Principles and Practice of Auditing

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Preface

We have great pleasure in presenting the first edition "*Principles and Practices of Auditing*" written for students of UG courses. The subject matter is written in a simple and easily understandable language with sufficient support from real business world information.

This is an attempt to provide the students with thorough understanding of auditing concepts. In writing this book we have benefited immensely from the studies of a number of books and the articles written by scholars spread over diversely.

We are sure this book will prove to be useful to students and teachers alike. This book would not have seen the light, but for the support of our family members and friends.

The book would not have seen the light, but for the grace of God and the blessings and support of our family members and friends. We are highly indebted to Himalaya publishing House Pvt. Ltd. who took keen interest at every steps in publishing this book.

Finally, we express our sincere thank to *SPS*, Bangalore, their excellent computer typesetting work and the printing.

Our work would not attain its fulfillment if we fail to thank the management of Dayanand Sagar College of Management and Information Technology, for giving us the support and encouragement to take up such a task.

We offer our gratitude to Himalya Publishing House Pvt. Ltd, who is leader in Commerce and Management publications. Our sincere regards to Mr. Niraj Pandey and Vijay Pandey for interest shown, and for the best effort put forth by the matter of publication of this book.

Any suggestions regarding improvement and errors, if any, will be gratefully acknowledged.

Bengaluru **Authors**
Aug, 2013

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INTRODUCTION

The word 'Audit' is originated from the Latin word 'audire' which means 'to hear'. In the earlier days, whenever there is suspected fraud in a business organization, the owner of the business would appoint a person to check the accounts and hear the explanations given by the person responsible for keeping the account and funds. In those days, the audit is done to find out whether the payments and receipt are properly accounted or not.

The objective of modern day accounting is not only for the verification of cash but to report the financial position of the undertaking as disclosed by its Balance sheet and Profit and Loss account.

Auditing is checking of accounting books and related documents to know whether they are true, complete and have been kept according to rules. This checking or examination becomes even more necessary when the accounting books are maintained by person other than the owner of the organization. The development of banking facilities and new means of communication and transportation have enlarge the field of investment.

Meaning of Auditing

Auditing refers to a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users.

Definitions of Auditing

According to ***Montgomery,*** "Auditing is a systematic examination of the books and records of a business or the organization in order to ascertain or verify and to report upon the facts regarding the financial operation and the result thereof."

According to ***Lawrence R. Dicksee,*** "Auditing is an examination of accounting records undertaken with a view to establishing whether they correctly and completely reflect the transactions to which they relate. In some instances, it may be necessary to ascertain whether the transactions themselves are supported by authority."

According to ***R. K. Mautz,*** “Auditing is being concerned with the verification of accounting data, with determining the accuracy and reliability accounting statement and reports."

According to ***Arther W. Holmes,*** "Auditing is the systematic and scientific examination, of the accounting records, vouchers and, other financial and legal records and documents of a private or public business organization, performed for the purpose (a) of ascertaining the accuracy and integrity of the accounting, (b) of fairly presenting of the financial condition at a given date and the results of operations for a period ending on that date both on the basis of consistency on conformity with accepted accounting principles, and (c) of rendering an expert and impartial opinion on the statement submitted”.

According to ***Spicer and Pegler,*** "Auditing is such an examination of books of accounts and vouchers of business, as will enable the auditors to satisfy himself that the balance sheet is properly drawn up, so as to give a true and fair view of the state of affairs of the business and that the profit and loss account gives true and fair view of the profit/loss for the financial period, according to the best of information and explanation given to him and as shown by the books; and if not, in what respect he is not satisfied."

HISTORY OF AUDIT IN INDIA

1857: The first ever Companies Act in India legislated.

1866: Law relating to maintenance of accounts and audit thereof introduced. Formal qualification as auditor now required.

1913: New Companies Act enacted. Books of accounts to be maintained specified.
Formal qualification to act as auditor named. A Certificate from the local government to be held in order to act as auditor. An unrestricted Certificate entitled a person to act as auditor throughout British India. A Restricted Certificate entitled him to act as auditor only within the province concerned and in the languages specified in the certificate.

1918: Government Diploma in Accounting (GDA) launched in Bombay. On completion of article of three years under an approved accountant and passing the Qualifying Examination the candidate would become eligible for the grant of an Unrestricted Certificate.

1920: The issue of Restricted Certificates discontinued.

1927: Society of Auditors founded in Madras.

1930: Register of Accountants (RA) to be maintained by the Government of India to exercise control over the members in practice. Those whose names found entry here were called Registered Accountants (RA).

1930: The Governor General in Council replaced the local government as the statutory authority to grant certificates to persons entitling them to act as auditors. Auditors allowed to practice throughout India.

1932: First Accountancy Board formed. The Board was to advise the Governor General in Council on matters relating to accountancy and to assist him in maintaining standards of qualification and conduct required of auditors.

