: The vouchers created outside the organisation are termed as external vouchers, such as bank statement.

5.7 Self-Assessment Test

Q.1 What is audit procedure? Explain different steps in audit procedure.

Q.2 Define vouching. Explain how to vouch cash transactions?

Q.3 Explain the procedure of vouching of trading transactions.

Q.4 How can an auditor vouch personal and impersonal ledger?

Q.5 What do you mean by Vouching? Explain the guidelines that the auditor have to follow during the examinations of vouchers.

Q.6 Write notes on

a) Objectives of vouching

b) Vouching of receipt side of cash book

c) Vouching of Purchase and sale book

d) Importance of vouching

e) Vouching of debtors and creditors ledger

f) Verification of stock and debtors

5.8 Answers to Check Your Progress

1. (d), 2. (c), 3. (d), 4. (a), 5. (a), 6. (d).

5.9 References/Suggested Readings

- **Basu, S.K.,** "Fundamental of Auditing" Pearson Publication, New Delhi.
- **Tandon, B. N., S. Sudharsanam, and S. Sundharabahu**, "*A Handbook of Practical Auditing",* S. Chand and Co. Ltd., New Delhi.
- **Pagare, Dinkar**, "*Principles and Practice of Auditing",* Sultan Chand and Sons, New Delhi.
- **Institute of Chartered Accountants of India**, ''*Auditing and Assurance Standards*'', ICAI, New Delhi.
- **Gupta Kamal, and Ashok Arora**, "*Fundamentals of Auditing,*" Tata Mc-Graw Hill Publishing Co. Ltd., New Delhi.

Subject: Auditing	
Course Code: BC-505	**Author:** Mr. Kapil Singh
Lesson No.: 06	**Vetter:** Prof. M.C. Garg
VERIFICATION OF ASSETS & LIABILITIES	

Structure

6.0 Learning Objectives

After reading this lesson, you will be able:

- To know the meaning of verification of assets and liabilities.
- To understand the difference between verification, valuation and vouching.
- To understand the importance of verification of assets and liabilities.
- To know about the confirmation and verification.
- To explain rules of verification of the assets and liabilities.

6.1 Introduction

The processes of routine checking and vouching would only substantiate transactions as they occur from day-to-day and confirm the acquisition of assets or assumptions of liabilities at the first instance but the value thereof may change by the end of a financial period when the balance sheet is prepared. Evidently, in the last analysis, variation in the inter-relation assets and liabilities is the most important factor of determining profit or loss through its influence on the difference between capitals at the commencement and at the close of a particular financial period. Such variation may be the result of genuine factors operating in course of normal business activities or it may be intentionally engineered by manipulation or falsification of accounts. Besides, any inappropriate valuation of assets and liabilities, whether inadvertently or fraudulently done, would vitiate the financial state of affairs of a business by exhibiting a wrong picture in the balance sheet.

Assets and liabilities are very important aspects of every business concern. To show the exact financial position of the concern, one of the main work of an auditor is to verify the assets and liabilities. An auditor should satisfy himself about the actual existence of assets and liabilities appearing in the Balance Sheet. If Balance Sheet incorporates incorrect assets, both Profit and Loss Account and Balance Sheet will not present a true and fair view. So, verification and valuation of assets and liabilities is very important for business.

6.2 Concept of Verification of Assets and Liabilities

Verification is a technique of auditing in which the auditor certifies the assets and liabilities as shown in the Balance Sheet by actual checking or any other technique. The owner or owners of an organization need to know whether the profit or loss as shows by the books is correct or not, and also whether the assets and liabilities as described in the Balance Sheet are present in the organization or not.

So, the verification of assets implies "an enquiry into the value, ownership and title, existence and possession, the presence of any change on the assets".

J. R. Batliboi defines it as, "The auditor must satisfy himself that assets really existed at the date of the Balance Sheet and were free from any charge and that they have been properly valued".

The Institute of Chartered Accountants of India (ICAI) defines verification as, "It aims at establishing existence, ownership, possession, freedom from encumbrances, proper recording, and proper valuation.

In short, verification is a function of examining assets and liabilities to check:

- Value
- Ownership
- Title
- Existence
- Possession and
- To see whether the assets are free from any charge or encumbrance etc.

6.2.1 Objectives of Verification of Assets and Liabilities

The main objectives of verification are as follows:

- To show the correct value of assets and liabilities.
- To know whether the Balance Sheet exhibits a true and fair view of the state of affairs of the business.
- To find out the ownership, possession and title of the assets appearing in the Balance Sheet.
- To find out whether assets are in existence.
- To find out whether there is an adequate internal control regarding acquisition, utilization and disposal of assets.
- To ensure that the assets have been properly recorded.
- Verification aims at determine the arithmetic accuracy of the accounts relating to assets and liabilities.

- To ascertain that, at the date of the balance sheet, an asset is actually present in the organization or not.
- To determine no fraud or irregularity has occurred in relation to the assets and liabilities of the organization.
- To determine whether the assets and liabilities have been correctly valued as per the principals of book keeping and accounting.

6.2.2 Importance of Verification of Assets and Liabilities

- **Showing the Actual Financial Position**-Balance Sheet is prepared to show the actual financial position of a business. If proper valuation is not made, such Balance Sheet does not provide true and fair information. So, to provide information about the real financial position, verification and valuation of assets are essential.
- **Ascertaining the Real Position of Profit or Loss**-Depreciation and other expenses on assets will be incorrect if proper valuation of assets is not made. So, to calculate the actual amount of profit or loss, proper valuation of assets and liabilities is necessary.
- **Increase Goodwill**-Proper valuation gives fair information about profitability and financial position of a business. So, people can get information which creates positive attitude towards company. The positive attitude of public can increase the goodwill of the concern.
- **Assures Safe Investment to Shareholders**-Verification and valuation provide actual information about assets and liabilities to the shareholders which assure safety of their investment.
- **Easy for Sale**-At the time of sale of the company, it can be sold at the price which is enlisted in the Balance Sheet, but the assets whose valuation is not made need valuation before selling the company.
- **Easy to Get Loan**-Companies disclose the Balance Sheet proved by auditor for public knowledge which increases the trust of the company. Hence, companies can easily obtain loan from financial Institutions.
- **Easy to Get Compensation**-Whenever the loss occurs due to any incident, insurance company provides compensation on the basis of valuation of assets. So, the company can easily get compensation.

6.2.3 Difference between Vouching and Verification

The main points of differences between the two are as follows:

Sr. No.	Basis of Differences	Vouching	Verification
1.	**Objective**	The objective of vouching is to establish the truth, relevancy, authorization and policies applied for the various entries in the books.	The objective of verification is to vouch for the existence, ownership, valuation and accuracy of the assets and liabilities.
2.	**Utility**	With the help of vouching, the auditor can only determine that the aforesaid assets should belong to the organization.	With the help of verification, information regarding any sale, destruction or illegal investment of assets till the date of the balance sheet can be determined.
3.	**Time**	Vouching can be done any time after the transactions are recorded in the books of accounts.	Verification can be done only after all the accounts have been prepared.
4.	**Status**	Vouching is a part of verification.	Verification is a part of vouching.
5.	**Performance**	Vouching is primarily done by audit clerks.	Verification is done by the auditor himself or his senior partner.

6.2.4 Difference between Verification and Valuation

Sr. no.	Basis of Difference	Verification	Valuation
1.	**Meaning**	Verification means clarifying the existence, valuation, existing obligations and accuracy of the items stated in	Valuation involves a critical examination of the pre-determined values of the assets by the auditor on the basis of accounting principles and

		the Balance Sheet.	conventions.
2.	**Advice**	The assets are verified by the auditor himself.	The auditor can obtain the help of an expert for the valuation of assets.
3.	**By whom**	Verification is done by the auditor himself or his senior partner.	Valuation is done by the management of an organisation but the accuracy of this valuation is done by the auditor.
4.	**Guarantee Or Responsibility**	The auditor is responsible for the verification of assets.	The auditor cannot give a guarantee for the valuation of assets as determined by the expert.
5.	**Evidence**	Adequate physical and documentary evidence is available for verification.	Very little actual proof is available for valuation therefore the auditor has to rely to a very large extent on the estimates of the management.

6.2.5 Confirmation and Verification

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

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

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

- Land and Building
- Plant and Machinery
- Stock-in-hand
- Stores and consumables

- Investments
- Securities
- Cash-in-hand
- Bills receivable

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

6.2.6 Auditor's Duty Regarding Verification

The auditor of a business is required to report in concrete terms that the Balance Sheet exhibits a true and fair view of the state of its affairs. In other words, he has to examine and ascertain the correctness of the money value of assets and liabilities appearing in the Balance Sheet and this examination is known as verification of assets and liabilities. Therefore, an auditor has to keep in mind the following points while verifying the assets:

- Ensuring the existence of assets.
- Acquiring the assets for business.
- Legal ownership and possession of the assets.
- Ensuring the proper valuation of assets.
- Ensuring that the assets are free from any charge.

6.3 Verification of Assets and Liabilities

Subject to the general principles of valuation and verification, an auditor should always take into full consideration special points in regard to the valuation and verification of individual items of assets on the basis of their precise nature and utility. Cash, book debts and stock-in-trade constitute three important assets requiring very careful attention. The following rules should be followed by an auditor for verifying the assets and liabilities:

6.3.1 Verification of Assets

- **Land and Building, Freehold Premises, Plant and Machinery and Furniture, Fixture and Fittings:** In case of these fixed asset the following points must be consider by auditor during verification:

- As far as possible, the task of verification should be done or by the auditor himself. He should not obtain any help from the employees of the client.
- The title documents of these assets should be verified to establish the title and right of the client on these assets. The ownership document must be on the name of owner or business.
- A physical verification of these assets should be done on the date of the balance sheet or end of financial year to satisfy any doubt as to their existence.
- Any addition or sale of assets should be shown as change in the assets. In case an asset has been purchased, then the same should be vouched for and the purchase or sale order should be verified.
- The incomes and expenditure incurred for various assets should be carefully verified as revenue and capital and it should be seen that expenses are incurred on existing assets only.
- In case there is a charge on any of these assets i.e. if it has been given as a security against any loan taken, then the Mortgage Deed should be verified.
- In case of any asset taken on lease a provision should be created if the lease has to be renewed. The auditor should see whether a sinking fund has created to provide for the renewal of the lease and whether the same has been shown on the liabilities side of the balance sheet.

➢ **Mortgage Property**

- The auditor should confirm that there should be no second or third mortgage on it.
- The auditor should obtain certificate from mortgagee that title deed is in his possession.
- The auditor cannot be held responsible if there is any defect of title. The Auditor can only verify that title deed apparently in order and in the name of client.
- If auditor feels necessary, he can obtain certificate from legal advisor about the validity of title deed of the client.

➢ **Building under Construction**

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

➢ **Leasehold Property**

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

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

➢ **Loose Tools**

- Loose tools include a number of different type of small tools which are difficult to account for verifying loose tools, the auditor should obtain details of these assets certified by authorized official.
- On the basis of these details, the auditor should do a physical verification of the assets.
- A revaluation on the basis of these assets is done on the Balance Sheet date and the difference between the opening balance and such revaluation is taken as depreciation.

➢ **Livestock**

- A register should be maintained in that organization dealing in livestock in which all details of the animals are recorded.
- The auditor should refer to this register to verify the cost of the animals, number of the animals, number of the animals, etc. and do a physical verification of these animals on the basis of this register.
- The animals are valued on full cost basis. This is so because any reduction in their value cannot be easily found out.

➢ **Investments**

- The auditor must verify the type of investment whether it is long-term or short-term.
- All type of securities must be checked by the auditor.
- The investments can also be verified with the help of the interest or dividends received should be taken revenue income whereas the cost incurred in purchasing the securities are capital expenses.

- The method to be adopted for valuation depends on the purpose for which the investments are made.

➢ **Stock-in-Trade**

- The quantity, value and calculations given in the stock sheets of the organization on the basis of which the stock has been valued are correct, as per their knowledge and belief.
- The materials included in the stock belong to the organization only.
- Stocks do not include any purchase of materials for which the invoice has not been recorded in the books.
- A single method is used for valuing all items of stock, and the lower cost or market value is taken. The method of valuation is the same as the previous year.

➢ **Copyright**

- The auditor should examine the agreement between the author and the publisher.
- If there are numbers of copyright with the same publisher, auditor should ask for the schedule of copyrights.

➢ **Debtors/Bill Receivable**

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

The verification process of the debtors involves the following:

- **Examination of Records-**Auditor should satisfy himself about the validity, accuracy and recoverability of debtors' balance.
- **Verify Discount policy**-Excessive discount allowed or bad debts written off should be verified.
- **Direct Confirmation Procedure-**Direct communication with debtors is the best way to ascertain whether the balances are accurate, genuine and undisputed.

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

Steps for Verification

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

➢ **Cash in Hand**

- If possible, the auditor should do cash count on the last day of the financial year (date of the Balance Sheet.) and tally this cash balance with the cash book.
- In case cash is kept at more than one place in an organization, the auditor should call for the cash from all those places and verify it in the presence of the cashier so that any deficiency in one place is not covered up by any other place.
- A certificate for the cash should be obtained from any sales represent active or branches in case they are in the possession of any cash belonging to the organization.

➢ **Cash at Bank**

- The auditor should prepare a bank reconciliation of account as on date. With the help of it, the auditor will clearly come to know the status about the cheque issued but not yet presented in the bank and cheques deposited in the bank but not yet cleared. There are many kinds of frauds which are detectable through preparation of bank reconciliation of account.
- The auditor should obtain different certificates from banks for different types of accounts like current account, fixed deposit account, savings account, overdraft account or cash credit account, etc.
- The auditor should obtain a letter of confirmation of bank balances directly from banks.
- The auditor should compare the bank balance as per the bank book and the pass book.
- If payments are deposited in foreign banks under exchange control regulation it should be verified by the auditor.

➢ **Preliminary Expenses**

- These expenses are shown in the balance sheet. These expenses are written off during a span of time of 3 to 10 years.
- The auditor should verify that un-written amount is shown in the balance sheet.

➢ **Discount on Issue of Shares/Debentures**

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

6.3.2 Verifications of Liabilities

Generally liabilities are valued at face value. Verification of liabilities is as important as that of assets because any under-statement or omission thereof would vitally affect the result of business and also the financial state of affairs. Usually liabilities are small in number and more or less fixed in nature and, as such, they offer less difficulties to an auditor than assets. An auditor should see that all liabilities or obligations genuinely outstanding on the closing date even those omitted accidentally or deliberately are duly accounted for, that all credit balances shown by books are real liabilities and that there is no manipulation in regard thereto.

An auditor must be satisfied that liabilities recorded in books are real, omission, if any, of liabilities are accounted for and duly disclosed. In fact, an auditor would be liable for negligence if he fails to detect omission of liabilities. Auditor's report should be qualified for any omission of liability.

➢ **Trade Creditors**

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

- Confirmation of balances should be done directly by the auditor and if there is any kind of discrepancy that might be sorted out.
- Auditor should carefully study the hire purchase agreement to verify the purchases made on the basis of hire-purchase.

➢ **Loans**

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

➢ **Bill Payable**

- The auditor should know about bill outstanding as on the date of the Balance Sheet and tally the total of this schedule with the bills payable book and bill payable account.
- The bills on which a payment has been made are received back into the business. Therefore, the amount bills payable can be verified with respect to the bills received back.

➢ **Bank Overdraft**

- To verify bank overdraft, the cash book and pass book should be checked.
- The balance of bank overdraft and the interest paid on it should be clarified from the bank through written communication.

➢ **Debentures**

- The auditor must verify whether the company has the right to issue debentures and if it does, the maximum amount of debentures it can issue.

- The copy of the Debenture Trust Deed should be verified and tallied with the Debenture Account.
- The register of charges should be verified to examine the security against the loan.

➢ **Capital**

- Auditor should carefully go through the Memorandum of Association and Articles of Association.
- The auditor should verify the total number of shares issued by the company and purchased shares by the shareholders and the money payable on the calls made.

6.4 Check Your Progress

1. Which of the following is not true with regard to verification of assets?
    (a) It invoices substantiation of occurrence of transactions
    (b) Its objective is to establish existence, ownership, possession, valuation and disclosure of assets
    (c) The auditor has to form an opinion on different aspects
    (d) All of the above are true
2. Which of the following statements is not true?
    (a) Valuation of assets is the responsibility of management
    (b) The auditor can rely on a certificate issued by an authorized valuationer as to the valuation of assets in the balance sheet
    (c) The auditor should value the asset as per generally accepted accounting principle
    (d) Valuation is no part of auditor's duty
3. What are the main objective of verification?
    (a) Verification aims at determine the arithmetic accuracy of the accounts relating to assets and liabilities.
    (b) To ascertain that, at the date of the balance sheet, an asset is actually present in the organization or not.
    (c) To determine no fraud or irregularity has occurred in relation to the assets and liabilities of the organization.
    (d) All of the above

4. Which of the following assets is least likely to be subjected to lien?
    (a) Freehold land
    (b) Plant and machinery
    (c) Leasehold property
    (d) Motor vehicles
5. Which of the following is true?
    (a) Verification proves the existence, ownership and title of assets.
    (b) Valuation certifies the correct value of asset.
    (c) Vouching is done after original entry in the books of accounts.
    (d) All of the above
6. Rules regarding verification of copyright includes….
    (a) The Auditor should examine the agreement between the author and the publisher.
    (b) If there are numbers of copyright with the same publisher. Auditor should ask for the schedule of copyrights.
    (c) Both A and B
    (d) None of the above

6.5 Summary

Assets and liabilities are very important aspects of every business concerns. To show the exact financial position of the concern, one of the main work of an auditor is to verify the assets and liabilities. Verification is a technique of auditing in which the auditor certifies the assets and liabilities as shown in the Balance Sheet by actual checking or any other technique. The owner or owners of an organization need to know whether the profit or loss as shown by the books is correct or not. It aims at determine the arithmetic accuracy of the accounts, to ascertain that, at the date of the balance sheet, an assets is actually present in the organization or not, to determine no fraud or irregularity has occurred in relation to the assets and liabilities of the organization, to determine whether the assets and liabilities have been correctly valued as per the principals of book keeping and accounting. Vouching and verification are different from each other as the objective of vouching is to establish the truth, relevancy, authorization and policies applied for the various entries in the books and the objective of verification is to vouch for the existence, ownership, valuation and accuracy of the assets and liabilities. There are some rules for verification of assets and liabilities like the task of verification should be done or by the auditor himself.