1933: First examination held by the Indian Accountancy Board. GDAs exempted from taking the test.

1935: The first Final Examination was held. GDAs exempted from taking the test.

1943: GDA abolished.

1948: Expert Committee formed to examine the scheme of an autonomous association of accountants in India.

1949: The Chartered Accountants Act, 1949 was passed on 1st May. The term Chartered Accountant came to be used in place of Indian Registered Accountants. Chartered Accountants Act was brought into effect on 1st July. The Institute of Chartered Accountants of India is born.

1999: ICAI completed 50 years on 1st July 1999.

SCOPE OF AUDIT

The scope of audit can be classified as follows:

1. Scope of Private Audit

Private audit is the audit of such firms as does not have any statutory obligation for conducting audit. It is conducted at the will of owners. Sole traders and partnership firms are such organizations. Audit is not a statutory requirement for these organizations. The owner of a proprietary concern himself takes the decision to get the accounts audited. He decides about the scope of audit and the appointment of the auditor. The auditing work will depend upon the agreement of audit and specific instructions given by the owner. Similarly, the audit of accounts of a partnership firm is not a statutory requirement. But, to avoid any misunderstanding and doubt, partners, in the partnership deed, may provide for audit of financial statements. Auditors are appointed by the mutual agreement. While conducting audit of these firms, the auditor must refer to the partnership deed and should determine the scope of his audit accordingly. It is in the interest of auditors to get the agreement in writing regarding the nature and scope of his work. In future, the auditor can protect himself by producing the agreement of audit, if he is held responsible for negligence.

2. Scope of statutory Audit

It is compulsory and obligatory by law for certain organizations to get their accounts audited. And audit which is a compulsory requirement under law is known as statutory audit. This audit is conducted by qualified persons. The qualified Chartered Accountants, who are not connected with preparation of accounts or management of the concern, can be appointed as auditors. The audit of accounts of companies by a qualified auditor is compulsory under the Companies Act, 1956. This provides the shareholders and other persons true and fair view of financial position of the business. They can protect themselves from any fraud committed by directors, promoters or managers. The audit is a moral check on the duties of the management. No doubt, the audit of companies has been made compulsory, yet the scope of audit has not been made clear in the companies Act, e.g. It has not been made definite which books the auditor should examine while conducting audit. Generally, concerned Acts describe only the object of auditing.

CHARACTERISTICS OF AUDITING

The main Characteristics of Auditing are as follows:

i) Audit is a crucial review of the system of accounting and internal control.

ii) Audit is an organized and scientific examination of the books of accounts of a business.

iii) Audit is undertaken by an independent person or body of persons who are duly qualified for the job.

iv) Audit is a verification of the results shown by the profit and loss account and the state of affairs as shown by the balance sheet.

v) Audit is done with the help of vouchers, documents, information and explanations received from the authorities.

vi) The auditor has to satisfy himself with the authenticity of the financial statements and report that they exhibit a true and fair view of the state of affairs of the concern.

vii) The auditor has to inspect, compare, check, review, scrutinize the vouchers supporting the transactions and examine correspondence, minute books of share holders, directors, Memorandum of Association and Articles of association etc., in order to establish correctness of the books of accounts.

BRANCHES OF AUDITING

The branches of audit can be classified as follows:

1. Internal Auditing

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization to accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

According to the Institute of Internal Auditors (IIA), the internal auditor evaluates the risks the organization faces with respect to governance, operations and information systems. Its mandate is to ensure (a) effective and efficient operations; (b) the reliability and integrity of financial and operational information; (c) safeguarding of assets; and (d) compliance with laws, regulations and contracts. The internal auditor's primary responsibility is the company’s management.

Internal auditing considers the examination, monitoring and analysis of activities related to a company's operation, including its business structure, employee behaviour and information systems. Although accounting is an important skill for an internal auditor, the focus for internal auditors is the evaluation of operational, risk management, internal control and the governance processes of the organisation. An internal audit is designed to review what a company is doing in order to identify potential threats to the organization's health and profitability, and to make suggestions for mitigating the risk associated with those threats in order to minimize costs.

2. External Auditing

External auditing refers to the auditing which considers the auditing by an outside group. External auditing is used by accreditation agencies, used by third party reimbursement agencies to determine appropriateness of claims. This is the process of examining the financial statements and the underlying records of a company in order to render an option as to whether the statements are fairly presented.

External auditors are independent firms that inspect the accounts of an entity and render an opinion on whether its statements conform to GAAP and present fairly the financial position of the company and the results of operations. The external auditor's primary obligation is to users of financial statements outside the organization. External auditors are required to register with ISO 9000.

QUALITIES OF AN AUDITOR

Following are the essential qualities of an auditor:

1. Auditing

An auditor's knowledge of auditing must be up to date. He must know the techniques of auditing. He must have the knowledge of other subjects relating to auditing.

2. Accounting Knowledge

The auditor should be at home in all the management accounting cost accounting and general accounting.

3. Knowledge of Business Law

An auditor must possess a considerable knowledge of business law. He must be aware about his duties and rights given by law.

4. Professionally Competent

It is a basic quality of an auditor. He must have a complete and thorough knowledge of the accountancy. To understand the accounting details he can apply his knowledge and skill. It is only possible if he has a sound background in accountancy and he is professionally competent.

5. Honest

Justice Hindley says "An auditor must be honest. He must not certify what he does not believe to be true and he must take a reasonable care and skill before he believes that what he certifies is true.

6. Knowledge of Taxation Law

Various types’ taxes are imposed by the government on the business. For example in some countries Income tax, sales tax, gift tax is imposed. So if auditor has not a considerable knowledge about the taxation. He cannot perform his services properly.

7. Computer Expert

The auditor must be able to operate the computer. Today the business organizations are using computers. If auditor does not know to use computer, he cannot work efficiently.

8. Knowledge of management System

The auditor must have the knowledge of management information system. It helps him to understand the internal set up of the business concern and its operation.

9. Preparation of Budget

The auditor must know that how the organization prepares the budget. If he does not know then it will be not possible for him to audit the various heads of the budget.

10. Intelligent

It is also an important quality of an auditor that he should be intelligent. He must be able to understand the technical details of any business.

11. Tactful

In a particular situation auditor should deal tactfully. He should ask the questions in such a manner that it does not show about his ignorance or weakness.

12. Maintain Secrecy

The auditor's nature of work is confidential. He should maintain secrecy from others about the affairs of his client.

13. Patience

There should be a quality of patience in the auditor. Before signing on any paper he should check the evidence and then sign it. He never checks the papers in hurry.

14. Critical Attitude

It is also very essential quality of the auditor. He should examine the statements critically. He should ask the various questions from the client and try to find contradictions.

15. Bold and Courageous

Auditor should be bold and courageous person. He should not be influenced by any authority. He should possess the courage to face the difference of opinion between him and client on any issue.

16. Courteous

It is an important quality which the auditor should possess. His attitude towards the staff of client should be very humble and polite. He should also stress on his own staff to be courteous with the client.

17. Independent

The auditor should be impartial. He should not have such relations with the organization which may affect his independence. He should give his opinion independently.

18. Common Sense

The auditor must have the quality of common sense and judgement. He may be able to assess the value of depreciation and bad debts.

OBJECTIVES OF AUDITING

The important objectives of auditing are given below:

1. Primary Objectives
2. Secondary Objectives.

1. Primary Objectives

To determine and judge the reliability of the financial statement and the supporting accounting records of a particular financial period is the main purpose of the audit. As per the Indian Companies Act, 1956 it is mandatory for the organizations to appoint a auditor who, after the examination and verification of the books of account, disclose his opinion that whether the audited books of accounts, Profit and Loss Account and Balance Sheet are showing the true and fair view of the state of affairs of the company's business. To get a true and fair view of the company's affairs and express his opinion, he has to thoroughly check all the transactions and relevant documents of the company made during the audited period. While carrying out the process of audit, the auditor may come across certain errors and frauds. But detection of fraud or errors is not the primary objective of the audit. They come under the secondary objectives of audit.

Audit also disclose whether the Accounting system adopted in the organization is adequate and appropriate in recording the various transactions as well as the setbacks of the system.

2. Secondary Objectives

In order to report the financial condition of the business, auditor has to examine the books of accounts and the relevant documents. In that process he may come across some errors and frauds. This may classify these errors and frauds as below:

A. Detection and prevention of Errors

B. Detection and prevention of Frauds

A. Detection and prevention of Errors

Following types of errors can be detected in the process of auditing:

i) Clerical Errors

ii) Errors of Principle

i) Clerical Errors

Due to wrong posting such errors may occur. Money received from Microsoft credited to the Semens's account is an example of clerical error. Even though the account was posted wrongly, the trial balance will agree. We can classify clerical errors as below:

a) Errors of Commission

b) Errors of Omission

c) Compensating Errors

a) ***Errors of Commission:*** These errors are errors caused due to wrong posting either wholly or partially in the books of original entry or ledger accounts or wrong totalling, wrong calculations, wrong balancing and wrong casting of subsidiary books. For example Rs. 5000 is paid to Microsoft for the supply of windows program and the same is recorded in the cash book. While posting the ledger the Microsoft's account is debited by Rs. 500. It may be due to the carelessness of the accountant. Most of these errors of commission are reflected in the trial balance and can be identified by routine checking of the books.

b) ***Errors of Omission:*** When there is no record of transactions in the books of original entry or omission of posting in the ledger could lead to such errors. Sales not recorded in the sales book or omission to enter invoices in the purchase book is examples of Errors of Omission. Errors due to entire omission will not affect the trial balance. Errors due to partial omission will affect the trial balance and can be detected.