He should not obtain any help from the employees of the client. The title documents of these assets should be verified to establish the title and right of the client on these assets. The ownership document must be on the name of owner or business. A physical verification of these assets should be done on the date of the balance sheet or end of financial year to satisfy any doubt as to their existence. Any addition or sale of assets should be shown as change in the assets. In case, an asset has been purchased, then the same should be vouched for and the purchase or sale order should be verified. All liabilities also should verified by auditor with the help of document available.

6.6 Keywords

- **Vouching**: Verification of entries in the books of account by examination of documentary evidence.
- **Verification -** Verification means clarifying the existence, valuation, existing obligations and accuracy of the items stated in the Balance Sheet.
- **Valuation-** Valuation involves a critical examination of the pre-determined values of the assets by the auditor on the basis of accounting principles and conventions.
- **Assets-** An asset is a resource with economic value that an individual, corporation, or country owns or controls with the expectation that it will provide a future benefit.
- **Liabilities-** A liability is something a person or company owes, usually a sum of money.

6.7 Self-Assessment Test

Q.1 What is verification of assets and liabilities? Explain its objectives and importance.

Q.2 Define verification of assets and liabilities. Differentiate the term vouching and verification.

Q.3 Differentiate between verification, vouching and valuation.

Q.4 Explain the rules regarding verification of assets.

Q.5 Explain the rules regarding verification of liabilities.

Q.6 Write short notes on:

a) Loose tools

b) Loans

c) Debtors and creditors

d) Fixed assets

e) Preliminary expenses

f) Auditor's Duty Regarding Verification

6.8 Answers to Check Your Progress

1(a), 2 (c), 3(d), 4 (c), 5(d), 6 (c)

6.9 References/Suggested Readings

- Basu, S.K., "Fundamental of Auditing" Pearson Publication, New Delhi.
- **Tandon, B. N., S. Sudharsanam, and S. Sundharabahu**, "*A Handbook of Practical Auditing",* S. Chand and Co. Ltd., New Delhi.
- **Pagare, Dinkar**, "*Principles and Practice of Auditing",* Sultan Chand and Sons, New Delhi.
- **Institute of Chartered Accountants of India**, ''*Auditing and Assurance Standards*'', ICAI, New Delhi.
- **Gupta Kamal, and Ashok Arora**, "*Fundamentals of Auditing,*" Tata Mc-Graw Hill Publishing Co. Ltd., New Delhi.

Subject: Auditing	
Course Code: BC-505	**Author:** Mr. Kapil Singh
Lesson No.: 07	**Vetter:** Prof. M.C. Garg

COMPANY AUDITOR: APPOINTMENT, POWERS, DUTIES AND LIABILITIES

Structure

7.0 Learning Objectives

After reading this chapter, you will be able to explain:

- Define a company auditor and explain the functions, qualities, right and duties of Company Auditor
- Discuss the provisions of Companies Act regarding appointment and removal of a company auditor.
- Qualifications, disqualifications and remuneration of an auditor.

7.1 Introduction

A limited company must appoint an authorised auditor. In most of the cases, the shareholders elect an auditor at the Annual General Meeting. An auditor is normally appointed for one year at a time and can be re-appointed as per the provisions of the Companies Act, 2013. If he is assigned the duty to hold office for longer than one year, it must be stated in the Articles of Association of the company. His role is to assess the annual reports of the company and make sure that they are correct and reliable.

7.2 Meaning, Functions, Qualities, Right and Duties of Company Auditor

A limited company has to appoint qualified auditors for carrying out audit assignments and other related activities. An auditor, duly qualified, renders services to the company and in return gets remuneration as per the provisions of Companies Act, 2013. He may also be removed from the office before the expiry or at the expiry of his term. He is a person who is appointed by the proper authority to carry out the audit assignments and other associated work. The person who checks the accuracy of the books of accounts and expresses an opinion on the financial statements of the business concern is called as an Auditor.

The person who is a Chartered Accountant holding Certificate of Practice from the Institute of Chartered Accountants of India is also referred to as an Auditor. Auditors enjoy a distinctive professional status in the society because of specialized functions of auditing.

According to **Lopes, L.G. in re Kingston Cotton Mills case, 1896,** "An auditor is not bound to be detective, or to approach his work with suspicion, or with the foregone conclusion that there is something wrong. He is a watch-dog but not a blood-hound. He is justified in believing servants of the company, and is entitled to rely upon their representations, provided he takes reasonable care."

According to **Lord Alverstone, C.J. The London Oil Storage Co., Ltd, vs. Seear Hasluck and Co., 1904,** "An auditor is not bound to assume when he comes to do his duty that he is dealing with fraudulent and dishonest people, if circumstances of suspicion arise it is his duty to probe them to the bottom,"

7.2.1 Functions of a Company Auditor

The following are the functions of an auditor:

- **Examination**: Auditor should examine the accounting system to ensure about their appropriateness.
- **Books**: Check the books of accounts to ensure the arithmetical accuracy.
- **Evidence**: The auditor should examine documentary evidence to support the entries in the books of accounts.
- **Full Inclusion**: Check whether all entries in the books of accounting have been taking while preparing financial statements.
- **Properness**: Examine whether information contained in financial statements is proper and it does not contain any fraudulent entry.
- **Verification of Assets and Liabilities**: Check the existence, valuation and disclosure of all assets and liabilities in financial statements.
- **Statutory Compliance**: Verify the compliance of financial statements with the relevant statutory authorities.
- **Disclosure**: Examine whether the information in financial statements is disclosed properly as per accounting principles.
- **Truth and Fairness**: Check whether financial statements represent a true and fair view of profit or loss and of assets and liabilities of the business concern.

7.2.2 Qualities of an Auditor

An auditor needs to be well versed in the fundamental principles and theory of all branches of accounting, e.g., financial accounting, cost accounts, income-tax, etc. A person cannot audit the accounts unless he knows how to prepare them. He should be aware of the latest development of the techniques of accounting so that he may modify his procedure of work.

- **Knowledge of principles of accounting-**He should not pass a transaction unless he knows that it is correct. This is possible only when one knows thoroughly well the principles of accounting.
- **Clear-**He should be prepared to seek clarification on technical questions rather than show a false pride or fear of displaying his ignorance.
- **Required Qualification-**The first quality of an Auditor is the qualification. He/she must possess the required qualification as decided by The Institute of Chartered Accountants of India (ICAI) or Central Government time to time.
- **Complete Knowledge of Nature and Objectives of a Business-**An Auditor must have the complete and comprehensive knowledge of nature and objectives of the business, whose accounts has to be audited. It will help in the commencement of audit and during the audit process.
- **Knowledge of Various Law-**An Auditor must have complete knowledge of various laws prevailing in the country. Some of them are as follows:
  - The Companies Act, 2013
  - The Partnership Act, 1932
  - The Income Tax Act, 1961
  - Goods & Services Act, 2017
  - The Contract Act, 1872
  - The Negotiable Instrument Act, 1881
- **Expert in the field of Auditing-**Auditor must have the required expertise in the field of auditing. It will be achieved through complete knowledge and actual practice of the knowledge in the businesses.
- **Diligent and Vigilant-**While doing their work of auditing, an auditor should be hard worker. Errors and frauds can be in any transaction so he must be vigilant and clever to detect the errors and know how to rectify all the errors.
- **Unbiased and honest-**An auditor must perform their duties as per the law, he should not be influenced by any person. He must be honest to their duties and state all matters in true and fair spirit. He should give the true view of the business to the owner of the business.

- **Fearless**-Auditor have to do their duties in a fearless manner. Auditor should not hide any error and fraud in the pressure. Auditor must not be influenced, directly or indirectly, by others in the discharge of his duties. So he must be fearless.
- **Tactful**- Auditor must be tactful and scrupulously honest. He must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes what he certifies is true.
- **Integrity**-He must be prepared to resign rather than sign a balance sheet, which he knows does not exhibit a true and fair view of the state of affairs of the concern and thus give a false report.

7.2.3 Rights of the Company Auditor

Following are the rights of company auditor:-

- **Right to access books of accounts**-Right to access at all the times to the books and accounts and vouchers of the company whether kept in head office of the company or elsewhere and shall be entitled to require from the office of the company such information and explanation as the auditor may think necessary for the performance of his duties as auditor.
- **Right to give true and fair view**-The auditor shall make a report to the members of the company on the accounts audited by him and on every balance sheet or profit and loss account which are laid before the company in general meeting. The said accounts give the information required by the act in the manner so required by and give a true and fair view.
- **Right to receive notice and speak**-Right to receive notice of and to attend every general meeting of the company. He is also have right to speak to such general meeting when the accounts are being discussed.
- **Right to be indemnified**-He has right to be indemnified for any liability incurred by him in defending himself against civil and criminal proceedings by the company.
- **Right to visit branches and to seek advice**-Right to visit branches of the company to audit the accounts if no other auditor has been appointed to audit branch accounts. He can also take legal and technical advice wherever necessary.
- **Right to receive remuneration**-Right to receive remuneration for the work done by him.

- **Right to sign the report**- Right to sign the report which is prepared by him.
- **Right to keep the working notes**-Right to keep the working notes and other necessary documents related to audit work with him.

7.2.4 Duties of Company Auditor

Duties of an auditor are as under:

- To make the report to the members of the company on the accounts examined by him. This should contain all the matters as the Companies Act.
- Auditor should perform his duties as per articles of association of the company.
- He should certify the statements included in prospectus whenever the same is issued.
- To comment on all such material violations of the law or sound accounting practices which can reasonably effect directly or indirectly the fortune of the accounts of the company.
- An auditor must know the provisions of memorandum and articles of association of the company.
- He not only should verify the arithmetic accuracy of the accounts but should check the fairness of accounts as well.

7.3 Provisions relating to Auditors as per Company Act, 2013

Companies Act 2013 has been enacted on 30th August 2013 and 98 Sections were made effective from 12th September 2013 and now around 185 Sections are made effective from 1st April 2014. Moreover, numbers of rules have also been notified and therefore it is important to get updated on the same.

Chapter X read with Section 139 to Section 148 deals with provisions relating to Audit & Auditors as given below:

- Section 139 – Appointment of auditors
- Section 140 – Removal, resignation of auditor and giving of special notice
- Section 141 – Eligibility, Qualifications and disqualifications of auditors
- Section 142 – Remuneration of auditors
- Section 143 – Powers and duties of auditors and auditing standards

- Section 144 – Auditor not to render certain services
- Section 145 – Auditor to sign audit reports, etc.
- Section 146 – Auditors to attend general meeting
- Section 147 – Punishment for contravention
- Section 148 – Central Government to specify audit of items of cost in respect of certain companies.

7.3.1 Appointment of Auditors

In case of a company, the auditor can be appointed:

- By the Board of Directors
- By Shareholders
- By Central Government

- **By the Board of Directors**
  - **First Auditor**: The first auditor of company other than a Government company is appointed by boards of directors within one month of its incorporation. Such auditor shall hold office till the completion of the first annual general meeting.
  - **Casual Vacancy**: In case of any casual vacancy (death, disqualification, removal etc.) in a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor General of India, be filled by the Board of Directors within thirty days, but if such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting.
- **By Shareholders**
  - **First Auditor-**In case of failure of the Board to appoint such auditor, it shall inform the members of the company, who shall within ninety days at an extraordinary general meeting

appoint such auditor and such auditor shall hold office till the conclusion of the first annual general meeting.

- **In Annual General Meeting-**Members of a company can appoint auditors in their annual general meeting as per section 139 of Companies Act, 2013.

➢ **By Central Government**

- **First Auditor-** In case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments, the first auditor shall be appointed by the Comptroller and Auditor General of India within sixty days from the date of registration of the company and in case the Comptroller and Auditor General of India does not appoint such auditor within the said period, the Board of Directors of the company shall appoint such auditor within the next thirty days; and in the case of failure of the Board to appoint such auditor within the next thirty days, it shall inform the members of the company who shall appoint such auditor within the sixty days at an extraordinary general meeting, who shall hold office till the conclusion of the first annual general meeting.
- **Subsequent Appointment**-In the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, the Comptroller and Auditor General of India shall, in respect of a financial year, appoint an auditor duly qualified to be appointed as an auditor of companies under this Act, within a period of one hundred and eighty days from the commencement of the financial year, who shall hold office till the conclusion of the annual general meeting.

- **Re-appointment of Auditor**
  - He is not disqualified for re-appointment.
  - He has not given the company a notice in writing of his unwillingness to be re-appointed.
  - A special resolution has not been passed at that meeting appointing some other auditor or providing expressly that he shall not be re-appointed.

Where at any annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company.

Where a company is required to constitute an Audit Committee under section 177, all appointments, including the filling of a casual vacancy of an auditor under this section shall be made after taking into account the recommendations of such committee.

7.3.2 Removal of Auditor

Auditor can be removed by any of the followings ways:

- **By a special Resolution**-The auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the previous approval of the Central Government.

- **Resignation**-The auditor who has resigned from the company shall file within a period of thirty days from the date of resignation, a statement in the prescribed form with the company and the Registrar, and in case of companies referred to in sub-section (5) of section 139, the auditor shall also file such statement with the Comptroller and Auditor General of India, indicating the reasons and other facts as may be relevant with regard to his resignation. If the auditor does not comply with, he shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees.

- **By Special Notice-**Special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor, or providing expressly that a retiring auditor shall not be re-appointed. On receipt of notice of such a resolution, the company shall forthwith send a copy thereof to the retiring auditor. Where notice is given of such a resolution and the retiring auditor makes with respect thereto representation in writing to the company (not exceeding a reasonable length) and requests its notification to members of the company.
- **By Tribunal-**Without prejudice to any action under the provisions of this Act or any other law for the time being in force, the Tribunal either suo motu or on an application made to it by the Central Government or by any person concerned, if it is satisfied that the auditor of a company has, whether directly or indirectly, acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its directors or officers, it may, by order, direct the company to change its auditors.

  If the application is made by the Central Government and the Tribunal is satisfied that any change of the auditor is required, it shall within fifteen days of receipt of such application, make an order that he shall not function as an auditor and the Central Government may appoint another auditor in his place.

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

7.3.3 Eligibility, qualifications and disqualifications of auditors

The followings are the eligibility and qualifications of an auditor:

- A person shall be eligible for appointment as an auditor of a company only if he is a chartered accountant.
- A firm whereof majority of partners practising in India are qualified for appointment as aforesaid may be appointed by its firm name to be auditor of a company.

- Where a firm including a limited liability partnership is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm.

Disqualifications-The following persons shall not be eligible for appointment as an auditor of a company, namely:

  - a body corporate other than a limited liability partnership registered under the Limited Liability Partnership Act, 2008 (6 of 2009);
  - an officer or employee of the company;
  - a person who is a partner, or who is in the employment, or an officer or employee of the company;
  - a person who, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company.

- A person or a firm who, whether directly or indirectly, has business relationship with the company, or its subsidiary, or its holding or associate company or subsidiary of such holding company or associate company of such nature as may be prescribed;
- A person whose relative is a director or is in the employment of the company as a director or key managerial personnel;
- A person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such persons or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies;
- A person who has been convicted by a court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction.
- Any person whose subsidiary or associate company or any other form of entity, is engaged as on the date of appointment in consulting and specialised services as provided in section 144.
- Where a person appointed as an auditor of a company incurs any of the disqualifications after his appointment, he shall vacate his office as such auditor and such vacation shall be deemed to be a casual vacancy in the office of the auditor.

7.3.4 Remuneration of auditors

- The remuneration of the auditor of a company shall be fixed in its general meeting. The Board may fix remuneration of the first auditor appointed by it.
- The remuneration shall in addition to the fee payable to an auditor, include the expenses, if any, incurred by the auditor in connection with the audit of the company and any facility extended to him but does not include any remuneration paid to him for any other service rendered by him at the request of the company.

7.3.5 Powers and duties of auditors

- Every auditor of a company shall have a right of access at all times to the books of account and vouchers of the company, whether kept at the registered office of the company or at any other place and shall be entitled to require from the officers of the company such information and explanation as he may consider necessary for the performance of his duties as auditor and amongst other matters inquire into the following matters, namely:
  - whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;
  - whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;
  - where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;
  - whether loans and advances made by the company have been shown as deposits;
  - whether personal expenses have been charged to revenue account;
  - where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

- The auditor shall make a report to the members of the company on the accounts examined by him and on every financial statements which are required by or under this Act to be laid before the company in general meeting and the report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of this Act or any rules made there under or under any order made under sub-section (11) and to the best of his information and knowledge, the said accounts, financial statements give a true and fair view of the state of the company‘s affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed.
- The auditor‘s report shall also state:
  - whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;
  - whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;
  - whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company‘s auditor has been sent to him under the provision to that sub-section and the manner in which he has dealt with it in preparing his report;
  - whether the company‘s balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;
  - whether, in his opinion, the financial statements comply with the accounting standards;
  - the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;
  - whether any director is disqualified from being appointed as a director under sub-section (2) of section 164;
  - any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;

  - whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls;
  - such other matters as may be prescribed.

- Where any of the matters required to be included in the audit report under this section is answered in the negative or with a qualification, the report shall state the reasons therefore.
- In the case of a Government company, the Comptroller and Auditor General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.
- The Comptroller and Auditor General of India shall within sixty days from the date of receipt of the audit report under sub-section (5) have a right to:
  - Conduct a supplementary audit of the financial statement of the company by such person or persons as he may authorise in this behalf; and for the purposes of such audit, require information or additional information to be furnished to any person or persons, so authorised, on such matters, by such person or persons, and in such form, as the Comptroller and Auditor General of India may direct.
  - Comment upon or supplement such audit report. any comments given by the Comptroller and Auditor General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub section (1) of section 136 and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.
- Without prejudice to the provisions, the Comptroller and Auditor General of India may, in case of any company covered under sub-section (5) or sub-section (7) of section 139, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company and the provisions of section 19A of the Comptroller and Auditor General‘s (Duties, Powers and Conditions of Service) Act, 1971 (56 of 1971), shall apply to the report of such test audit.

- Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed:
- Every auditor shall comply with the auditing standards.
- The Central Government may prescribe the standards of auditing or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949 (38 of 1949), in consultation with and after examination of the recommendations made by the National Financial Reporting Authority:
- The Central Government may, in consultation with the National Financial Reporting Authority, by general or special order, direct, in respect of such class or description of companies, as may be specified in the order, that the auditor's report shall also include a statement on such matters as may be specified therein.
- Notwithstanding anything contained in this section, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within such time and in such manner as may be prescribed.
- No duty to which an auditor of a company may be subject to shall be regarded as having been contravened by reason of his reporting the matter referred to in sub-section (12) if it is done in good faith.
- If any auditor, cost accountant or company secretary in practice does not comply with the provisions of sub-section (12), he shall be punishable with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees.

7.3.6 Auditor not to render certain services

An auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the audit committee but which shall not include any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company):

- accounting and book keeping services;
- internal audit;
- design and implementation of any financial information system;
- actuarial services;
- investment advisory services;
- investment banking services;
- rendering of outsourced financial services;
- management services; and
- any other kind of services as may be prescribed.

7.3.7 Auditor to sign audit reports

The person appointed as an auditor of the company shall sign the auditor’s report or sign or certify any other document of the company in accordance with the provisions of sub-section (2) of section 141, and the qualifications, observations or comments on financial transactions or matters, which have any adverse effect on the functioning of the company mentioned in the auditor’s report shall be read before the company in general meeting and shall be open to inspection by any member of the company.

7.3.8 Auditors to attend general meeting

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

7.3.9 Punishment for contravention

- If any of the provisions of sections 139 to 146 is contravened, the company shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than ten thousand rupees but which may extend to one lakh rupees, or with both.
- If an auditor of a company contravenes any of the provisions of section 139, section 143, section 144 or section 145, the auditor shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees.
- If an auditor has contravened such provisions knowingly or wilfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be punishable with imprisonment for a term which may extend to one year and with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees.
- Where an auditor has been convicted under contravention any of the provisions of section 139, section 143, section 144 or section 145, he shall be liable to:
  - Refund the remuneration received by him to the company.
  - Pay for damages to the company, statutory bodies or authorities or to any other persons for loss arising out of incorrect or misleading statements of particulars made in his audit report.
- The Central Government shall, by notification, specify any statutory body or authority or an officer for ensuring prompt payment of damages to the company or the persons above and such body, authority or officer shall after payment of damages to such company or persons file a report with the Central Government in respect of making such damages in such manner as may be specified in the said notification.
- Where, in case of audit of a company being conducted by an audit firm, it is proved that the partner or partners of the audit firm has or have acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to or by, the company or its directors or officers, the liability, whether civil or criminal as provided in this Act or in any other law for the time being in force, for such act shall be of the partner or partners concerned of the audit firm and of the firm jointly and severally.

7.3.10 Central Government to specify audit of items of cost in respect of certain companies

- Notwithstanding anything contained in this Chapter, the Central Government may, by order, in respect of such class of companies engaged in the production of such goods or providing such services as may be prescribed, direct that particulars relating to the utilisation of material or labour or to other items of cost as may be prescribed shall also be included in the books of account kept by that class of companies
- If the Central Government is of the opinion, that it is necessary to do so, it may, by order, direct that the audit of cost records of above class of companies, which have a net worth of such amount as may be prescribed or a turnover of such amount as may be prescribed, shall be conducted in the manner specified in the order.
- The audit work of such companies shall be conducted by a Cost Accountant in practice who shall be appointed by the Board on such remuneration as may be determined by the members in such manner as may be prescribed.
- An audit conducted under this section shall be in addition to the audit conducted under section 143.
- The qualifications, disqualifications, rights, duties and obligations applicable to auditors shall, so far as may be applicable, apply to a cost auditor appointed under this section and it shall be the duty of the company to give all assistance and facilities to the cost auditor appointed under this section for auditing the cost records of the company.
- A company shall within thirty days from the date of receipt of a copy of the cost audit report prepared in pursuance of a direction above furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein.
- If, after considering the cost audit report referred to under this section and the information and explanation furnished by the company under sub-section (6), the Central Government is of the opinion that any further information or explanation is necessary, it may call for such further information and explanation and the company shall furnish the same within such time as may be specified by that Government.
- If any default is made in complying with the provisions of this section:

- Company and every officer of the company who is in default shall be punishable in the manner as provided in sub-section (1) of section 147.
- The cost auditor of the company who is in default shall be punishable in the manner as provided in sub-sections (2) to (4) of section 147.

7.3.11 Liabilities of an Auditor

Following are the liabilities of an auditor

- If an auditor is guilty of negligence in the execution of his duty, he may be held liable to make good any damage resulting from that negligence.
- An auditor is appointed to detect frauds, errors etc. He is responsible on account of negligence in performance of his duties.
- Any clause in the agreement between the company and the auditor whereby the auditor is freed from liability has been declared void.
- If in the course of the winding up of a company, it appears that the auditor has been guilty of any misfeasance or breach of trust in relation to the company, he may be held liable as an officer of the company. The court may examine into his conduct and compel him to contribute such sum to the assets of the company by way of compensation in respect of the breach of the trust as the court thinks fit.
- If the dividends have been improperly declared and paid of the accounts audited by him and which did not show a true and fair picture and were incorrect and misleading, he will be liable to refund such an amount.
- Where a prospectus is issued inviting persons to subscribe for shares or debentures of a company, an auditor is liable in respect of an untrue statements which is made by him as an expert, to pay compensation to every person who subscribes for any shares or debentures on the faith of the prospectus for any loss or damages, he may have sustained by reason of untrue statements included therein.
- If an auditor makes false statements, particularly knowing it to be false or omits any material fact, knowing it to be material, he may be punishable with imprisonment or a fine.

- If an auditor is a party to untrue statements in prospectus, he shall be punishable with imprisonment or fine or both.
- Under Indian Penal Code – whosoever issues or signs any certificate required by law to be given or signed or relating to any fact which such certificate by law, admissible by evidence. Knowing or believing that such certificate is false in any material point, shall be punishable in the same manner as if he gives a false evidence.

“Auditor is a watchdog, not a bloodhound”

The perception of auditor’s duty with regards to detection and prevention of frauds and errors was initially based on the decision given in Kingston Cotton Mills Co. (1896) case. The learned judge Lopes summed up auditor’s duty by stating, “Auditor is a watchdog, not a bloodhound.” An auditor is appointed by the shareholders in case of a limited company. He is expected to play the role of a watchdog on their behalf and should look after their interests.

Unlike a bloodhound, the duty of the auditor is verification and not detection. If he discovers something suspicious, during the course of audit, he should probe the matter thoroughly and appraise the shareholders about it. In the absence of such suspicious circumstance, he is fully justified in believing and relying on representations made by the ‘tried servants’ of the company. In short, in case of frauds and errors, the auditor has a duty of reasonable care only.

In Westminster Road Construction and Engineering Co. (1932) case, the court emphasized the adoption of audit procedures to confirm the facts stated through management representations. Thus, it widened the scope of auditor’s duty with regards to frauds and errors and laid down more strict standards of reasonable care.

Being a watchdog, he is justified in believing the company’s officers provided he takes reasonable care. He is guilty of negligence if he accepts the certificate of a responsible officer in the absence of any suspicious circumstances. However, if he feels suspicious, he should probe the matter sincerely and report such matter to the shareholders.

Liabilities under Chartered Accountants Act, 1949: Liabilities of Chartered Accountant acting as an auditor may be in the form of disciplinary proceedings under the Chartered Accountant Act, 1949. It may arise on account of professional misconduct on the part of auditor.

A Chartered accountant in practice or acting as an auditor will be deemed guilty of professional misconduct if he-

- Fails to disclose material facts known to him which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statement not misleading.
- Fails to report a material mis-statement, known to him to appear in a financial statement.
- Is grossly negligent in the conduct of his professional duties.
- Fails to obtain sufficient information to warrant the expression of an opinion or his exceptions are sufficiently material to neglect the expression of an opinion.
- Fails to invite attention to any material departure from the generally accepted procedure of audit applicable to the circumstances.

Under Section 21, the Council of The Institute refers the case of professional misconduct of a member to the disciplinary committee. If the Council finds that the member is guilty of professional misconduct after giving due notice to the member to explain then it may make any of the following orders:

- Reprimand the members.
- Remove his name from the register of members for a period not exceeding 5 years
- If the misconduct on the part of the members is other than that specified in the first Schedule then the Council may refer the case to the appropriate authority.

Liabilities under other Acts

The liabilities of an auditor under various other Acts are as follows:

- Section 46 of the Banking Companies Act, 1949 provides that if an auditor wilfully makes a statement in any return, Balance Sheet or other document which is false or wilfully omits to make material statement then he is punishable with an imprisonment for a term which may extend to 3 years and is also liable to fine.
- Section 45 of the Banking Companies Act, 1949 has provided that if the auditor has publically examined in the winding up proceedings and on such examinations if he is not found fit to act as an auditor of the company then the High Court may make an order that he will not be appointed as an auditor of the company for a period not exceeding 5 years.

- Life Insurance Corporation Act, 1956 under Section 104 has stated that the auditor may be sentenced to imprisonment or fine or both if he gives a false statement knowingly in any report, return or other such forms to be issued under the Act.
- Section 197 of Indian Penal Code provides that if an auditor issues or signs a certificate required by law knowingly or believing that such certificate is false in any material point then he shall be punishable in the same manner as if he gave false evidence.
- Income Tax Act, 1961 under Section 278 provides that if an auditor induces any person to make and deliver an account, statements or declarations relating to any income chargeable to tax which is false and the auditor believes it to be true then he shall be punishable with imprisonment which may extend to 6 months or with fine which may extend to Rs.1000 or both.
- Under Consumer Protection Act, 1986 an auditor may be held liable as a professional. The Act has been enacted to protect the interest of the consumers.
- The Supreme Court has held that the Chartered Accountants are liable to be prosecuted under the Consumer Protection Act when it is clearly established that they have given opinion or advice on the payment of fees.

Liabilities towards third parties

There are several persons who take advantage of the accounts audited by the auditor. They rely completely upon the final accounts certified by the auditor and enter into transactions with the company without any further enquiry. These parties include the creditors, the bankers, tax authorities, and prospective shareholders etc.

It is a debatable question whether the auditor owes any duties to the third parties and can be made liable to them for negligence or breach of duty or trust.

Liability of the auditor towards the third parties is of following types:

- For negligence-It has been judicially held that the auditor is not liable to third parties since no contractual obligation exists between the auditor and the third parties. Since, he is not appointed by them; he owes no duty to the person who holds him liable unless, he owes any duty to the person who holds him liable for damages caused to him.
- For frauds- The third parties can hold the auditor liable in case there has been any fraud on the part of the auditor even if there is no contractual obligation between the auditor and the third parties. The

third parties can sue the auditor if the report of the auditor is of such a nature as amounts to fraud but it must be proved that the auditor did not act honestly and the auditor knew it. In this context the following points were laid down:

- That the statement of balance sheet signed by the auditor was materially untrue.
- That any statement was made with the intention that the third party should act on it.
- That the auditor knew that the statement was untrue.
- The third party did act upon such a statement and consequently suffered a loss.
- That the auditor gave his consent for the inclusion of such a statement in the prospectus.

The auditor can be held liable to third parties only when the above mentioned facts are proved against him.

Liability for Unlawful Acts of the Clients

An auditor may obtain knowledge about the unlawful acts or defaults committed by his clients during the course of his audit. The auditor should have informed the proper authorities about it and if he does not do so then he will be liable for the same. It is felt that if the default is committed by the client then it is not the duty of the auditor to inform the facts in his possession to the authorities concerned. However, if the offence is serious then he should seek legal advice as to what he should do. In the opinion of the Institute of Chartered Accountant, he must consider the following points:

- He must not do anything to assist the client to commit any criminal offence.
- Whether the possible consequences of the offence are such as to prevent the accounts to give a true and fair view then the auditor must make reservation in his report on such accounts.
- Whether in all the circumstances, he is prepared to continue to act for the client.

Under such circumstances, he must act very carefully. He must not do such things which may unnecessarily injure the confidence of client in him. If necessary he should terminate his association with the client rather than open himself to such liability.

Liability towards Article Clerks

The auditor may be held liable in the following cases to his Article Clerks:

- In the Anupam Rai vs. P.K.Mukherjee case, it was decided that the auditor will be liable if he does not act honestly with his Article Clerk.

- If the auditor removes any of his Article Clerks without any proper notice then he would be held liable.
- If the auditor does not return the premium taken from his Article Clerks then he would be liable.
- If the auditor gives a false certificate of returning premium to them, then also he would be held liable.

7.4 Check Your Progress

1. Sec.143 of Companies Act 20913 deals with….

    a) Powers and rights of an auditor

    b) Removal of an auditor

    c) Appointment of an auditor

    d) Remuneration of an auditor

2. Qualification of an auditor is……

    a) HSSC

    b) UPSC

    c) CA

    d) None of the above

3. The retiring auditor does not have a right to…….

    a) To make written representation

    b) Speak as a member of the company

    c) Be heard at the meeting

    d) Get his representation circulated

4. Rights of an Auditor include:

    (a) Right to take legal and technical advice wherever necessary.

    (b) Right to receive remuneration for the work done by him.

    (c) Right to sign the report and keep the working notes with him.

(d) All of the above

5. Basic qualities in an auditor include:

(a) He must be prepared to hear arguments and must be reasonable.

(b) He must be vigilant, cautious, methodical and accurate.

(c) He should have the ability to write the report, correctly, concisely and forcefully.

(d) All of the above

6. Duties of an auditor include:

(a) To make the report to the members of the company on the accounts examined by him this should contain all the matters as the companies act.

(b) Auditor should perform his duties as per articles of association of the company.

(c) He should certify the statements included in prospectus whenever the same is issued and also certify the contents of the statutory report.

(d) All of the above

7.5 Summary

A limited company must appoint an authorised auditor. In most of the cases, the shareholders elect an auditor at the annual general meeting. An auditor, duly qualified, renders services to the company and in return gets remuneration as per the provisions of Companies Act, 2013. He may also be removed from the office before the expiry or at the expiry of his term. He is a person who is appointed by the proper authority to carry out the audit assignments and other associated work. The person who checks the accuracy of the books of accounts and expresses an opinion on the financial statements of the business concern is called as an Auditor. Unlike a bloodhound, the duty of the auditor is verification and not detection. If he discovers something suspicious, during the course of audit, he should probe the matter thoroughly and appraise the shareholders about it. In the absence of such suspicious circumstance, he is fully justified in believing and relying on representations made by the ‘tried servants’ of the company. An auditor may obtain knowledge about the unlawful acts or defaults committed by his clients during the course of his audit. The auditor should have informed the proper authorities about it and if he does not do so then he will be liable for the same. It is felt that if the default is committed by the client then it is not the duty of the auditor to inform the facts in his possession to the authorities concerned.

7.6 Keywords

- **Auditing**: It is the evaluation of a person, organization, system, process, enterprise, project or product.
- **First Auditor-** The first auditor of a company, other than a government company, shall be appointed by the board of directors within thirty days of the date of incorporation of a company.
- **Actuarial services-** Actuarial service is a way of determining, assessing, and planning the financial impact of risk by companies.
- **Company Auditor**- A person who is appointed to perform audit work of a company.
- **Negligence**- It means when a person fails to use reasonable skill and care or not acted for the benefit of the Company.
- **Misfeasance**- It means breach of duty or trust in the conduct of the Company's affairs.
- **Contravention-** An action which offends against a law, treaty, or other ruling.
- **Casual Vacancy**: The term Casual Vacancy (not defined in Companies Act) means any vacancy caused due to death, resignation, and disqualification of Auditor.

7.7 Self-Assessment Test

Q.1 Write the meaning of Company Auditor? What are the prescribed provisions of Companies Act regarding qualifications and disqualifications of a company auditor?

Q.2 Explain in detail the provisions of the Company Act with regard to the appointment of a company auditor.

Q.3 What are the various provisions of the Company Act with regard to punishment on contravention?

Q.4 What do you mean by auditor? Also write the procedure for appointing a new auditor in place of retiring auditor.

Q.5 Who is an auditor? Explain the qualities and functions of an auditor.

Q.6 Discuss the various rights of Company Auditor.

Q.7 State the various duties and liabilities of Company Auditor.

7.8 Answers to Check Your Progress

1(a), 2 (c), 3(b), 4 (d), 5(d), 6 (d)

7.9 References/Suggested Readings

- **Jha, Aruna**, "*A Student's Guide to Auditing",* Taxmann.
- Basu, S.K., "Fundamental of Auditing" Pearson Publication, New Delhi.
- **Tandon, B. N., S. Sudharsanam, and S. Sundharabahu**, "*A Handbook of Practical Auditing",* S. Chand and Co. Ltd., New Delhi.
- **Pagare, Dinkar**, "*Principles and Practice of Auditing",* Sultan Chand and Sons, New Delhi.

Subject: Auditing	
Course Code: BC-505	**Author:** Mr. Kapil Singh
Lesson No.: 08	**Vetter:** Prof. M.C. Garg
AUDIT REPORT	

Structure

8.0 Learning Objectives

After reading this lesson, you will be able:

- To know the meaning, definition and features of audit report.
- To discuss the various types of auditor’s report and contents thereof.
- To differentiate between clean and qualified report.
- To differentiate between audit report and audit certificate.

8.1 Introduction

It is compulsory on the part of limited companies to appoint an auditor and such an auditor has to give qualified, unqualified, negative report or he may make disclaimer of opinion as prescribed as per the provisions of law depending upon his observations regarding the preparation and presentation of financial statements. For any enterprise, the audit report is a key deliverable which shows the end results of the entire audit process. The users of financial statements like investors, lenders, customers, and others base their decisions and plans on audit reports of any enterprise. An audit report is always critical to influencing the perceived value of any financial statement’s audit. The auditor should be careful in issuing the audit report as there is are a large number of people placing reliance on such report and taking decisions accordingly. The report should be issued by being unbiased and objective in discharging the functions.

8.2 Meaning of an Audit Report

An auditor of a limited company has to communicate his findings about the financial position of the organization through his report. Audit of limited companies also require that an auditor has to report on certain matters concerning with the functioning of the organizations. Audit report is the final stage of audit process. The results of the audit are communicated through audit report. Audit report is the written opinion of an auditor regarding company’s financial statements.

Audit report is a document prepared by an auditor to certify the financial position and accounting records of a firm. Audit report is the statement included in the financial statements. It contains the opinion of the auditor in financial statements. The auditor reports to the shareholders who have appointed him. He has to provide his opinion on the truth and fairness of financial statements. Thus, the auditor protects the interest of shareholders through audit report. An auditor report is the formal result of all the efforts that goes into an audit communicating the auditor’s finding on the financial statements to the interested users.