c) ***Compensating:*** Errors are errors committed in such a way that the net result of these errors on the debit side and credit side would be nullifying the net effect of the error. For example, Ram's account which was to be debited for Rs. 5000 was credited for Rs. 5000 and similarly, Sita's Account which was to be credited for Rs. 5000 was debited for Rs. 5000. These two mistakes will nullify the effect of each other. Unless detailed investigation is undertaken such errors are difficult to locate as both the sides of the trial balance are equally affected.

ii) Errors of Principle

While recording a transaction, the fundamental principles of accounting is not properly observed, these types of errors could occur. Over valuation of closing stock or incorrect allocation of expenditure or receipt between capital and revenue are some of the examples of such errors. Such errors will not affect the trial balance but will affect the Profit and Loss account. It may occur due to lack of knowledge of sound principles of accounting or can be committed deliberately to falsify the accounts. To detect such errors, the auditor has to do a careful examination of the books of account.

B. Detection and Prevention of frauds

To get money illegally from the organization or from the proprietor frauds are committed intentionally and deliberately. If it remains undetected, it could affect the opinion of the auditor on the financial condition and the working results of the organization. Therefore, it is necessary for the auditor to exercise utmost care to detect such frauds. It can be committed by the top management or by the employees of the organization. Frauds could be of the following types:

i) Misappropriation of cash

ii) Misappropriation of goods

iii) Falsification or Manipulation of accounts

iv) Window dressing

v) Secret Reserves

i) ***Misappropriation of Cash:*** Since the owner has very limited control over the receipt and payments of cash, misappropriation or defalcation of cash is very common especially in big business organizations. Cash can be misappropriated by various ways as mentioned below:

a) Recording fictitious payments

b) Recording more amount than the actual amount of payment

c) Suppressing receipts

d) Recording fewer amounts than the actual amount of payment.

There should be strict control over receipts and payments of cash known as "Internal check system" to prevent such frauds. The auditor should check the Cash Book with original records, bills register, invoices, vouchers, counterfoils or receipt books, wage sheets, salesman's diary, bank statements etc. in order to discover such frauds.

ii) ***Misappropriation of goods:*** Companies handling with high value goods are pray to this kind of misappropriation. Without proper records of stock inward and stock outward, it is difficult for the auditor to find out such fraud. Periodical and surprise checking of stock and maintaining the proper record of inward and outward movement of stock can reduce the possibility of such fraud.

iii) ***Falsification or manipulation of accounts:*** In order to achieve certain specific objectives, accounts may be manipulated by those responsible persons who are in the top management of the organization. They prepare accounts such a manner that they disclosed only a fake picture not the true picture. Some of the ways used in manipulating the accounts are as follows:

a) Inflating or deflating expenses and incomes

b) Writing off of excess or less bad debts.

c) Over-valuation or under-valuation of closing stock.

d) Charging excess or less depreciation

e) Charging capital expenditures to revenue and vice-versa

f) Providing for excess or less doubtful debts.

g) Suppressing sales and purchase or showing fictitious sales and purchases etc.

iv) ***Window dressing:*** This is the way of presenting the financial data in a much better position than the original position. It is known as window dressing. Some of the reasons for doing window dressing are as follows:

a) To win the confidence of share holders.

b) To obtain further credit.

c) To raise the price of shares in the market by paying higher dividend so that shares held may be sold.

d) To attract prospective partners or shareholders.

e) To win the confidence of shareholders.

v) Secret Reserves: In secret reserves, accounts are prepared in such a way that they disclose worse picture than actually what they are. The objectives of preparing accounts in this way are:

a) To conceal the true position from the competitors.

b) To avoid or reduce the tax liability.

c) To reduce the price of shares in the market by not paying dividend or paying lower dividend so that the shares may be bought at a much lower price.

It is very difficult to detect such frauds since these frauds are committed by those persons in the organizations who are at the top positions like directors, managers, financial controllers etc. To detect these kinds of frauds, the auditor must be vigilant and should make searching inquiries to arrive at the true position.

ADVANTAGES OF AUDITING

It is compulsory for all the organizations registered under the companies act must be audited. There are advantages in auditing the accounts even when there is no legal obligation for doing so. Some of the advantages are listed below:

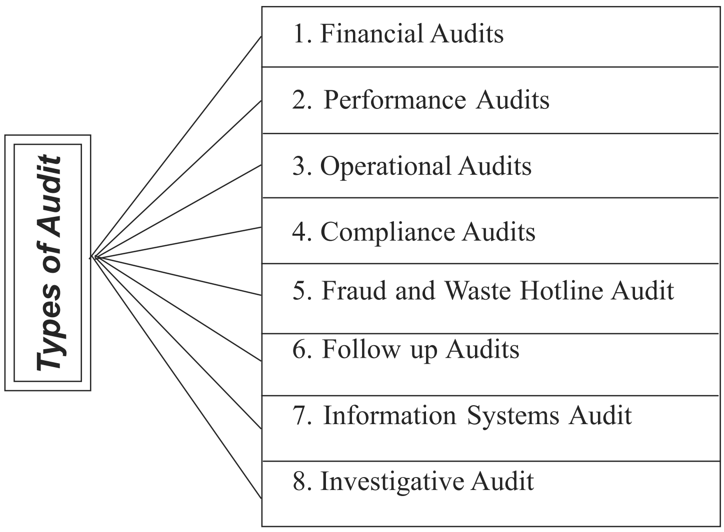
1. Audited accounts are readily accepted in Government authorities like income Tax Dept., Sales Tax dept., Land Revenue departments, banks etc.
2. By auditing the accounts errors and frauds can be detected and rectified in time.
3. Audited accounts carry greater authority than the accounts which have not been audited.
4. For obtaining loan from financial institutions like Banks, LIC, HUDCO, HDFC, IFCI etc., previous years audited accounts evaluated for determining the capability of returning the loan.
5. Regular audit of account create fear among the employees in the accounts department and exercise a great moral influence on clients staff thereby restraining them to commit frauds and errors.
6. Audited accounts facilitate settlement of claims on the retirement/death of a partner.
7. In the event of loss of property by fire or on happening of the event insured against. Audited accounts help in the early settlement of claims from the insurance company.
8. 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.

9. 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.
10. The audit of accounts by a qualified auditor also help the management to understand the financial position of the business and also it will help the management to take decision on various matters like report in internal control system of the organization or setting up of an internal audit department etc.
11. 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.
12. In the event of admission of a new partner, audited accounts will facilitate the formation of terms and conditions for joining the new partner. Last 3 years audited accounts and balance sheet will give a general idea about the growth and financial position of the business to the new partner.

TYPES OF AUDIT

Audits can be classified into the following categories:



1. Financial Audits

Financial audit refers to an accounting process applied in business. The process involves using an individual body for evaluating the financial transactions and statements of a business. The ultimate purpose of financial audit is presenting an accurate amount of the business transactions of a company. Besides, it ensures that the accounts presented to the public and shareholders are accurate and justified. The results of financial audit are useful for banks, shareholders, and anybody else with an interest in the company.

Basic Procedures for a Financial Audit

Generally, four key phases are outlined for financial audit process. These phases include planning the audit, determining the working of internal control, testing significant assertions about the data and evaluating compliance, and reporting the evaluations. These phases are explained below:

Step-1: Planning

The process of financial audit begins with a plan that involves the method of collecting data to form an opinion about the organization or company's financial status. A way is planned to collect a sample reflecting a point in time in the life of the company or organization. The financial transactions and documents are then looked at. It is noteworthy that the sample should show compliance with GAAP.

Step-2: Internal controls

The next step involves giving a look at the internal controls. The auditor demands info, looks closely at the records, and watches financial procedures in action. Without these steps, the auditor cannot give a statement about the financial status of the organization.

Step-3: Testing

Testing implies checking whether the internal controls are working or not. An auditor requests more info, returns to the company for more inspections, and watches how financial procedures are being performed. If the evidence demonstrates GAAP compliance, the auditor determines that the company successfully detects and prevents the errors.

Step-4: Reporting

The final step in financial audit involves giving a conclusion on how the company adheres to accounting standards. The audit from a CPA gives the organization an unqualified approval, a qualified approval, a disclaimer, or an adverse finding. The unqualified approval is considered as the best result and the adverse finding is considered to be the worst result.

Financial audits include determining whether (a) financial information is presented in accordance with established or stated criteria, (b) the entity has adhered to specific financial compliance requirements, or (c) the entity's internal control structure over financial reporting and/or safeguarding assets is suitably designed and implemented to achieve control objectives.

It reviews accounting and financial transactions to determine if commitments, authorization, receipt, and disbursement of funds are properly and accurately recorded and reported. It determines if there are sufficient controls over cash and other assets and if adequate process controls exist for the acquisition and use of resources.

2. Performance Audits

Performance Audit refers to an audit performed on an asset manager by an outside accounting firm to verify that the performance figures shown to the public on marketing materials represent the true aggregate results of the firm's client. The CFA Institute has established performance presentation guidelines, called global investment performance standards (GIPS) that must be maintained by asset managers. Economy and efficiency audits include determining (a) whether the city division is acquiring, protecting, and using its resources (such as personnel, property, and space) economically and efficiently, (b) the causes of inefficiencies or uneconomical practices, and (c) whether the entity has complied with laws and regulations concerning matters of economy and efficiency.

3. Operational Audits

An operational audit process is the series of steps an auditor takes to evaluate the operational activities of a given company or other organization. The process is very similar to the processes for other forms of audits, such as the financial audit, but the operational audit process is a much more in-depth review of the business. It usually does not focus on a single department or project, because each department plays a role in the overall operational process and is interconnected.