An audit report is a statement of collected and considered facts, so drawn up as to give clear and concise information to the persons who are not already in possession of full facts of subject matter of report.

Lancaster has defined a report as "a report is a statement of collected and considered facts, so drawn up as to give clear and concise information to persons who are not already in possession of the full facts of subject matter of the report."

According to **Cambridge Business English Dictionary**, "Audit report is defined as a formal document that states an auditor's judgment of a company's accounts".

Under Sec. 143(3) of the Companies Act, 2013, auditor of a company must report to its members:

- The accounts examined by him;
- Balance Sheet, Profit and Loss Account, and Cash Flow statement, which are laid in general meeting of a company during his tenure of office; and
- The document declared to be attached to the Balance Sheet and Profit and Loss Account.

8.2.1 Features of an Audit Report

- It represents the result of examination done by the auditor.
- It involves collection of evidence about the financial statement.
- It contains an expression of opinion regarding whether Profit And Loss Account exhibits the true results of the business and whether Balance Sheet reflects the true financial position of the business.
- The language and words used in the audit report are of great importance. The extent of liability of an auditor for negligence and fraud depends upon the wording of the report.

8.2.2 Audit committee

An audit committee is a committee of a Board of Directors of a company entrusted with the task of:

- Overseeing the financial reporting process of the company,
- Considering various issues related to the audit functions and
- Reviewing the Company's financial and risk management policies.

With the setting up of Audit Committee in specified companies in India, there has been an improvement in the financial reporting process and audit function particularly because the auditors now have an opportunity to discuss various audit related issues at a forum where non-executive directors or independent directors are in majority.

Requirements under the Companies Act, 2013

The Companies Act, 2013 has notified Section 177, Rule 6 and 7 of Companies (Meetings of Board and its Powers) Rules, 2014 which deals exclusively with Audit Committee. Audit committee is mandatory as amended by Companies (Amendment) Act, 2017.

Composition of Audit Committee

Audit Committee shall constitute of minimum three directors, with independent director forming majority. Audit committee including its Chairperson shall be persons with ability to read and understand the financial statement.

The auditors and Key Managerial Personnel (KMP) of the company shall have a right to be heard in the meetings of the Audit Committee when it considers the auditor‘s report but shall not have the right to vote.

Functions of Audit Committee

- Appointment and fixation of the remuneration of the Auditor.
- Valuation of the undertakings or assets of the company.
- Evaluation of any related party transaction.
- Evaluation of the internal financial control and risk management.
- Examination of the Financial Statements.
- Scrutiny of Inter Corporate Loans and Investments.
- Evaluation of the use of the funds rose through public offers.

Powers of Audit Committee

- Call for comments of the auditor about internal control systems.
- To review the Financial Statements before submission of the report of the Board.

- Power to discuss any issues with the statutory and internal auditor and the management of the company in relation to matters contained in the Financial Statements.
- Power to obtain professional advice from the external sources.
- Power to have full access to the information contained in the records.

Vigil Mechanism

Vigil Mechanism provides adequate safeguard against victimization of persons. It is established for directors and employees to report their grievances and concerns. Rule 7 of Companies (Meetings of Board and its Powers) Rules, 2014 describes about establishment of Vigil Mechanism for every listed company and companies prescribed as below:

- Companies which accepts deposits from public.
- Companies which have borrowed money from banks and public financial institutions in excess of Rs. 50 Crores.

The Board of Directors shall nominate a director to play the role of Audit Committee for the purpose of Vigil Mechanism for reporting purpose. The aggrieved person will have direct access with the Chairperson/Nominated Director of the Audit Committee. In case of repeated frivolous complaints, the audit committee or the director nominated can take suitable action against the concerned director or employee including reprimand. The details of establishment of such mechanism shall be disclosed on the company's website, and in the Board's report.

Penalty for Violation of Audit Committee Provisions

The company shall be punishable with fine of Rs. 1 Lakh to Rs. 5 Lakhs and every officer of the company who is in default shall be punishable with imprisonment up to 1 year or with fine of Rs. 25,000/- to Rs. 1 Lakh, or with both.

8.2.3 Element of Auditor's Report or Essential of a Good Audit Report

Following provisions relating to the contents of the auditor's report:

- **Title**: An audit report should have appropriate heading "Auditor's Report" which separates it from other reports.

- **Addressee**: The addressee normally refers to the person who appoints the auditor. If a company appoints the auditor, the addressee should be shareholders. As per law, the complete address of the addressee is required. Addressee for the statutory audit shall be shareholders and in case of special audit, it is Central Government.
- **Opening or Introductory Paragraph**: It includes:
  - Identification of Financial Statements-It should contain that financial statements of the company are properly identified and audited with regard to the name of the company, the date and the period covered by the financial statements.
  - It should also contain that preparation of the financial statements are the responsibility of the management and the responsibility of the auditor is to express his opinion based on audit of these statements.
- **Scope Paragraph**: In this paragraph, nature of the audit is described by stating that:
  - Whether accounting principles are used in the preparation of the financial statements.
  - Significant estimates are made by the management in the preparation of financial statement.
  - The audit was conducted in accordance with the auditing standards generally accepted in India.
  - The requirements of the relevant legislation have been complied with at the time of preparing financial statements.
  - Whether financial statements have been audited in accordance with the generally accepted auditing standards and practice.
  - Whether financial statements are free from any material misstatement.
  - Overall financial statements as presented by the company are properly evaluated.
- **Opinion Paragraph**: The auditor's opinion on the books of account and financial statements examined by him is based on the information and free from bias. The auditor has to give his opinion as follows:
  - Whether the financial statements are arithmetically correct and correspond to the figures recorded in the books of accounts.

- In case of unqualified opinion, whether the financial statements represent a true and fair view of the state of affairs and the results of operations.
- In case of qualified opinion, if the Balance Sheet and Profit and Loss Account do not present a true and fair view, the reasons for what and where is wrong.

➢ **Date of the report**: The date of auditor's report on the financial statement is the date on which the auditor signs the report expressing his opinion on the financial statements. The date of the report enables the reader that the auditor has considered the effects of the events and transactions within his knowledge on the financial statements up to that date.

Here, it is to be noted that the auditor should not date or sign the report on financial statements earlier than the date on which the financial statements are signed or approved by the management.

➢ **Place of signature on audit report**: Audit report should specifically give the name of the place where the auditor has to sign the report.

➢ **Auditor's signature**: The auditor should sign the audit report in his personal name. Where the auditor is a firm, the auditor should sign the report in his personal name and in the name of the firm. The signing auditor should also mention the membership number assigned to him by the Institute of Chartered Accountants of India.

8.2.4 Contents and Specimen of Audit Report

As per Sec. 143 of the Companies Act, the auditor's report shall also state:

- Whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements.
- Whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him.
- Whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company's auditor has been sent to him and the manner in which he has dealt with it in preparing his report.

- Whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns.
- Whether, in his opinion, the financial statements comply with the accounting standards.
- The observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company.
- Whether any director is disqualified from being appointed as a director under sub-section (2) of section 164.
- Any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith.
- Whether the company has adequate internal financial control system in place and the operating effectiveness of such controls.
- Such other matters as may be prescribed.

Specimen of an Audit Report

To

The shareholders of

……………… (Name of the Company)

……………… (Name of the City)

We have audited the annexed Balance Sheet of …………. Company Limited as on 31st March 2020 and Profit and Loss Account and the Cash flow Statement of the Company for the year ended on that date attached thereto. The preparation of these financial statements is the responsibility of the company's management.

Our responsibility is to express an opinion on these financial statements based on our audit and we state that:

1. We conducted our audit in accordance with the auditing standards accepted in India.
2. We have obtained all the information and explanations which, to the best of our knowledge and belief, were necessary for the purpose of our audit.
3. In our opinion, proper books of accounts, as required by law, have been kept by the company as far as appears from our examination of the books and records.

4. The Balance Sheet, Profit and Loss Account and Cash Flow Statement dealt with by the report are in agreement with the books of accounts.

5. In our opinion and to the best of our information and according to the explanations given to us, the accounts and the notes thereon give the information required by the Companies Act, 2013 in the manner so required and give a true and fair view in conformity with the Accounting Principles generally accepted in India : (a) In the case of Balance Sheet of the state of affairs of the company as on 31st march 2020, and (b) In the case of Profit and Loss Account of the Company's profit or loss for the year ended on that date. (c) In the case of Cash Flow Statement, of the cash flows for the year ended on that date.

Place of Signature………….. For ABC and Co.

Date……… Chartered Accountants

Signature

(Name of the member signing the audit report)

(Designation i.e. Partner or Proprietor)

Membership Number

8.3 Types of Auditor's Report

Basically there are four types of Audit Reports which an auditor has to submit to the shareholders:

1) A Clean or Unqualified Report
2) Qualified Report
3) Adverse or Negative Report
4) Disclaimer of Opinion

1. A Clean or Unqualified Report

An auditor will give clean or unqualified report or express unqualified opinion if—

- He is completely satisfied about the correctness of Profit & Loss Account and Balance Sheet.
- He concludes that the financial statements give a true and fair view of profitability or results of operation and financial position of a company.
- He finds that proper financial reporting framework was used for the preparation and presentation of the financial statements.

An unqualified opinion implies that:

- There is adequate disclosure of any changes in accounting principles or in the method of their application, including their effects on financial statements.
- Generally Accepted Accounting Principles are consistently applied at the time of preparing financial statements.
- The financial statements are prepared keeping in view the relevant statutory requirements and regulations as and when required.
- All material facts and matters which are relevant for the proper presentation of financial information are properly disclosed by the company.

Specimen of a Clean or Unqualified Report

Forum of Audit Report

To

The shareholders of

……………… (Name of the Company)

……………… (Name of the City)

We have audited the annexed Balance Sheet of …………. Company Limited as on 31st March 2020 and Profit and Loss Account and the Cash flow Statement of the Company for the year ended on that date attached thereto. The preparation of these Financial Statements is the responsibility of the company's management.

Our responsibility is to express an opinion on these financial statements based on our audit and we state that:

1. We conducted our audit in accordance with the auditing standards accepted in India.
2. We have obtained all the information and explanations which, to the best of our knowledge and belief, were necessary for the purpose of our audit.
3. In our opinion, proper books of accounts, as required by law, have been kept by the company as far as appears from our examination of the books and records.
4. The Balance Sheet, Profit and Loss Account and Cash Flow Statement dealt with by the report are in agreement with the books of accounts.
5. The Accounts ………………….. Branch Office have been audited under the Act by ………………. The report on the said accounts which has been forwarded to us has been dealt with by us in the manner we have considered necessary while preparing this report.

6. In our opinion and to the best of our information and according to the explanations given to us, the accounts and the notes thereon give the information required by the Companies Act, 2013 in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India :

(a) In the case of Balance Sheet of the state of affairs of the company as on 31st march 2020, and

(b) In the case of Profit and Loss Account of the Company's profit or loss for the year ended on that date.

(c) In the case of Cash Flow Statement of the cash flows for the year ended on that date.

Place of Signature………….. For ABC and Co.

Date……… Chartered Accountants

Signature

(Name of the member signing the audit report)

(Designation, i.e., Partner or Proprietor)

Membership Number

2. Qualified Report

An auditor will give qualified report or express qualified opinion if:

- The Profit & Loss Account and Balance Sheet do not present true and fair view of the results of operations or profitability and the state of affairs.
- He gives an opinion about the state of affairs or profitability of a business subject to certain reservations.
- Lack of conformity with generally accepted accounting principles exists at the time of preparation of financial statements.
- There is inadequate or incomplete disclosure of material matters as per legal requirements.
- Proper books of accounts have not been maintained by the company which is required to be maintained by law and rules.
- The auditor does not get all the information and explanations that he considers necessary for carrying out audit work.

It should be noted that:

- The auditor has to give complete and detailed information about the subject matter of the qualification.
- He should quantify the effect of the qualifications on the financial statements, if such qualifications materially affect the financial statements.
- If it is not possible to quantify the effect of the qualification then management estimates may be used for the same or he has to state the reasons for not qualifying the effect of the qualification.
- A qualification must be clear and precise and should give full information.

The various reasons for the qualification of Auditor's Report are:

- Insufficient provisions for depreciation.
- Incorrect valuation of assets.
- Creation of secret reserves.
- Omission of certain liabilities.
- Inadequate provision for doubtful debts.

Specimen of a Qualified Report

Forum of Audit Report

To

The Shareholders of

…………………… (Name of the company)

……………………. (Name of the city)

We have audited the annexed Balance Sheet of …………. Company Limited as on 31st March 2020 and Profit and Loss Account and the Cash flow Statement of the Company for the year ended on that date attached thereto. The preparation of these financial statements is the responsibility of the company's management.

Our responsibility is to express an opinion on these financial statements based on our audit and we state that:

1. We have obtained all the information and explanations which, to the best of our knowledge and belief, were necessary for the purpose of our audit.

2. In our opinion, proper books of accounts, as required by law, have been kept by the company as far as appears from our examination of the books and records subject to the comments given as follows:

(a) In the absence of stock registers, adjustments relating to balances on the register have been accepted on the basis of management decisions.

(b) We did not carry out the counting of physical inventories as at 31 March 2020 as that date fell prior to the date of our appointment by the company. Further, due to the nature of the records of the Company, we were unable to satisfy ourselves as regards inventory quantities by other audit procedures.

(c) The provision for depreciation of fixed assets is inadequate.

3. The Balance Sheet, Profit and Loss Account and Cash Flow Statement dealt with by the report are in agreement with the books of accounts.

4. Subject to the above qualification, In our opinion and to the best of our information and according to the explanations given to us, the accounts and the notes thereon and documents attached thereto give the information required by the Companies Act, 2013 in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India:

(a) In the case of Balance Sheet of the state of affairs of the company as on 31^{st} march 2020, and

(b) In the case of Profit and Loss Account of the Company's profit or loss for the year ended on that date.

(c) In the case of Cash Flow Statement, of the cash flows for the year ended on that date.

Place of Signature………….. For ABC and Co.

Date……… Chartered Accountants

Signature

(Name of the member signing the audit report)

(Designation, i.e., Partner or Proprietor)

Membership Number

Difference between Clean Report and Qualified Report

Sr. No.	Basis of Difference	Clean Report	Qualified Report
1	**When to prepare?**	It is given by auditor if he is satisfied with the fairness of Balance sheet and Profit and Loss Account.	It is given by auditor if he is not satisfied with the fairness of Balance sheet and Profit and Loss Account.
2	**Content**	In a clean report, an auditor will state that, “In our opinion, the financial statements give a true and fair view of the financial position.”	In a qualified report, an auditor will state that, “In our opinion, with the exception in some areas, the financial statements give a true and fair view of the financial position.”
3	**Responsibility of Board of Directors**	There is no responsibility of Board of directors for this report.	Board of directors are bound to give explanation in respect of each qualification in the audit report.

3. Adverse or Negative Report: He will give negative or adverse report when:

- He feels that the accounts and financial statements, taken as a whole, do not present true and fair picture of the results of operations and the balance sheet.
- There is disagreement with the management on the generally accepted accounting principles and policies.
- Financial statements contain misstatement of material facts and matters.
- Omission of a material disclosure.

Specimen of a Negative report

FORM OF AUDIT REPORT

To

The shareholders of

……………… (Name of the Company)

……………… (Name of the City)

We have audited the annexed Balance Sheet of …………….. Company Limited as on 31st March 2020 and Profit and Loss Account and the Cash flow Statement of the Company for the year ended on that date attached thereto. The preparation of these financial statements is the responsibility of the company's management.

Our responsibility is to express an opinion on these financial statements based on our audit and we state that:

1. We conducted our audit in accordance with the auditing standards accepted in India.
2. We have material disagreement with the management in respect of following the generally accepted accounting policies regarding the matters given below:

a) While the company collects the proceeds of sales on instalment basis over a five year period, it credits the Sales Account with the total amount of sales at the time of the sale itself.

b) The Company is maintaining its Accounts on cash basis. It recognizes income only when it is received in cash. Expenses are recognized as and when they are paid.

We are of the opinion that the financial statements do not give a true and fair view in conformity with the accounting principles generally accepted in India:

(a) In the case of Balance Sheet of the state of affairs of the company as on 31st march 2020, and

(b) In the case of Profit and Loss Account of the Company's profit or loss for the year ended on that date.

(c) In the case of Cash Flow Statement, of the cash flows for the year ended on that date.

Place of Signature………….. For ABC and Co.

Date……… Chartered Accountants

Signature

(Name of the member signing the audit report)

(Designation, i.e., Partner or Proprietor)

Membership Number

Difference between Clean Report and Adverse Report

Sr. No.	Basis of Difference	Clean Report	Adverse Report
1	**Meaning**	Auditor prepares it if he is fully satisfied with the fairness of Balance sheet and Profit and Loss Account of the company.	Auditor prepares it when he does not agree with the affirmation made in Balance sheet and Profit and Loss Account.
2	**True and Fair**	Auditor is satisfied that the financial statements give a true and fair view of the financial position of the company.	When there is sufficient reason with the auditor that the financial statements do not give a true and fair view of the financial position.
3	**Opinion**	In clean report, auditor gives clean opinion without any pressure.	The auditor gives opinion that on the basis of proper examination of financial statements he is not satisfied with the affirmation made by company.

4. Disclaimer of Opinion

He will express disclaimer of opinion if:

- Audit examination is not adequate because of absence of sufficient information to express opinion.
- Audit examination is not properly conducted because of limitations on the scope of audit imposed by the client.
- There is certain material indeterminate or uncertain items because of which adequate audit examination and fair presentation of financial statement becomes impossible.

Specimen of a Negative Report

Forum of Audit Report

To

The shareholders of

……………… (Name of the Company)

……………… (Name of the City)

We have audited the annexed Balance Sheet of …………….. Company Limited as on 31st March 2020 and Profit and Loss Account and the Cash flow Statement of the Company for the year ended on that date attached thereto. The preparation of these financial statements is the responsibility of the company's management.

We report that:

1) The management of the company specifically asked us not to follow the procedures formulated by us to confirm the accounts receivable.
2) The books of accounts of the company were seized by the Enforcement Directorate and were not available to us for audit.
3) Most of the vouchers of the Company have been destroyed due to fire. The management has made the efforts to reconstruct the records, even then large number of receipts and other supporting documents are not available.