The goal of the operational audit process is to determine whether the internal controls of the business, such as policies and procedures, are sufficient to produce an optimum level of efficiency and effectiveness. This is critical for businesses, because a lack of efficiency and effectiveness typically translates to fewer sales or increased operational costs, which sometimes mean the inability of the business to compete and stay in business.

Going through the operational audit process provides a company with objective opinions. Those opinions often generate quicker production or sales turnaround, better allocation of costs, improved control systems, the location of areas of delay and an overall streamlined workflow. However, similar to any audit, operational audits cost money to perform. Those involved in the audit cannot be engaged in other operational processes when they are meeting with the auditor or gathering data for the auditor to use. Additionally, operational audits take considerable time to complete, and it can be harder to determine exactly what is causing problems the more complex operations are. Additionally, even though overhauling operations based on audit results may save the business money in the long run, doing so can rattle employees, because initial confusion and necessitate increased training or significant staffing alterations.

4. Compliance Audits

A compliance audit is a comprehensive review of an organization's adherence to regulatory guidelines. Independent accounting, security or IT consultants evaluate the strength and thoroughness of compliance preparations. Auditors review security polices, user access controls and risk management procedures over the course of a compliance audit.

What, precisely, is examined in a compliance audit will vary depending upon whether an organization is a public or private company, what kind of data it handles and if it transmits or stores sensitive financial data. For instance, SOX requirements mean that any electronic communication must be backed up and secured with reasonable disaster recovery infrastructure. Healthcare providers that store or transmit e-health records, like personal health information, are subject to HIPAA requirements. Financial services companies that transmit credit card data are subject to PCI DSS requirements. In each case, the organization must be able to demonstrate compliance by producing an audit trail, often generated by data from event log management software.

Compliance auditors will generally ask CIOs, CTOs and IT administrators a series of pointed questions over the course of an audit. These may include what users were added and when, who has left the company, whether user IDs were revoked and which IT administrators have access to critical systems. IT administrators prepare for compliance audits using event log managers and robust change management software to allow tracking and documentation authentication and controls in IT systems. The growing category of GRC (governance, risk management and compliance) software enables CIOs to quickly show auditors (and CEOs) that the organization is in compliance and will not be subject to costly fines or sanctions.

5. Fraud and Waste Hotline Audit

Fraud and Waste Hotline audit undertakes forensic investigations including suspected fraudulent activities and manages fraud hotline which refers issues to divisional management and the Internal Audit Division as appropriate. The Fraud and Waste Hotline program provides staff and members of the public with a means to report any observed or suspected fraud, waste or misuse involving City resources.

Financial accountability is a top priority for the City of Toronto. The City's Fraud Prevention Policy formalizes the expectations of personal honesty and integrity required of city officials and employees. In addition, a Fraud & Waste Hotline is available to enhance awareness regarding the prevention and detection of any fraudulent or irregular activity. The program is operated by the Auditor General's Forensic Unit.

6. Follow up Audits

Follow-Up Audit refers to an audit designed to evaluate the effectiveness of a corrective action. These are audits conducted approximately six months after an internal or external audit report has been issued. They are designed to evaluate corrective action that has been taken on the audit issues reported in the original report. When these follow-up audits are done on external auditors' reports, the results of the follow-up may be reported to those external auditors.

On an annual basis, the Auditor General notifies the City Manager or appropriate management representative (for ABCs) in writing of his outstanding recommendations. Management staff will report back to the Auditor General on recommendations that have been implemented. The Auditor General then satisfies himself that the recommendations have in fact been implemented.

7. Information Systems Audit

Information System Audit is the process of collecting and assessing evidence to show that the safeguards to protect against abuse, safeguards assets maintains data integrity and allows the organisation to continue successfully. Often in today's world the reason a system is audited is to determine the organisation is adhering or able to adhere to regulatory requirements such as SOX or HIPAA.

Information Systems Audit reviews the internal control environment of automated information processing systems and how people use these systems. It evaluates system input and output processing controls, backup and recovery plans, system security, and computer facilities.

Information System Auditing, also referred to as automated data processing (ADP) auditing, electronic data processing (EDP) auditing and information technology (IT) auditing, is primarily an examination of the system controls within an IT architecture which is the process of evaluating the suitability and validity of an organization's IT configurations, practices and operations. Information System Auditing has been developed to allow an enterprise to achieve goals effectively and efficiently through assessing whether computer systems safeguard assets and maintain data integrity.

Within a for-profit organization, the managers are typically concerned that the systems they use provide the most effective way to maximize return on stakeholder investments. Groups such as environmental groups and civil rights groups are concerned with other aspects of how an enterprise runs their business.

Nearly 60 years ago most systems were manual with paper. Much of that work has now been replaced with computer systems. With the widespread use of computers we are now compelled to maintain control of the data in those systems. The misuse of data can lead to misallocated resources, abuse of privacy can occur with uncontrolled distribution of data. Whenever one of these events occur the media makes sure the world knows about it as it produces good news copy, many people don't understand and therefore fear is easy to generate. This provides support for the notion George Orwell's 1984 is upon us.

With the widespread use of computers and the ever increasing computing power available in desktop and mobile computing devices, it is important to control how the data within these devices is managed. Everest 1985 proposed that the data within an organization was an image of itself The failure or success of this image will determine the success or failure of the organization, if some is lost then the organization will incur loss.

An example of this is when the purchasing records are destroyed then a business can suffer failure through inability to manufacture and/or supply to customers. This can occur when management fails to provide adequate budget to support proper backups. The lost data then becomes unrecoverable.

The misuse of computer system can lead either directly or indirectly to poor decision making. This can occur when either someone edits data to represent incorrect information thereby leading others to make bad decisions or the person reviewing data can tamper with it to allow them to give incorrect information. Recently the world has seen a number of events that are evidence of what goes wrong when this happens. Computer abuse is becoming more prevalent in organisations and that abuse is an increasing expense to the business.

8. Investigative Audit

Investigative Audit which deals with innocent errors and abnormal or invalid financial incidents/events and having fraudulent potential or capable of bringing undesired financial implications to the investigated subject.

While a financial audit samples the financial system and verifies that the sampled transactions add up according to basic accounting principles, an investigative audit goes deeper into the financial infrastructure investigating the bookkeeping, the transactions, the payments and the entities behind them, questioning their correctness validity and legality and exposing the truth behind the plain numbers.

Investigative Audit may result from findings during a routine audit or from information received from personnel. Audits are specialized and tailored to the circumstances and can include investigation of alleged violations of laws, regulations, or University policy.

This is an audit that takes place as a result of a report of unusual or suspicious activity on the part of an individual or a department. It is usually focused on specific aspects of the work of a department or individual. All members of the campus community are invited to report suspicions of improper activity to the Director of Internal Auditing Services on a confidential basis.

AUDIT PROGRAM

Audit program refers to an audit program is a set of policies and procedures that dictate how an evaluation of a business is done. This generally involves specific instructions as to what, and how much, evidence must be collected and evaluated, as well as who will collect and analyze the data and when this should be done. These types of programs are used to check up on things like a business' performance, finances, economy and efficiency and are generally tailored to a specific business or purpose.

PURPOSES OF AUDIT PROGRAM

Audit programs are important because they standardize the data collection and evaluation process. By setting out a specific list of steps to be followed and data to be collected, the program ensures that auditors collect all the information they need in an efficient manner while under appropriate supervision. Keeping the process standardized also means that all the data collected can be used to make useful comparisons between businesses, departments, and previous years' inspections, since the same set of data is collected each time. Additionally, audit programs are having a program like this in place makes sure that any problems are discovered promptly and reported to the correct person.

COMMON ELEMENTS OF AUDIT PROGRAM

Most audit programs include instructions for risk assessment, the frequency of inspections, evaluation planning, a reporting structure, and security measures. Risk assessment is used to identify and analyze potential dangers for specific areas of the business, like failure to comply with laws or regulations, threats to a business' reputation, or financial fraud. This is usually done on a consistent basis to keep pace with changes to internal control and work processes. The level of risk found in an assessment is also used in choosing the frequency of the audit cycle, which is how often evaluations are done. Other factors that affect the frequency of reviews include the time people in a business have to perform them, as well as the number of staff a business can spare or hire to do them.

Audit programs also commonly include a reporting structure. This includes information about who a reviewer reports to if he or she finds a problem, how the report is to be made, and how long reports are kept on file. This ensures that problems don't get swept under the rug or lost in filing. Security measures are another important part of a program, since much of the data collected during evaluations is sensitive. Computer software used in this process is usually limited to auditing departments, and is almost always password protected. Businesses also review their audit software regularly to determine its reliability and overall efficiency, and change to another one if needed.

Another essential component of an audit program is planning. Although strategies are generally devised with respect to individual organizations, a well-rounded plan generally covers scheduling, staff needs, reporting, and the overall goals of the audit. Many organizations find that this planning is most efficient when the results of risk assessment are combined with the resources needed to determine the timing and frequency of inspections. Planning is generally the final step that takes place before the audit actually occurs.

REGULATIONS AND CERTIFICATION

There are no worldwide laws or certifications for audit programs, but there are guidelines and best practices, such as the International Standards on Auditing (ISA), which are standards for financial audits published by the International Federation of Accountants (IFAC). In the US, some types of audit findings about companies that are publicly traded also have to be reported to the Securities and Exchange Commission (SEC), such as the way they evaluate their internal controls and whether those controls are effective.

There are many local and regional bodies awarding auditing certifications, as well as several internationally recognized certifications. Common certifications include Certified Internal Auditor (CIA) and membership in the International Register of Certificated Auditors (IRCA).