So we make a disclaimer of opinion i.e., we are unable to state whether the Profit and Loss Account and Balance Sheet give a true and fair view of the profitability or state of affairs of the Company.

Place of Signature………….. For ABC and Co.
Date……… Chartered Accountants
Signature
(Name of the member signing the audit report)
(Designation, i.e., Partner or Proprietor)
Membership Number

Apart from above reports, reports can be of followings types:

(1) Partial Report: If the auditor is not appointed to verify all the accounts, but only some books of accounts and the auditor issues a report, then, it is known as Partial Report. While writing this report, the auditor should keep in mind that a person reading the report should not take it as a full report. Therefore, in such kind of a report, the auditor should make it clear that he has been appointed for a partial verification and the report is a partial report. If the auditor does not specify the fact that it is a partial report he will be held guilty of negligence.

(2) Interim Report: When an auditor issues a report in the middle of the year on certain special issues then such a report is known as an 'Interim Report'. Normally such a report is presented on declaring interim dividend or when the Central Government issues an order.

(3) Final Report: When the auditor issues a report after the completion of the audit for the entire business year then such a report is known as a Final Report. Normally an auditor issues such a report only. This report plays an important part in the life of a company. Therefore special care should be exercised in framing this report.

Auditor's Certificates

Auditor's certificate is the verification of the truthfulness of a statement given by him.

In addition to audit report, an auditor has to issue certificates on certain specific matters.

As per Companies Act, 2013 an auditor is required to issue certificate in many situations instead reports or other documents. For example, under Section 66 (3) an auditor is required to file certificate of conformity of accounting standard (prescribed under section 133) by company for accounting treatment when company want to introduce the scheme of reduction of share capital, and under Section 230 (7e) an auditor is required to file a certificate of conformity of accounting standard (prescribed under section 133) by company for accounting treatment before Tribunal when company want to introduce the scheme of compromises, arrangement or amalgamation.

Following are some of the guidelines issued by the Institute of Chartered Accountants of India in respect of special purpose audit reports:

1) Specific books, accounts or documents covered by the certificate should be clearly indicated.
2) It should indicate the manner or procedure in which the audit was conducted i.e., company has applied generally accepted auditing practices while conducting audit assignments.
3) It should indicate the assumptions made at the time of preparing report.
4) Sources from where information and explanations are gathered should also be mentioned in the certificate.
5) He should confirm in writing the accuracy of the facts stated in the certificate.
6) Limitation on the scope of certificate should also be mentioned.

Auditor's certificate on compliance with corporate governance norms:

- The statutory auditors of the company should give a certificate to the company regarding compliance with corporate governance norms as specified by SEBI.
- The company should enclose the certificate with the director's report sent annually to all the shareholders. The company will send the certificate to stock exchanges, together by annual returns filed by it.

In this regard, ICAI has suggested the following format of the certificate.

AUDITOR CERTIFICATE

To

The members of ……………….. (Name of the Company)

We have examined the compliance of conditions of corporate governance by ………. (Name of the company), for the year ended on …………………, as stipulated in clause 49 of the listing agreement of the said company with stock exchanges in India,

The compliance of conditions of corporate governance is the responsibility of the management. Our examination was limited to procedures and implementation thereof, adopted by the company for ensuring the compliance of conditions of corporate governance. It is neither an audit nor an expression of opinion on the financial statements of the company.

In our opinion and to the best of our information and according to the explanations given to us, subject to the following:

1. …………………
2. ……………........
3. …………………

We certify that the company has complied with the conditions of corporate governance as stipulated in the above mentioned listing agreement.

We state that no/………. investor grievances is/are pending for a period exceeding one month against the company as per the records maintained by the Shareholders/Investors Grievance Committee.

We further state that such compliance is neither an assurance as to the future viability of the company nor the efficiency or effectiveness with which the management has conducted the affairs of the company.

Place: ………… ABC Co.

Date: ………………. Chartered Accountants

Signature

Difference between Audit Report and Audit Certificate

Sr. No	Audit Report	Audit Certificate
1	It is prepared by drawing certain conclusions based on evidence and facts available with company.	It is the verification of accuracy of facts.
2	In the audit report, auditor provides opinion.	In audit certificate, auditor provides conclusions.
3	This is required only at the end of every audit.	This is required in statutory report, prospectus, import license and liquidation of company.
4	Liability of auditor is less in audit report.	Liability of auditor is comparatively is more in audit certificate.
5	Auditor may give suggestion regarding to prevention of frauds.	There is no scope of suggestions in audit certificate.

8.4 Check Your Progress

1. Which one is the feature of an audit report?

   (a) It represents the result of examination done by the auditor.

   (b) It involves collection of evidence about the financial statement.

   (c) It contains an expression of opinion about the financial statement.

   (d) All of the above

2. Which one is the function of audit committee?

(a) Overseeing the financial reporting process of the company,

(b) Considering various issues related to the audit functions and

(c) Reviewing the Company's financial and risk management policies

(d) All of the above

3. Which one is the essential of good audit report?

a) Title
b) Opening paragraph
c) Auditor's sign
d) All of the above

4. Audit report can be :

(a) A Clean or Unqualified Report

(b) Qualified Report and Adverse or Negative Report

(c) Both a & b

(d) None of the above

5. "In the audit report auditor provide opinion while in audit certificate auditor provide conclusions." Is this statement true or false?

a) False
b) True
c) Cannot say
d) None of the above

6. When the auditor is appointed to verify only some books of accounts not all and the auditor issues a report, then, it is known as……………

a) Partial Report

b) Interim Report

c) **Final Report**

d) None of the above

8.5 Summary

Audit committee is a significant organ in the corporate form of organization. It is constituted to review the financial reporting process and financial and risk management policies of the organization. Audit report communicates the auditor's findings on the financial statements to the interested users. Audit report should be properly framed so that it may convey the same meaning for which it was prepared. An auditor should sign the audit report in his personal name or where he is a partner in a firm, he should sign the report in his personal name and in the name of the firm. An auditor has to submit audit report to the shareholders stating his opinion on the financial position, profitability or results of operations. Auditor certificate is the verification of the truthfulness of a statement given by him. In addition to audit report, an auditor has to issue certificates on certain specific matters. Audit report's and Accountant Report's containing financial information should be inserted in the offer documents.

8.6 Keywords

- **Audit Committee**: The committee formed to review the financial statements of the company ensuring that it properly represents the profitability, results of operations and the financial position of the company.
- **Audit Report**: The report in which auditor expresses his opinion as to whether the financial statements of the company give a true and fair picture of the state of affairs and the results of its operations is known as Audit Report.
- **Clean or unqualified Report**: Auditor gives clean or unqualified report if he is reasonably satisfied about the correctness of the Profit and Loss Account and Balance sheet and agreed that Generally Accepted Accounting Principles are properly followed while preparing and presenting financial statements.
- **Qualified Report**: An auditor will express qualified opinion or give qualified report if Profit and Loss Account or Balance Sheet do not present true and fair view of the state of affairs of the company.
- **Negative or Adverse Report**: Auditor will give negative or adverse opinion when there is disagreement with the management on the Generally Accepted Accounting Principles or policies.

- **Audit Certificate**: It is a confirmation of accuracy of the facts stated in the financial statements of a company.

8.7 Self-Assessment Test

Q.1 Write a note on Audit Committee.

Q.2 Explain in detail role or functions of Audit committee.

Q.3 What is Auditor's report? Also write contents of Auditor's report.

Q.4 What are the various types of Auditor's Report? Explain.

Q.5 Distinguish between a clean and a qualified report. Draft a qualified report.

Q.6 Under what circumstances may an auditor issue a disclaimer? Draft a report disclaiming an opinion.

Q.7 What is audit certificate? Differentiate between audit report and audit certificate.

8.8 Answers to Check Your Progress

1(d), 2 (d), 3(d), 4 (c), 5(b), 6 (a)

8.9 References/Suggested Readings

- **Jha, Aruna**, "*A Student's Guide to Auditing",* Taxmann.
- Basu, S.K., "Fundamental of Auditing" Pearson Publication, New Delhi.
- **Tandon, B. N., S. Sudharsanam, and S. Sundharabahu**, "*A Handbook of Practical Auditing",* S. Chand and Co. Ltd., New Delhi.
- **Singh, Avtar,** "Company Law", Eastern Book Co., Lucknow.
- **Pagare, Dinkar**, "*Principles and Practice of Auditing",* Sultan Chand and Sons, New Delhi.
- **Institute of Chartered Accountants of India**, ''*Auditing and Assurance Standards*'', ICAI, New Delhi.

Subject: Auditing	
Course Code: BC-505	**Author:** Mr. Kapil Singh
Lesson No.: 09	**Vetter:** Prof. M.C. Garg
INVESTIGATION	

Structure

9.0 Learning Objectives

After the reading of this chapter, the reader will be able:

- To define investigation and explain its features, objectives and need.
- To differentiate between Auditing and Investigation.
- To differentiate between Inquiry and Investigation.
- To explain the various types of Investigation.
- To highlight the provision relating to investigation as per Companies Act, 2013.

9.1 Introduction

Investigation is the systematic examination of books of accounts and records into the technical, financial and the economic position of the business or organization. It is done for special purpose by an investigator. The purpose of the investigation can be to establish the effectiveness, efficiency and the economy of the processes of the businesses transactions and to further analyses the effectiveness of their control over the company's income. It is in fact a kind of special audit with predetermined scope depending upon the purpose to be achieved. Investigation is neither accounting nor auditing. Investigation is carried out not in substitution of audit, but in addition to audit. The investigator may even have to investigate the audited accounts. An investigation on behalf of a person intending to purchase running business of a sole trader will be restricted to the determination of value of assets, liabilities, reserves, and existing potential and future prospects. An investigation to settle suspected irregularities in cash or stock would normally cover a period from three to six months. An auditing investigation is essential to any company in order to keep updated with the different transactions of the company; this is to ensure control and resourcefulness of the company's transactions.

9.2 Meaning and Definition of Investigation

Investigation is a detailed examination of accounts and enquiry into the state of affairs of the business or for a specific purpose. It involves the process of analyzing, collecting and presenting evidences and facts in a manner which enables the parties to know the essential facts regarding the matter under enquiry. Investigation covers not only profit and loss statements, balance sheet of an organization but all those financial statements which the employer have direct intention to investigate of more than one financial period and the program depends on each type of investigation. Investigation is conducted in deduction of suspected fraud and theft, to identify causes for continuous loss and low productivity and to evaluate the credit worthiness of business. It is synonymous with the words; examine, inquire, explore, probe, dig or delve into, and research. It comes from the Latin word "investigatus" which is the past participle of "investigare" meaning "to track or investigate." Its first known use was in the early 16th century.

In the words of **Spicer and Pegler**, "The term 'investigation' implies an examination of records for some special purpose".

According to **Lancaster**, "An Investigation may be defined as an examination of enquiry into the accounts of a business with a view to disclosing the true position of the affair in relation to the special matters falling within the scope of the investigation."

According to **Taylor and Perry**, "Investigation involves and enquiry into the fact beyond the books of accounts into the technical, financial and economic position of the organization".

9.2.1 Characteristics of Investigation

- It is an in depth and systematic examination of books of accounts of a company.
- It is done to detect and prevent frauds and suspects.
- It covers not only profit and loss statement, balance sheet of an organization but other financial matters also.
- It is carried out to attain the specific objectives desired by the employer.
- It includes finding out technical, financial and the economic position of the business or organization.
- Type of investigation is to be done depends upon the nature of frauds.

9.2.2 Objectives of Investigation

The following are the objectives of Investigation:

- To ascertain the financial position of an organization.
- To ascertain the profitability and earning capacity of the concern.
- To investigate when fraud is suspected by the employer.
- To investigate on behalf of Income Tax authorities for tax liability.
- To investigate for the purpose of lending money to a concern.

- To investigate for claims under insurance policy covering losses.

9.2.3 Difference between Auditing and Investigation

Sr. no.	Basis for Difference	Auditing	Investigation
1.	**Meaning**	The process of inspecting the books of accounts and records of an entity and reporting on it is known as Auditing.	It is the inquiry conducted for establishing a specific fact or truth is known as Investigation.
2.	**Nature of inquiry**	It is general examination books of accounts.	It is critical and in depth examination books of accounts.
3.	**Evidences**	The evidences are persuasive in nature.	The evidences are unquestionable; therefore, its nature is decisive.
4.	**Period**	Normally, it is done annually.	It can be conducted as per requirements.
5.	**Scope**	Scope of audit is limited. As the information may be collected from the internal records only.	Scope of investigation is wider. As the information and explanations can be collected from outsider also.
6.	**Performed by**	It is carried out by Chartered Accountant.	It is carries out by experts.
7.	**Compulsory**	Audit of accounts are compulsory.	Investigation is done for special purposes.
8.	**Appointment**	Auditor is appointed by the owner i.e. shareholders of the company.	The management or shareholders or one-third party of the members can appoint investigator.
9.	**Report**	The auditor has to prepare his audit report as per the provisions of Companies Act, 2013.	The investigator has to prepare his investigation report as per the nature of investigation.

10.	**Ownership**	An owner of the business cannot perform the audit of the company, but it is the owner who appoints the auditor.	An investigation is usually conducted by the owner of the business or as an undertaking by an outside third party.
11.	**Start**	An audit starts after the end of the financial year.	An investigation starts whenever any suspicious event takes place in an organization.

9.2.4 Difference between Investigation and Inquiry

Investigation is defined as the process of inquiring into something thoroughly. It is the systematic examination and scrutiny of the factors that have affected the subject of the investigation in order to uncover facts regarding the matter. On the other hand, inquiry is defined as the systematic search for information, knowledge and truth about certain things and matters of public interest. It is the process of solving a problem through researching and probing. It involves questioning and interrogation. It is aimed not only at searching for and acquiring knowledge and information about something, but it is also meant to settle any doubt that individuals may have on the subject.

Sr. no.	Investigation	Inquiry
1.	Investigation is related to proceeding for steps taken by the investigator.	Inquiry is related to the proceeding of magistrate prior to trial.
2.	An investigation starts when an investigator forms a definite opinion that there are grounds for investigating the frauds.	An inquiry may start with shadowy beginnings.
3.	The main object of investigation is to collect evidence and facts.	An inquiry aims at determining the truth or falsity of certain facts.
4.	The investigation is not a judicial proceeding.	An inquiry is a judicial proceeding.

5.	The investigation is the first stage of the fraud case.	The inquiry is the second stage of a case which follows the investigation.
6.	In the investigation, oath cannot be administered to the person examined or interrogated.	In an inquiry, oath can be administered to the persons to be examined.

9.2.5 Essential Precautions in the Conduct of Investigation

The following essential consideration should be considered before starting any investigation:

- **Knowledge of Companies Act:** An Investigator should be aware with the provisions of the Companies Act in regard to investigation. Fully compliance of all provision should be ensured by investigator.
- **Purpose**: An investigator should consider the purpose of the client i.e. why client want to initiate an investigation. In this regard, all instructions and restriction should be provided by client to investigator.
- **Knowledge of Business**: Investigator should be familiar with the internal working, practices that has been followed by organization.
- **Accuracy of Financial Statement**: Investigator should analyze the last year balance sheet, profit & loss account and other accounts and their accuracy. Last year accounts should be compared with current year accounts.
- **Opinion of Auditor**: An investigator should check the auditor report. If he need any clarification then he should take the opinion of auditor regarding accounts or organization.
- **Opinion of Expert**: Investigator should take the opinion on the areas where an investigator has some confusion. For example investigator can take help of income tax authorities in Income tax matters.
- **Period of Investigation**: an investigator should identify the period of investigation i.e. the number of years should be found for which the accounts are to be investigated.

- **Scope of Investigation**: investigator need to define the scope of investigation. Whenever he determines the scope then the nature, objectives, period, internal system, practices followed in organization should be kept in mind.
- **Proper work Procedure**: All work of investigation should be carried out with the proper work procedure and all reports & related documents should be retained by investigator.
- **Unbiased investigation**: The investigation should be conducted in unbiased manner. Investigator need to do their work diligently without influence of any person or organization.

9.3 Types of Investigation

9.3.1 Investigation on the behalf of the Owner of Business

Sometimes owner of business may order to initiate investigation process when he feels some suspect in transactions and working of employee. There can be kinds of frauds that are committed in a business i.e. misappropriation of cash, misappropriation of goods and manipulation in accounts.

- **Misappropriation of Cash:** The investigator, when entrusted with this task, should bear in mind that this type of fraud generally involves either or all of the cases, such as cash received but not recorded or recorded for a shorter amount, cash paid against false bills or vouchers, fictitious entries in records etc. He should, therefore, consider the following points:
  - The systems of cash receipts and disbursements, and cash sales and purchases, and the existence of internal checks at various stages.
  - The separation of duties and incompatible functions, e.g., an employee who receives and deposits cash and cheque should not prepare sales invoices or reconcile bank accounts; an authorized cheque signer should not approve vouchers for payment.
  - Testing cash transactions with a ‘block reconciliation’ for a selected period to obtain the proof of cash.
  - The systems of maintaining petty cash.
  - The systems of authorization with respect to withdrawals (by partners); advances paid and adjustments; payments of commission, discounts, ‘duplicate’ bills, ‘proforma’ invoices, donations and charities, etc.

- **Misappropriation of Goods:** The investigator should consider the following points in particular:
  - The systems of internal accounting and administrative control with regard to the production and/ or receipts and dispatches of goods.
  - The systems of record keeping and its adequacy.
  - The systems of authorization with respect to receipts, issues, transfers and returns of all goods including the internal check and control of all relevant documents.
  - The procedures adopted for the issue of free samples to customers and of goods for internal use and captive consumption in the manufacture of other goods or in the assembly of other final products.
- **Manipulation of Accounts:** The following points should be looked into by an investigator:
  - The stock-in-trade and the valuation thereof. Whether the methods of valuation are proper and consistent from period to period.
  - The internal accounting controls associated with administrative routines with respect to purchases, sales, disposals and transfers of various goods and the payment of wages to a large number of workmen.
  - The rates and amounts of depreciation charged in the accounts. Whether the method is followed consistently from period to period, and in accordance with the applicable laws.
  - The appropriateness of the allocation of capital and revenue expenditure in the accounts, and whether the accounting policy in this regard is consistently followed.
  - The valuation of all assets and liabilities and their consistent application, and the criteria chosen for revaluation of assets as a matter of policy.
  - Inter-company transactions and the transactions relating to the personal expenses of the directors or other officers with a view to checking their admissibility or otherwise.

After completing the investigation, the investigator should submit a report to his client that he should enumerate all the circumstances in which there is possibility of misappropriation of cash, goods and manipulation of accounts and he should also give suggestions to prevention of frauds in near future.

9.3.2 Investigation on the behalf of the Prospective Buyer

Purchasing the running business is very common practice now-a-days. Whenever anyone wants to purchase any running firm then he should be interested to know the real position of company i.e. profits, earning capacity etc. For this, the prospective buyer may consider having an investigation process conducted. While conducting the investigation on the behalf of prospective buyer, investigator should consider the following points:

- **Nature of business**: A limited company or a trading concern or a partnership business.
- **Status of business i.e. position in market**: Recently incorporated or an old one having an image in the market. Whether the shares are quoted in the stock exchanges or not.
- **Market share of Company**: If the information available then investigator should analyze the actual value of share on the basis earning capacity of the company.
- **Memorandum of Association & Article of Association**: The study of Memorandum of Association & Article of Association can be helpful to know the complete and clear picture of the company.
- **Auditor's Report**: The auditor's report can be helpful to know the real situation of a business and its accounts.
- **Special Knowledge**: If the prospective buyer need some special knowledge to run the existing business then the investigator should know it and same has to be conveyed to the client.
- **Position of assets and liabilities**: The position of assets and liabilities, existence of various fixed assets and their values, existence of raw-materials and stores and finished goods and their values, value of investments, trend of sales and profits, age schedule of debtors, nature and types of contingent liabilities, contracts and agreements with the parties, etc.
- **Earning capacity**: The study of important accounting ratios, such as Gross profit ratio, Net profit ratio, Return on Capital employed, Earnings per share, Dividend per share, Current ratio, Liquidity ratio, Stock turnover ratio, Cost ratios, Debtors/Creditors ratios, etc. for three to five years would also give indications as to the past performances for meaningful comparisons with those of other similar businesses in the same industry.

- **Capital and organization aspects**: The present structure (viz., authorized, issued, called-up and paid-up capital) and the reserve capital, if any; the rights of shareholders; accumulated reserves; rates of dividend declared for the past 3 to 5 years, etc.

After analyzing the above factors, investigator will prepare his report and submit the same to his client, on the basis of it prospective buyer will decide whether to purchase the business or not.

9.3.3 Investigation on the behalf of an Incoming Partner

Whenever any person wants to become the member of any existing partner partnership firm then he orders to find out the actual financial position of the firm. While investigating a partnership firm on the behalf of an incoming partner, the following point should be considered:

- First of all, the investigator should find out in which of the following circumstances in the person being offered the partnership:
  - on the death of a partner
  - on the retirement of a partner
  - in the form of new partner
- Investigator should study the all financial statements in detail to ensure the true picture of financial position of partnership firm.
- He should identify whether the assets and liabilities are correctly valued or not. Investigator should identify how much amount of capital and goodwill has to be brought by new partner and where it can be invested in the business of partnership firm or utilized in paying off debts, or invested in other business, or taken away by the existing partners.
- Ascertaining the role of the new partner if admitted, and examining the conditions as to salary, commission, etc.
- Investigator should identify how much amount of profit will be given to new partner in comparison to old partners with respect of their share in firm.
- Review of the existing partnership deed to ascertain as to the clause that may be unsuitable to a new partner.

- The investigator should analyze the trends of the sales, expenses, profits etc. of last years to find out the prospects of future of business of partnership firm.

After obtaining all these information investigator should submit a report to his client that whether it is beneficial to become the member of the firm or not.

9.3.4 Investigation on the behalf of the Lender

Requirement of capital in business is important to grow and expansion. The investigator on behalf of a client (bank or party) should consider the following points:

- The reason for which a company requires the loan. If the amount of loan is being taken for productive uses then it is relatively safe. If it is taken for unproductive use then the lender should be careful before advancing the loan.
- The terms of repayment of the loan, and the capacity of the company to fulfill them. If the loan is taken against security then the nature and kind of securities pledged by the company for such loan and their status.
- The investigator should analyze the final accounts in details. Its earning capacity should be estimated and its current assets and liability should be analyzed.
- The borrowing powers of the company and the authorization thereof in the articles and in the board's resolution of the company.
- The financial position, the trend of operational activities in the recent past, the future projection of activities, the debtors/creditors position, the status of current liabilities and contingent liabilities, etc. of the company.
- The information about the other loans, if any, taken by the company and the extent of arrears of repayment, if any. If the other financial institution has refused to grant the loan then why they have refused to grant the loan to the company.
- The details of insurance policies and the risks covered and the present position regarding the payment of premiums.
- The present position with respect to the payment of various taxes to the Government and the adequacy of the provision for taxation.

- The position of the cash flow vis-a-vis the funds flow broken into several periods for the current year as well as for the next few years duly projected on the basis of action plans and programs of the company.

After conducting in depth examination all of the above factors, investigator will submit his report to his client. On the basis of the report, lender will decide whether they should advance the loan or not.

9.3.5 Investigation on the behalf of the Investor

Investment decision is important in one's life. Every investor wants to be secure from investment view point whether his investment will be safe or not. If he has some confusion then he can appoint an investigator. This investigator will consider the followings point:

- The investigator first of all finds out the nature and future prospects of the business.
- The investigator should analyze the value of goodwill of the company.
- Financial position of company should also be found out. In this regard, a detailed examination should be done to know the actual value assets and liabilities.
- Various rights of shareholders and debenture holders should be analyzed.
- The investigator will found out the earning capacity of firm. All ratios should be detail examined.
- All the investments of the company should be analyzed with a proper arrangement.
- Creditor, bad and doubtful debt and the provision should be analyzed.
- Investigator will found out the experience and qualification of managers, who are running the business.
- Detailed examine of the documents of company like Memorandum of Association & Article of Association.
- Investigator should also found out the procedure adopted in the books of accounts in the organization.

After analyzing the above factors, the investigator should prepare a report and submit the same to the client. On the basis of this report, client will decide whether to invest in the company or not.

9.3.6 Investigation by Central Government

The Indian Companies Act, 2013 contain a number of provisions relating to the investigation of the affairs of a company. According to sections 206-227 of the Act, Central Government can order the investigation of the affairs of a company.

Power to call for information, inspect books and conduct inquiries (Section 206)

- Where on a scrutiny of any document filed by a company or on any information received by him, the Registrar may call the company for explanation by a written notice.
- On the receipt of a notice, it shall be the duty of the company and of its officers concerned to furnish such information or explanation.
- If no information or explanation is furnished to the Registrar within the time then the Registrar, by another written notice, call on the company to produce for his inspection such further books of account, books, papers and explanations.
- If the Registrar is satisfied on the basis of information available with or furnished to him, he may call on the company to furnish in writing any information or explanation on matters specified in the order within the specified time.
- Without prejudice to the foregoing provisions of this section, the Central Government may, if it is satisfied that the circumstances so warrant, direct inspection of books and papers of a company by an inspector appointed by it for the purpose.
- The Central Government may, having regard to the circumstances by general or special order, authorize any statutory authority to carry out the inspection of books of account of a company or class of companies.
- If a company fails to furnish any information or explanation or produce any document required under this section, the company and every officer of the company, who is in default shall be punishable with a fine which may extend to one lakh rupees and in the case of a continuing failure, with an additional fine which may extend to five hundred rupees for every day after the first during which the failure continues.

Conduct of inspection and inquiry (Section 207)

- Where a Registrar or inspector calls for the books of account and other books and papers, it shall be the duty of every director, officer or other employee of the company to produce all such documents to the Registrar or inspector.
- The Registrar or inspector, making an inspection or inquiry may, during the course of such inspection or inquiry, as the case may be make or cause to be made copies of books of account and other books and papers; or place or cause to be placed any marks of identification in such books in token of the inspection having been made.
- Notwithstanding anything contained in any other law for the time being in force or in any contract to the contrary, the Registrar or inspector making an inspection or inquiry shall have all the powers as are vested in a civil court under the Code of Civil Procedure, 1908 (5 of 1908), while trying a suit in respect of the following matters, namely:
  - the discovery and production of books of account and other documents, at such place and time as may be specified by such Registrar or inspector making the inspection or inquiry;
  - summoning and enforcing the attendance of persons and examining them on oath; and
  - Inspection of any books, registers and other documents of the company at any place.
- If any director or officer of the company disobeys the direction issued by the Registrar or the inspector under this section, the director or the officer shall be punishable with imprisonment which may extend to one year and with fine which shall not be less than twenty-five thousand rupees but which may extend to one lakhs rupees.
- If a director or an officer of the company has been convicted of an offence under this section, the director or the officer shall, on and from the date on which he is so convicted, be deemed to have vacated his office as such and on such vacation of office, shall be disqualified from holding an office in any company.

Report on inspection made (Section-208)

The Registrar or inspector shall, after the inspection of the books of account or an inquiry and other books and papers of the company, submit a report in writing to the Central Government along with such documents and a recommendation of Investigation into the affairs of the company.

Search and seizure (Section-209)

- If Registrar or inspector has reasonable ground to believe that the books and papers of a company, or relating to the key managerial personnel or any director or auditor or company secretary in practice if the company has not appointed a company secretary, are likely to be destroyed, mutilated, altered, falsified or secreted, he may, after obtaining an order from the Special Court for the seizure of such books and papers:
  - enter, with such assistance as may be required, and search, the place or places where such books or papers are kept; and
  - Seize such books and papers as he considers necessary after allowing the company to take copies of, or extracts from, such books or papers at its cost.
- The Registrar or inspector shall return the books and papers seized as soon as may be, and in any case not later than one hundred and eightieth day after such seizure, to the company from whose custody or power such books or papers were seized:
- The provisions of the Code of Criminal Procedure, 1973 (2 of 1974) relating to searches or seizures shall apply, mutatis mutandis, to every search and seizure made under this section.

Investigation into affairs of company (Section-210)

- Where the Central Government is of the opinion, that it is necessary to investigate into the affairs of a company:
  - on the receipt of a report of the Registrar or inspector under section 208;
  - on intimation of a special resolution passed by a company that the affairs of the company ought to be investigated; or
  - in public interest,
- Central Government may order an investigation into the affairs of the company.
- Where an order is passed by a court or the Tribunal in any proceedings before it that the affairs of a company ought to be investigated, the Central Government shall order an investigation into the affairs of that company.
- The Central Government may appoint one or more persons as inspectors to investigate into the affairs of the company and to report thereon in such manner as the Central Government may direct.

Establishment of Serious Fraud Investigation Office (Section-211)

- The Central Government shall, by notification, establish an office to be called the Serious Fraud Investigation Office to investigate frauds relating to a company.
- The Serious Fraud Investigation Office shall be headed by a Director and consist of such number of experts from the following fields to be appointed by the Central Government from amongst persons of ability, integrity and experience in:
  - Banking;
  - Corporate Affairs;
  - Taxation;
  - Forensic Audit;
  - Capital Market;
  - Information Technology;
  - Law; Or
  - Such other fields as may be prescribed.
- The Central Government shall, by notification, appoint a Director in the Serious Fraud Investigation Office, who shall be an officer not below the rank of a Joint Secretary to the Government of India having knowledge and experience in dealing with matters relating to corporate affairs.
- The Central Government may appoint such experts and other officers and employees in the Serious Fraud Investigation Office as it considers necessary for the efficient discharge of its functions under this Act.
- The terms and conditions of service of Director, experts, and other officers and employees of the Serious Fraud Investigation Office shall be such as may be prescribed.

Investigation into affairs of Company by Serious Fraud Investigation Office (Section-212)

- Where the Central Government is of the opinion, that it is necessary to investigate into the affairs of a company by the Serious Fraud Investigation Office:
  - on receipt of a report of the Registrar or inspector under section 208;

  - on intimation of a special resolution passed by a company that its affairs are required to be investigated;
  - in the public interest; or
  - on request from any Department of the Central Government or a State Government,

- The Central Government may, by order, assign the investigation into the affairs of the said company to the Serious Fraud Investigation Office.
- Where any case has been assigned by the Central Government to the Serious Fraud Investigation Office for investigation under this Act, no other investigating agency of Central Government or any State Government shall proceed with investigation in such case.
- Serious Fraud Investigation Office shall follow the procedure provided in this Chapter; and submit its report to the Central Government within such period as may be specified in the order.
- The Director, Serious Fraud Investigation Office shall cause the affairs of the company to be investigated by an Investigating Officer who shall have the power of the inspector under section 217.
- The company and its officers and employees, who are or have been in employment of the company, shall be responsible to provide all information, explanation, documents and assistance to the Investigating Officer as he may require for conduct of the investigation.
- If the Director, Additional Director or Assistant Director of Serious Fraud Investigation Office authorized in this behalf by the Central Government by general or special order, has on the basis of material in his possession reason to believe (the reason for such belief to be recorded in writing) that any person has been guilty of any offence, he may arrest such person and shall, as soon as may be, inform him of the grounds for such arrest.
- The Director, Additional Director or Assistant Director of Serious Fraud Investigation Office shall, immediately after arrest of such person, forward a copy of the order, along with the material in his possession, referred to in that sub-section, to the Serious Fraud Investigation Office in a sealed envelope, in such manner as may be prescribed and the Serious Fraud Investigation Office shall keep such order and material for such period as may be prescribed.

- Every arrested person shall within twenty-four hours, be taken to a Judical Magistrate or a Metropolitan Magistrate, as the case may be, having jurisdiction.
- The Central Government if so directs, the Serious Fraud Investigation Office shall submit an interim report to the Central Government.
- On completion of the investigation, the Serious Fraud Investigation Office shall submit the investigation report to the Central Government.
- On receipt of the investigation report, the Central Government may, after examination of the report (and after taking such legal advice, as it may think fit), direct the Serious Fraud Investigation Office to initiate prosecution against the company and its officers or employees.

Investigation into company‘s affairs in other cases (Section-213)

- On an application made by not less than one hundred members or members holding not less than one-tenth of the total voting power, in the case of a company having a share capital; or not less than one-fifth of the persons on the company‘s register of members, in the case of a company having no share capital, and supported by such evidence as may be necessary for the purpose of showing that the applicants have good reasons for seeking an order for conducting an investigation into the affairs of the company.
- On an application made to it by any other person or otherwise, if it is satisfied that there are circumstances suggesting that:
  - The business of the company is being conducted with intent to defraud its creditors, members or any other person or otherwise for a fraudulent or unlawful purpose.
  - Persons concerned in the formation of the company or the management of its affairs has in connection therewith been guilty of fraud, misfeasance or other misconduct towards the company or towards any of its members.
  - The members of the company have not been given all the information with respect to its affairs which they might reasonably expect, including information relating to the calculation of the commission payable to a managing or other director, or the manager, of the company.
- The Tribunal may order, after giving a reasonable opportunity of being heard to the parties concerned, that the affairs of the company ought to be investigated by an inspector or inspectors

appointed by the Central Government and where such an order is passed, the Central Government shall appoint one or more competent persons as inspectors to investigate into the affairs of the company in respect of such matters and to report thereupon to it in such manner as the Central Government may direct.

Security for payment of costs and expenses of investigation (Section-214)

Where an investigation is ordered by the Central Government or in pursuance of an order made by the Tribunal, the Central Government may before appointing an inspector, require the applicant to give such security not exceeding twenty-five thousand rupees as may be prescribed, as it may think fit, for payment of the costs and expenses of the investigation and such security shall be refunded to the applicant if the investigation results in prosecution.

Firm, body corporate or association not to be appointed as inspector (Section-215)

No firm, body corporate or other association shall be appointed as an inspector.

Investigation of ownership of company (Section-216)

- Central Government may appoint one or more inspectors to investigate and report on matters relating to the company, and its membership for the purpose of determining the true persons:
    - who are or have been financially interested in the success or failure, whether real or apparent, of the company; or
    - who are or have been able to control or to materially influence the policy of the company.
- The Central Government may define the scope of the investigation, whether as respects the matters or the period to which it is to extend or otherwise, and in particular, may limit the investigation to matters connected with particular shares or debentures.

Procedure, powers, etc. of inspectors (Section-217)

- It shall be the duty of all officers and other employees and agents including the former officers, employees and agents of a company which is under investigation and where the affairs of any other body corporate or a person are investigated, to preserve and to produce to an inspector or any person authorized by him in this behalf all books and papers of, or relating to the company. The concerned person will provide all assistance in connection with the investigation which they are reasonably able to give.

- The inspector may require any body corporate, other than a body corporate to furnish such information to, or produce such books and papers before him or any person authorized by him.
- The inspector shall not keep in his custody any books and papers produced for more than one hundred and eighty days and return the same to the company, body corporate, firm or individual by whom or on whose behalf the books and papers were produced.
- An inspector may examine on oath any of the persons referred above; and with the prior approval of the Central Government, any other person, in relation to the affairs of the company, or other body corporate or person.
- The Inspector shall have all the powers as are vested in a civil court under the Code of Civil Procedure, 1908 (5 of 1908), regarding the discovery and production of books of account and other documents, summoning and enforcing the attendance of persons and examining them on oath; and inspection of any books, registers and other documents of the company at any place.
- If any director or officer of the company disobeys the direction issued by the Registrar or the inspector under this section, the director or the officer shall be punishable with imprisonment which may extend to one year and with fine which shall not be less than twenty-five thousand rupees but which may extend to one lakh rupees.
- If any person fails without reasonable cause or refuses:
  - to produce any book or paper
  - to furnish any information which is his duty to furnish;
  - to appear before the inspector personally
  - to answer any question which is put to him by the inspector
  - to sign the notes of any examination

  He shall be punishable with imprisonment for a term which may extend to six months and with fine which shall not be less than twenty-five thousand rupees but which may extend to one lakh rupees, and also with a further fine which may extend to two thousand rupees for every day.

- The officers of the Central Government, State Government, police or statutory authority shall provide assistance to the inspector for the purpose of inspection, inquiry or investigation, which the inspector may, with the prior approval of the Central Government, require.
- The inspector through an application is made to the competent court in India may request for the evidence available in a country or place outside India.

Protection of employees during investigation (Section-218)

- During the course of any investigation of the affairs and other matters of or relating to a company, other body corporate or person proposes:
  - to discharge or suspend any employee; or
  - to punish him, whether by dismissal, removal, reduction in rank; or
  - to change the terms of employment to his disadvantage,

The company, other body corporate or person, as the case may be, shall obtain approval of the Tribunal.

- If the company, other body corporate or person concerned does not receive within thirty days of making of application above, the approval of the Tribunal, then and only then, the company, other body corporate or person concerned may proceed to take against the employee, the action proposed.
- If the company, other body corporate or person concerned is dissatisfied with the objection raised by the Tribunal, it may, within a period of thirty days of the receipt of the notice of the objection, prefer an appeal to the Appellate Tribunal in such manner and on payment of such fees as may be prescribed.
- The decision of the Appellate Tribunal on such appeal shall be final and binding on the Tribunal and on the company, other body corporate or person concerned.

Power of inspector to conduct investigation into affairs of related companies, etc (Section-219)

If an inspector appointed under section 210 or section 212 or section 213 to investigate into the affairs of a company considers it necessary for the purposes of the investigation, to investigate also the affairs of:

- any other body corporate which is, or has at any relevant time been the company's subsidiary company or holding company, or a subsidiary company of its holding company;

- any other body corporate which is, or has at any relevant time been managed by any person as managing director or as manager, who is, or was, at the relevant time, the managing director or the manager of the company;
- any other body corporate whose Board of Directors comprises nominees of the company or is accustomed to act in accordance with the directions or instructions of the company or any of its directors; or
- any person who is or has at any relevant time been the company's managing director or manager or employee.

He shall, subject to the prior approval of the Central Government, investigate into and report on the affairs of the other body corporate or of the managing director or manager; in so far as he considers that the results of his investigation are relevant to the investigation of the affairs of the company for which he is appointed.

Seizure of documents by inspector (Section-220)

- Where in the course of an investigation, the inspector has reasonable grounds to believe that the books and papers of, or relating to, any company or other body corporate or managing director or manager of such company are likely to be destroyed, mutilated, altered, falsified or secreted, the inspector may enter, with such assistance as may be required, the place or places and seize books and papers as he considers necessary after allowing the company to take copies.
- The inspector shall keep in his custody the books and papers seized under this section for such a period not later than the conclusion of the investigation as he considers necessary and thereafter shall return the same to the company or the other body corporate, or, as the case may be, to the managing director or the manager or any other person from whose custody or power they were seized.
- The provisions of the Code of Criminal Procedure, 1973 (2 of 1974), relating to searches or seizures shall apply mutatis mutandis to every search or seizure made under this section.

Freezing of assets of company on inquiry and investigation (Section-221)

- Where it appears to the Tribunal, on a reference made to it by the Central Government or in connection with any inquiry or investigation into the affairs of a company or on any complaint made by such number of members as specified under section 244 or a creditor having one lakh amount outstanding against the company or any other person having a reasonable ground to believe that the removal, transfer or disposal of funds, assets, properties of the company is likely to take place in a manner that is prejudicial to the interests of the company or its shareholders or creditors or in public interest, it may by order direct that such transfer, removal or disposal shall not take place during such period not exceeding three years as may be specified in the order or may take place subject to such conditions and restrictions as the Tribunal may deem fit.

- In case of any removal, transfer or disposal of funds, assets, or properties of the company in contravention of the order of the Tribunal as above, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to three years or with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees, or with both.

Imposition of restrictions upon securities (Section-222)

- Where it appears to the Tribunal, in connection with any investigation under section 216 or on a complaint made by any person in this behalf, that there is good reason to find out the relevant facts about any securities issued or to be issued by a company and the Tribunal is of the opinion that such facts cannot be found out unless certain restrictions, as it may deem fit, are imposed, the Tribunal may, by order, direct that the securities shall be subject to such restrictions as it may deem fit for such period not exceeding three years as may be specified in the order.
- Where securities in any company are issued or transferred or acted upon in contravention of an order of the Tribunal under as above, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to six months or with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees, or with both.

Inspector's report (Section-223)

- An inspector may, and if so directed by the Central Government shall, submit interim reports to that Government, and on the conclusion of the investigation, shall submit a final report to the Central Government.
- Every report made shall be in writing or printed as the Central Government may direct.
- A copy of the report made may be obtained by making an application in this regard to the Central Government.
- The report of any inspector shall be authenticated either by the seal of the company whose affairs have been investigated; or by a certificate of a public officer having the custody of the report, as provided under section 76 of the Indian Evidence Act, 1872 (1 of 1872), and such report shall be admissible in any legal proceeding as evidence in relation to any matter contained in the report.
- Nothing in this section shall apply to the report referred to in section 212.

Actions to be taken in pursuance of inspector‘s report (Section-224)

- If, from an inspector‘s report, made under section 223, any person has been guilty of any offence for which he is criminally liable, it shall be the duty of all officers and other employees of the company or body corporate to give the Central Government the necessary assistance in connection with the prosecution.
- The Central Government can authorize any person to present to the Tribunal a petition for winding up of company on the ground just and equitable to be wound up or file an application under section 241.
- The Central Government ask the company to start proceedings ought, in the public interest, for the recovery of damages in respect of any fraud, misfeasance or other misconduct in connection with the promotion or formation, or the management of the affairs, of such company or body corporate; or for the recovery of any property of such company or body corporate which has been misapplied or wrongfully retained.
- The Central Government shall be indemnified by such company or body corporate against any costs or expenses incurred by it in, or in connection with, any proceedings.

- Where the report made by an inspector states that fraud has taken place in a company and due to such fraud any director, key managerial personnel, other officer of the company or any other person or entity, has taken undue advantage or benefit, whether in the form of any asset, property or cash or in any other manner, the Central Government may file an application before the Tribunal for appropriate orders with regard to disgorgement of such asset, property, or cash, as the case may be, and also for holding such director, key managerial personnel, officer or other person liable personally without any limitation of liability.

Expenses of investigation (Section-225)

- The expenses of investigation initially paid by the Central Government, but shall be reimbursed by the following persons:
  - any person who is convicted on a prosecution instituted, or who is ordered to pay damages or restore any property in proceedings brought, to the extent that he may in the same proceedings be ordered to pay the said expenses as may be specified by the court convicting such person, or ordering him to pay such damages or restore such property, as the case may be;
  - any company or body corporate in whose name proceedings are brought as aforesaid, to the extent of the amount or value of any sums or property recovered by it as a result of such proceedings;
  - unless, as a result of the investigation, a prosecution is instituted under section 224,
  - any company, body corporate, managing director or manager dealt with by the report of the inspector; and the applicants for the investigation, to such extent as the Central Government may direct.
- Any amount for which a company or body corporate is liable, shall be a first charge on the sums or property mentioned in that clause.

Voluntary winding up of company, etc., not to stop investigation proceedings (Section-226)

An investigation may be initiated and no such investigation shall be stopped or suspended by reason only of:

- an application has been made under section 241;

- the company has passed a special resolution for voluntary winding up; or
- any other proceeding for the winding up of the company is pending before the Tribunal.

9.3.7 Investigation by Tax Authorities

Whenever income tax department feels that correct return of tax has not filed by the tax payer to avoid taxes, and then it can order the investigation of the accounts of a company. This type of investigation is ordered under Income Tax Act, 1961 can be of in two circumstances:

- If the income tax officer has reason to believe that the assesse has not file income tax return or any income chargeable to tax has escaped assessment for any assessment year, he may, subject to the provisions of sections 148 to 153, assess or reassess such income and also any other income chargeable to tax which has escaped assessment and which comes to his notice subsequently in the course of the proceedings under this section, or recompute the loss or the depreciation allowance or any other allowance, as the case may be, for the assessment year concerned.
- If the income tax officer has enough information to believe that the assesse has not declared a lot of income that should have been taxed. The main reason of this investigation is to find out the tax liability on uncalculated income. In this regard, the investigator should consider the following points:
  - All cash receipt and payment should be examined properly.
  - It should be checked that all purchases and sales are correct or not.
  - Whether the income and expenditure are correct from taxation viewpoint.
  - Reserves and provisions should be examined in details.
  - Valuation of stock should also be analyzed.
  - Bank pass book of the client should be checked to verify the sources of income.

After analyzing of above factors, the investigator submits a report in which limitations and deficiency faced by investigator should be mentioned.

9.3.8 Contents of Investigations Report: In above types of investigation, the investigator may draft the investigation report. The report may contain the followings:

- The purpose and scope of investigation.
- The period covered by the investigation.
- The terms of investigation with reference to the written instructions of the client.
- The various limitations faced by the investigator that may materially affect the conclusion drawn should be mentioned.
- The assumption forms the basis of investigation. The assumption should not defeat the very purpose of the investigation.
- The investigation report should contain headings, with subheadings, charts, graphs, etc.
- Conclusion of the investigator should be stated in clear and certain terms.
- The supporting documents and data may be presented as appendices to report.

9.4 Check Your Progress

1. Investigation word came from the Latin word….

   a) Investigatus
   b) Investor
   c) Both a & b
   d) None of the above

2. Which one included in the feature of investigation?

   (a) It is an in depth and systematic examination of books of accounts.

   (b) It is done to detect and prevent frauds and suspects.

   (c) It is carried out to attain the specific objectives.

   (d) All of the above

3. Which one of the following is the objective of investigation ……..?

   (a) To ascertain the financial position of an organization.

   (b) To ascertain the profitability and earning capacity of the concern.

   (c) To investigate when fraud is suspected by the employer.

(d) All of the above

4. "Investigation starts when there is any suspect while audit starts at the end of the year" is this statement true.

   a) True
   b) False
   c) Statement is incorrect
   d) None of the above

5. Which one of the following precaution should be taken by investigator before starting any investigation?

   a) Scope of Investigation
   b) Nature of business
   c) Audit report
   d) All of the above

6. Investigation can be ordered on the behalf of ………….?

   a) Owner of business
   b) Investor
   c) Prospective buyer
   d) All of the above

9.5 Summary

Investigation is a detailed examination of accounts and enquiry into the state of affairs of the business or for a specific purpose. It involves the process of analyzing, collecting and presenting evidences and facts in a manner which enables the parties to know the essential facts regarding the matter under enquiry. The purpose of the investigation can be to establish the effectiveness, efficiency and the economy of the processes of the businesses transactions and to further analyses the effectiveness of their control over the company's income. It is in fact a kind of special audit with predetermined scope depending upon the purpose to be achieved. It is different from accounting or audit or inquiry. The investigator need to consider the number of factors before initiating the investigation process like nature and objective of business, scope of investigation, audit report, books of accounts, etc. Sometime owner of business may also orders to initiate investigation process when he feels some suspect like misappropriation of cash, misappropriation of goods and manipulation in accounts. Besides owner of business, it can be initiate on the behalf of incoming partner, investor, lender of money, prospective buyer etc. Central Government and income tax department can also order the investigation to satisfy the proper adherence of provision of various Acts.

9.6 Keywords

- **Investigation**: Investigation is a detailed examination of accounts and enquiry into the state of affairs of the business or for a specific purpose.
- **Inquiry**: Inquiry is defined as the systematic search for information, knowledge and truth about certain things and matters of public interest.
- **Investigator**: The person or officer who conducts the process of investigation is known as Investigator.
- **Investigation Report:** It the report prepared by investigator after conducting the process of investigation.

9.7 Self-Assessment Test

Q.1 What is investigation? Explain its features and objectives.

Q.2 Define investigation. What precautions should be considered before investigation?

Q.3 Differentiate between investigation and auditing.

Q.4 What is investigation? Explain the types of investigation.

Q.5 Explain the provisions related to investigation in Companies Act, 2013.

Q.6 Write short notes on:

a) Investigation by Central Government

b) Investigation by Income Tax Department

9.8 Answers to Check Your Progress

1(a), 2 (d), 3(d), 4 (a), 5(d), 6 (d)

9.9 References/Suggested Readings

- Basu, S.K., "Fundamental of Auditing" Pearson Publication, New Delhi.
- **Tandon, B. N., S. Sudharsanam, and S. Sundharabahu**, "*A Handbook of Practical Auditing",* S. Chand and Co. Ltd., New Delhi.
- **Pagare, Dinkar**, "*Principles and Practice of Auditing",* Sultan Chand and Sons, New Delhi.
- **Institute of Chartered Accountants of India**, ''*Auditing and Assurance Standards*'', ICAI, New Delhi.
- **Gupta Kamal, and Ashok Arora**, "*Fundamentals of Auditing,*" Tata Mc-Graw Hill Publishing Co. Ltd., New Delhi.

Subject: Auditing	
Course Code: BC-505	**Author:** Mr. Kapil Singh
Lesson No.: 10	**Vetter:** Prof. M.C. Garg
PROFESSIONAL ETHICS OF AUDITING	

Structure

10.0 Learning Objectives

After the reading of this chapter, the reader will be able:

- To define the term professional ethics and its importance.
- To know the various professional ethics for Auditors.

- To know the provisions for professional ethics under Chartered Accountant Act, 1949.
- To explain the various professional misconduct in the First & Second Schedules of the Act.

10.1 Introduction

Professional ethics refers to the professionally accepted standards of personal and business behavior, values, and guiding principles. It encompasses the personal, organizational, and corporate standards of behavior expected of professionals. Professionals and those working in acknowledged professions, exercise specialist knowledge, and skill. How the use of this knowledge should be governed when providing a service to the public can be considered a moral issue and is termed professional ethics. Professionals are capable of making judgments, applying their skills, and reaching informed decisions in situations that the general public cannot because they have not received the relevant training. Codes of professional ethics are often established by professional organizations to help guide members in performing their job functions according to sound and consistent ethical principles. The key reason accountants need to have an ethical code is that people rely on them and their expertise. It is important to note that this reliance extends beyond clients to the general community. Accountants deal with a range of issues on behalf of clients. They often have access to confidential and sensitive information. Auditors claim to give an independent view. It is, therefore, critical that accountants are independent. Compliance with a shared set of ethical guidelines gives protection to accountants as well, as they cannot be accused of behaving differently from other accountants.

10.2 Professional Ethics

The word 'Ethics' word is derived from the ancient Greek word 'ethikos' means relating to one's character, which itself comes from the word 'ethos' means character or moral nature. It is the study of what is right and wrong in human behavior. It involves traditions and conventions through the years of growth of civilization. These are the different from legal law as ethics does not include any legal force rather then it is based on the principle of good behavior and manners. Ethics refers to human conduct as to make judgments between what is right and what is wrong. It could be that there are several factors that may encourage one to adopt unethical behavior, but the right person is he who, despite facing ethical dilemmas, assesses the situations and makes differentiation between what is morally good and bad in order to follow the rules and code of professional conduct.

Professional ethics refers to the professionally accepted standards of personal and business behavior, values, and guiding principles. It encompasses the personal, organizational, and corporate standards of behavior expected of professionals. Professionals and those working in acknowledged professions, exercise specialist knowledge, and skill.

Albert Schweitzer says, “Ethics is the activity of man directed to secure the inner perfection of his own personality.”

According to **Linda Elder**, “Ethics is a set of concepts and principles that guide us in determining what behavior helps or harms sentient creatures.”

The Cambridge Dictionary of Philosophy defines the word “Ethics is commonly used interchangeably with morality and sometimes it is used to mean the moral principles of a particular tradition, group or individual.”

In short, it can be said that the professional ethics are the principles that govern the behavior of a person or group in a particular business set up.

10.2.1 Objectives of Professional Ethics

Professional accountants play an important role in building up the economic well-being of their community and country with their attitude, behavior, and unique services. They have common objectives, whether they work in capacities of external auditors, internal auditors, financial experts, tax experts, and management accountants. Their common objectives are to perform their duties and responsibilities and to attain the highest levels of performance by the ethical requirements generally to meet the public interest and maintain the reputation of the accounting profession. Personal self-interest must not prevail over these duties. The IFAC and ICAEW Codes of Ethics help accountants to meet these obligations by setting out ethical guidance to be followed. To achieve these objectives, they have to establish creditability, professionalism, quality of service, and confidence. Acting in the public interest involves having regard to the legitimate interests of clients, government, financial institutions, employees, investors, the business and financial community, and others who rely upon the objectivity and integrity of the accounting profession to support the dignity and orderly functioning of commerce.

10.2.2 Importance of Professional Ethics:

Good Ethics is a fundamental requirement of any profession. It is integral to the success of the business as well. Ethics is a system of moral principles governing the appropriate conduct of a person or a group. Maintaining good ethics is being consistent with the principles of correct moral conduct constantly. "Good ethics is good business." as it not leads to run the business successfully, but it also provides many ways for growth and development by leaving a good impression about an organization in the market. An organization strives continually to be in pursuit of its goals while benefiting the employees in building up their high competencies. In this direction, the adherence to high ethical standards of the employees can be very much contributory to the impressive achievements of business goals being turned out as planned and intended. Good ethics causes to gain confidence of superiors while promoting integrity, which means to continue doing right things even when we are not watched. The importance of ethics in professional life can be evidenced by a number of instances showing failure of businesses and several scandals. It may be rightly said that the situations would not have been so worsened had there been observance of ethical standards. Therefore, maintaining ethical standards is must for the prosperity of an organization as well as the development of one's personality. Good ethics will lead us to maintain our honest image. It will enable us to refrain from such activities that may discredit to our profession. Thus, adhesion to good ethics is to let our conscience be our guide at all times.

10.2.3 Professional Ethics in Auditing

Professional ethics are the principles that govern the behavior of a person or group in a particular business environment. Most professional associations have embodied the principles into code of ethics for their members. These principles mainly include:

- **Integrity-**A professional accountant should be straightforward and honest in all professional and business relationships.
- **Objectivity**-A professional accountant should not allow bias, conflict of interest or undue influence of others to override professional or business judgments.
- **Professional Competence and Due Care-**A professional accountant has a continuing duty to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation, and techniques. Professional accountants should act diligently and by applicable technical and professional standards when providing professional services.
- **Confidentiality-**A professional accountant should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any such

information to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of the professional accountant or third parties.

- **Professional Behavior-**A professional accountant should comply with relevant laws and regulations and should avoid any action that discredits the profession.
- **Responsibilities-**In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities.
- **The Public Interest-**Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate a commitment to professionalism.
- **Independence-**A member should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.
- **Scope and Nature of Services-**A member in public practice should observe the Principles of the Code of Professional Conduct in determining the scope and nature of services be provided.

10.3 Professional Ethics under Chartered Accountant, Act, 1949

The Chartered Accountants Act, 1949 is a statute enacted by the Constituent Assembly of India, which was acting as the provisional Parliament of India in 1949 to regulate the profession of Chartered Accountants in India. Under this act, The Institute of Chartered Accountants of India was established to educate, register and regulate Chartered Accountants in India. The Act provides for ethical practices of Chartered Accountants and disciplinary proceedings against a Chartered Accountant.

10.3.1 Professional Misconduct

Section 22 of the Chartered Accountant Act, 1949 defines the word Professional Misconduct as the expression, “conduct which, if proved, will render a person unfit to be a member of the Institute” shall be deemed to include any act or omission specified in the Schedule, but nothing in this Section shall be construed to limit or abridge in any way the power conferred on the Council under sub-section (1) of Section 21 to inquire into the conduct of any member of the Institute under any other circumstances.

10.3.2 Entry of names in the Register

Any of the following persons shall be entitled to have his name entered in the Register, namely:

- Any person who is a registered accountant or a holder of a restricted certificate at the commencement of this Act;
- Any person who has passed such examination and completed such training as may be prescribed for members of the Institute;
- Any person who has passed the examination for the Government Diploma in Accountancy or an examination recognized as equivalent thereto by the rules for the award of the Government Diploma in Accountancy before the commencement of this Act, and who, although not duly qualified to be registered as an accountant under the Auditor's Certificates Rules, 1932, fulfils such conditions as the Central Government may specify in this behalf;
- Any person who, at the commencement of this Act, is engaged in the practice of accountancy in any and who, although not possessing the requisite qualifications to be registered as an accountant under the Auditor's Certificates Rules, 1932, fulfils such conditions as the Central Government may specify in this behalf;
- Any person who has passed such other examination and completed such other training without India as is recognized by the Central Government or the Council as being equivalent to the examination and training prescribed for members of the Institute.

  Provided that in the case of any person who is not permanently residing in India, the Central Government or the Council, as the case may be, may impose such further conditions as it may deem fit;
- Any person domiciled in India who at the commencement of this Act is studying for any foreign examination and is at the same time undergoing training, whether within or without India, or, who, having passed such foreign examination, is at the commencement of this Act undergoing training, whether within or without India.

Provided that any such examination or training was recognized before the commencement of this Act for the purpose of conferring the right to be registered as an accountant under Auditor's Certificates Rules, 1932, and provided further that such person passes the examination or completes the training within five years after the commencement of this Act.

- Every person belonging to the class mentioned in clause (i) of sub-section (1) shall have his name entered in the Register without the payment of any entrance fee.
- Every person belonging to any of the classes mentioned in clauses (ii), (iii), (iv), (v) and (vi) of sub-section (1) shall have his name entered in the Register on application being made and granted in the

prescribed manner and on payment of such fees, as may be determined, by notification, by the Council, which shall not exceed rupees three thousand.

Provided that the Council may, with the prior approval of the Central Government, determine the fee exceeding rupees three thousand, which shall not in any case exceed rupees six thousand.

- The Central Government shall take such steps as may be necessary for the purpose of having the names of all persons belonging to the class mentioned in clause (i) of sub-section (1) entered in the Register.

10.3.3 Fellows and Associates

The members of the Institute shall be divided into two classes designated respectively as associates and fellows.

- Any person shall, on his name being entered in the Register, be deemed to have become an associate member of the Institute and be entitled to use the letters A.C.A. after his name to indicate that he is an associate member of the Institute of Chartered Accountants of India.
- A member, being an associate who has been in continuous practice in India for at least five years, whether before or after the commencement of this Act, or whether partly before and partly after the commencement of this Act, and a member who has been an associate for a continuous period of not less than five years and who possesses such qualifications as the Council may prescribe with a view to ensuring that he has experience equivalent to the experience normally acquired as a result of continuous practice for a period of five years as a chartered accountant shall, on payment of such fees, as may be determined, by notification, by the Council, which shall not exceed rupees five thousand and on application made and granted in the prescribed manner, be entered in the Register as a fellow of the Institute and shall be entitled to use the letters F.C.A. after his name to indicate that he is a fellow of the Institute of Chartered Accountants of India.

  Provided that the Council may with the prior approval of the Central Government, determine the fee exceeding rupees five thousand, which shall not in any case exceed rupees ten thousand.

10.3.4 Disabilities or Disqualification

A person shall not be entitled to have his name entered in or borne on the Register if he:

- Has not attained the age of twenty-one years at the time of his application for the entry of his name in the Register; or
- Is of unsound mind and stands so adjudged by a competent Court; or
- Is an un-discharged insolvent; or
- Being a discharged insolvent, has not obtained from the Court a certificate stating that his insolvency was caused by misfortune without any misconduct on his part; or
- Has been convicted by a competent Court whether within or without India, of an offence involving moral turpitude and punishable with transportation or imprisonment or of an offence, not of a technical nature, committed by him in his professional capacity unless in respect of the offence committed he has either been granted a pardon or, on an application made by him in this behalf, the Central Government has, by an order in writing, removed the disability; or
- Has been removed from membership of the Institute on being found on inquiry to have been guilty of professional or other misconduct.

Provided that a person who has been removed from membership for a specified period, shall not be entitled to have his name entered in the Register until the expiry of such period.

10.3.5 Removal of Name from the Register

The Council may remove from the Register the name of any member of the Institute:

- Who is dead; or
- From whom a request has been received to that effect; or
- Who has not paid any prescribed fee required to be paid by him; or
- Who is found to have been subject at the time when his name was entered in the Register, or who at any time thereafter has become subject, to any of the disabilities mentioned in Section 8, or who for any other reason has ceased to be entitled to have his name borne on the Register.

- The Council shall remove from the Register the name of any member in respect of whom an order has been passed under this Act removing him from membership of the Institute.
- If the name of any member has been removed from the Register under clause (c) of subsection (1), on receipt of an application, his name may be entered again in the Register on payment of the

arrears of annual fee and entrance fee along with such additional fee, as may be determined, by notification, by the Council which shall not exceed rupees two thousand.

Provided that the Council may with the prior approval of the Central Government, determine the fee exceeding rupees two thousand, which shall not in any case exceed rupees four thousand.

10.3.6 Enquiry into the Charges of Misconduct of Members

On receipt of any information or complaint along with the prescribed fee, the Disciplinary Directorate shall arrive at a prima facie opinion on the occurrence of the alleged misconduct. Where the Disciplinary Directorate is of the opinion that a member is guilty of any professional or other misconduct mentioned in the First Schedule, he shall place the matter before the Board of Discipline and where the Disciplinary Directorate is of the opinion that a member is guilty of any professional or other misconduct mentioned in the Second Schedule or in both the Schedules, he shall place the matter before the Disciplinary Committee.

In order to make investigations under the provisions of this Act, the Disciplinary Directorate shall follow such procedure as may be specified.

Where a complainant withdraws the complaint, the Director (Discipline) shall place such withdrawal before the Board of Discipline or, as the case may be, the Disciplinary Committee, and the said Board or Committee may, if it is of the view that the circumstances so warrant, permit the withdrawal at any stage.

10.3.7 Appeal against the order of the Board of Discipline or Disciplinary Committee to Authority

- Any member of the Institute aggrieved by any order of the Board of Discipline or the Disciplinary Committee imposing on him any of the penalties referred to in sub-section (3) of Section 21A and sub-section (3) of Section 21B, may within ninety days from the date on which the order is communicated to him, prefer an appeal to the Authority.

  Provided that the Director (Discipline) may also appeal against the decision of the Board of Discipline or the Disciplinary Committee to the Authority, if so authorized by the Council, within ninety days:

  Provided, further that the Authority may entertain any such appeal after the expiry of ninety days, if it is satisfied that there was sufficient cause for not filing the appeal in time.

- The Authority may, after calling for the records of any case, revise any order made by the Board of Discipline or the Disciplinary Committee under sub-section (3) of Section 21A and sub-section (3) of Section 21B and may:
    - Confirm, modify or set aside the order;
    - Impose any penalty or set aside, reduce, or enhance the penalty imposed by the order;
    - Remit the case to the Board of Discipline or Disciplinary Committee for such further enquiry as the Authority considers proper in the circumstances of the case; or
    - Pass such other order as the Authority thinks fit.

    Provided that the Authority shall give an opportunity of being heard to the parties concerned before passing any order.

10.3.8 The First Schedule

- **PART I: Professional misconduct in relation to chartered accountants in practice**

A chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he:

- Allows any person to practice in his name as a chartered accountant unless such person is also a chartered accountant in practice and is in partnership with or employed by him.
- Pays or allows or agrees to pay or allow, directly or indirectly, any share, commission or brokerage in the fees or profits of his professional business, to any person other than a member of the Institute or a partner or a retired partner or the legal representative of a deceased partner, or a member of any other professional body or with such other persons having such qualifications as may be prescribed, for the purpose of rendering such professional services from time to time in or outside India.

    Explanation − In this item, “partner” includes a person residing outside India with whom a chartered accountant in practice has entered into partnership which is not in contravention of item (4) of this Part.
- Accepts or agrees to accept any part of the profits of the professional work of a person who is not a member of the Institute.

    Provided that nothing herein contained shall be construed as prohibiting a member from entering into profit sharing or other similar arrangements, including receiving any share commission or brokerage in the fees, with a member of such professional body or other person having qualifications, as is referred to in item (2) of this Part;

- Enters into partnership, in or outside India, with any person other than a Chartered

  Accountant in practice or such other person who is a member of any other professional body having such qualifications as may be prescribed, including a resident who but for his residence abroad would be entitled to be registered as a member under clause (v) of sub-section (1) of Section 4 or whose qualifications are recognized by the Central Government or the Council for the purpose of permitting such partnerships.
- Secures, either through the services of a who is not an employee of such chartered accountant or who is not his partner or by means which are not open to a chartered accountant, any professional business.

  Provided that nothing herein contained shall be construed as prohibiting any arrangement permitted in terms of items (2), (3) and (4) of this Part;
- Solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means.

  Provided that nothing herein contained shall be construed as preventing or prohibiting:
  - Any chartered accountant from applying or requesting for or inviting or securing professional work from another chartered accountant in practice; or
  - A member from responding to tenders or enquiries issued by various users of professional services or organizations from time to time and securing professional work as a consequence.
- Advertises his professional attainments or services, or uses any designation or expressions other than chartered accountant on professional documents, visiting cards, letter heads or sign boards, unless it be a degree of a University established by law in or recognized by the Central Government or a title indicating membership of the Institute of Chartered Accountants of India or of any other institution that has been recognized by the Central Government or may be recognized by the Council.

  Provided that a member in practice may advertise through a write up setting out the services provided by him or his firm and particulars of his firm subject to such guidelines as may be issued by the Council.
- Accepts a position as auditor previously held by another chartered accountant or a certified auditor who has been issued certificate under the Restricted Certificate Rules, 1932, without first communicating with him in writing;

- Accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of Section 225 of appointment have been duly complied with.
- Charges or offers to charge, accepts or offers to accept in respect of any professional employment, fees which are based on a percentage of profits or which are contingent upon the findings or results of such employment, except as permitted under any regulation made under this Act.
- Engages in any business or occupation other than the profession of chartered accountant unless permitted by the Council so to engage.

  Provided that nothing contained herein shall disentitle a chartered accountant from being a director of a company (not being a managing director or a whole time director) unless he or any of his partners is interested in such company as an auditor.
- Allows a person not being a member of the Institute in practice, or a member not being his partner to sign on his behalf or on behalf of his firm, any balance sheet, profit and loss account, report or financial statements.

➢ **PART II: Professional misconduct in relation to members of the Institute in service**

A member of the Institute (other than a member in practice) shall be deemed to be guilty of professional misconduct, if he being an employee of any company, firm or person:

- Pays or allows or agrees to pay directly or indirectly to any person any share in the emoluments of the employment undertaken by him.
- Accepts or agrees to accept any part of fees, profits or gains from a lawyer, a chartered accountant or broker engaged by such company, firm or person or agent or customer of such company, firm or person by way of commission or gratification.

➢ **PART III: Professional misconduct in relation to members of the Institute generally**

A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he:

- Not being a fellow of the Institute, acts as a fellow of the Institute.
- Does not supply the information called for, or does not comply with the requirements asked for, by the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority.

- While inviting professional work from another chartered accountant or while responding to tenders or enquiries or while advertising through a write up, or anything as provided for in items (6) and (7) of Part I of this Schedule, gives information knowing it to be false.

- **PART IV: Other misconduct in relation to members of the Institute generally**

A member of the Institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if he:

- Is held guilty by any civil or criminal court for an offence which is punishable with
- Imprisonment for a term not exceeding six months.
- In the opinion of the Council, brings disrepute to the profession or the Institute as a result of his action whether or not related to his professional work.

10.3.9 The Second Schedule

- **PART I: Professional misconduct in relation to chartered accountants in practice**

A chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he:

- Discloses information acquired in the course of his professional engagement to any person other than his client so engaging him, without the consent of his client or otherwise than as required by any law for the time being in force.
- Certifies or submits in his name, or in the name of his firm, a report of an examination of financial statements unless the examination of such statements and the related records has been made by him or by a partner or an employee in his firm or by another chartered accountant in practice.
- Permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that he vouches for the accuracy of the forecast.
- Expresses his opinion on financial statements of any business or enterprise in which he, his firm, or a partner in his firm has a substantial interest.
- Fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary in making such financial statement where he is concerned with that financial statement in a professional capacity.
- Fails to report a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity.

- Does not exercise due diligence, or is grossly negligent in the conduct of his professional duties.
- Fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion.
- Fails to invite attention to any material departure from the generally accepted procedure of audit applicable to the circumstances.
- Fails to keep moneys of his client other than fees or remuneration or money meant to be expended in a separate banking account or to use such moneys for purposes for which they are intended within a reasonable time.

➢ **PART II: Professional misconduct in relation to members of the Institute generally**

A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he:

- Contravenes any of the provisions of this Act or the regulations made thereunder or any guidelines issued by the Council.
- Being an employee of any company, firm or person, discloses confidential information acquired in the course of his employment except as and when required by any law for the time being in force or except as permitted by the employer.
- Includes in any information, statement, return or form to be submitted to the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority any particulars knowing them to be false.
- Defalcates or embezzles moneys received in his professional capacity.

➢ **PART III: Other misconduct in relation to members of the Institute generally**

A member of the Institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if he is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term exceeding six months.

10.4 Check Your Progress

1. The word ‘Ethics’ has been derived from the Greek word………

    a) Ethikos
    b) Ethicon
    c) Both a & b

d) None of the above

2. Which one of the following is the professional ethics for auditors?

a) Integrity
b) Objectivity
c) Confidentiality
d) All of the above

3. The Chartered Accountants Act was passed in the year ……..

a) 1948
b) 1949
c) 1950
d) 1951

4. Which one of the following is the disqualification for auditors?

(a) Has not attained the age of twenty-one years at the time of his application for the entry of his name in the Register.
(b) Unsound mind and stands so adjudged by a competent Court.
(c) Un-discharged insolvent.
(d) All of the above

5. The Council may remove from the Register the name of which member of the Institute….

(a) Name of dead person.
(b) From whom a request has been received to that effect.
(c) Who has not paid any prescribed fee required to be paid by him.
(d) All of the above

6. "Professional ethics refers to the professionally accepted standards of personal and business behavior, values, and guiding principles." Is this statement true?

(a) Yes

(b) No

(c) Incorrect statement.

(d) None of the above

10.5 Summary

Good Ethics is a fundamental requirement of any profession. It is integral to the success of the business as well. Ethics is a system of moral principles governing the appropriate conduct of a person or a group. Professional accountants play an important role in building up the economic well-being of their community and country with their attitude, behavior, and unique services. They have common objectives, whether they work in capacities of external auditors, internal auditors, financial experts, tax experts, and management accountants. Professional ethics refers to the professionally accepted standards of personal and business behavior, values, and guiding principles. It encompasses the personal, organizational, and corporate standards of behavior expected of professionals. Most professional associations have embodied the principles into code of ethics for their members. These principles mainly include: Integrity, Objectivity, Professional Competence and Due Care, Confidentiality, Professional Behavior etc. The Chartered Accountants Act, 1949 is a statute enacted by the Constituent Assembly of India, which was acting as the provisional Parliament of India in 1949 to regulate the profession of Chartered Accountants in India. The Act provides for ethical practices of Chartered Accountants and disciplinary proceedings against a Chartered Accountant.

10.6 Keywords

- **Ethics-** It is the study of what is right and wrong in human behavior.
- **Professional ethics**-It refers to the professionally accepted standards of personal and business behavior, values, and guiding principles.
- **Integrity-**The quality of being honest and having strong moral principles..
- **Objectivity**-The quality of being able to make a decision or judgment in a fair way that is not influenced by personal feelings or beliefs.
- **Professional Misconduct-** Conduct which, if proved, will render a person unfit to be a member of the Institute.
- **Professional Competence-** These are skills, knowledge and attributes that are specifically valued by the professional associations, organizations and bodies connected to your future career.

10.7 Self-Assessment Test

Q.1 What is Professional Ethics? Explain its objectives and importance.

Q.2 Define the term Professional Ethics. What are the various professional ethics for auditors?

Q.3 What is misconduct according to the Chartered Accountant, Act, 1949? State clauses of misconduct contained in the First Schedule Part-I of the Act?

Q.4 State clauses of misconduct contained in the Second Schedule of the Act?

Q.5 Explain the various provisions of Chartered Accountant, Act, 1949 related to the professional ethics.

Q.6 Write short notes on

a) Professional Misconduct

b) Entry of Names in the Register

c) Fellows and Associates

d) Appeal to Authority

10.8 Answers to Check Your Progress

1(a), 2 (d), 3(b), 4 (d), 5(d), 6 (a)

10.9 References/Suggested Readings

- Basu, S.K., "Fundamental of Auditing" Pearson Publication, New Delhi.
- **Tandon, B. N., S. Sudharsanam, and S. Sundharabahu**, "*A Handbook of Practical Auditing",* S. Chand and Co. Ltd., New Delhi.
- **Pagare, Dinkar**, "*Principles and Practice of Auditing",* Sultan Chand and Sons, New Delhi.
- **Institute of Chartered Accountants of India**, ''*Auditing and Assurance Standards*'', ICAI, New Delhi.
- **Gupta Kamal, and Ashok Arora**, "*Fundamentals of Auditing,*" Tata Mc-Graw Hill Publishing Co. Ltd., New Delhi.

NOTES

NOTES

NOTES

NOTES

NOTES