AUDIT REPORT

The auditor's report is a formal opinion or disclaimer thereof, issued by either an internal auditor or an independent external auditor as a result of an internal or external audit or evaluation performed on a legal entity or subdivision thereof. The report is subsequently provided to a "user" as an assurance service in order for the user to make decisions based on the results of the audit.

An auditor's report is considered an essential tool when reporting financial information to users, particularly in business. Since many third-party users prefer, or even require financial information to be certified by an independent external auditor, many auditees rely on auditor reports to certify their information in order to attract investors, obtain loans, and improve public appearance. Some have even stated that financial information without an auditor's report is "essentially worthless" for investing purposes.

Recorded in the annual report, the auditor's report tests to see that a corporation's financial statements comply with GAAP. This is sometimes referred to as the clean opinion.

Most auditors’ reports consist of three paragraphs. The first states the responsibilities of the auditor and directors. The second is the scope, stating that GAAP was used. Finally, the third paragraph gives the auditor's opinion.

Example: (Annexure to the Auditors' Report)

The Annexure referred to in our report to the members of Infosys Limited ('the Company') for the year ended 31 March 2013. We report that:

(i) (a) The company has maintained proper records showing full particulars, including quantitative details and situation of fixed assets.

(b) The company has a regular programme of physical verification of its fixed assets by which fixed assets are verified in a phased manner over a period of three years. In accordance with this programme, certain fixed assets were verified during the year and no material discrepancies were noticed on such verification. In our opinion, this periodicity of physical verification is reasonable having regard to the size of the Company and the nature of its assets.

(c) Fixed assets disposed off during the year were not substantial, and therefore, do not affect the going concern assumption.

(ii) The company is a service company, primarily rendering information technology services. Accordingly, it does not hold any physical inventories. Thus, paragraph 4(ii) of the Order is not applicable.

(iii) (a) The company has granted loans to bodies corporate covered in the register maintained under section 301 of the companies Act, 1956 ('the Act'). The maximum amount outstanding during the year was Rs 1,885,474,274 and the year-end balance of such loan amounted to Rs 1,844,887,863. Other than the above, the company has not granted any loans, secured or unsecured, to companies, firms or parties covered in the register maintained under section 301 of the Act.

(b) In our opinion, the rate of interest and other terms and conditions on which the loans have been granted to the bodies corporate listed in the register maintained under Section 301 of the Act are not, prima facie, prejudicial to the interest of the company.

(c) In the case of the loans granted to the bodies corporate listed in the register maintained under section 301 of the Act, the borrowers have been regular in the payment of the interest as stipulated. The terms of arrangement do not stipulate any repayment schedule and the loans are repayable on demand. Accordingly, paragraph 4(iii) (c) of the Order is not applicable to the company in respect of repayment of the principal amount.

(d) There are no overdue amounts of more than rupees one lakh in respect of the loans granted to the bodies corporate listed in the register maintained under section 301 of the Act.

(e) The company has not taken any loans, secured or unsecured from companies, firms or parties covered in the register maintained under section 301 of the Act. Accordingly, paragraphs 4(iii)(e) to 4(iii)(g) of the Order are not applicable.

(iv) In our opinion and according to the information and explanations given to us, there is an adequate internal control system commensurate with the size of the Company and the nature of its business with regard to purchase of fixed assets and sale of services. The activities of the company do not involve purchase of inventory and the sale of goods. We have not observed any major weakness in the internal control system during the course of the audit.

(v) (a) In our opinion and according to the information and explanations given to us, the particulars of contracts or arrangements referred to in section 301 of the Act have been entered in the register required to be maintained under that section.

(b) In our opinion, and according to the information and explanations given to us, the transactions made in pursuance of contracts and arrangements referred to in (v) (a) above and exceeding the value of Rs 5 lakh with any party during the year have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time.

(vi) The company has not accepted any deposits from the public.

(vii) In our opinion, the company has an internal audit system commensurate with the size and the nature of its business.

(viii) The Central Government of India has not prescribed the maintenance of cost records under Section 209(1) (d) of the Act for any of the services rendered by the company.

(ix) (a) According to the information and explanations given to us and on the basis of our examination of the records of the Company, amounts deducted/ accrued in the books of account in respect of undisputed statutory dues including Provident Fund, Investor Education and Protection Fund, Income-tax, Sales-tax, Wealth tax, Service tax and other material statutory dues have been regularly deposited during the year by the Company with the appropriate authorities. As explained to us, the Company did not have any dues on account of Employees' State Insurance, Customs duty and Excise duty.

According to the information and explanations given to us, no undisputed amounts payable in respect of Provident Fund, Investor Education and Protection Fund, Income-tax, Sales-tax, Wealth tax, Service tax and other material statutory dues were in arrears as at 31 March 2013 for a period of more than six months from the date they became payable.

(b) According to the information and explanations given to us, there are no material dues of Wealth tax and Cess which have not been deposited with the appropriate authorities on account of any dispute.

(x) The company does not have any accumulated losses at the end of the financial year and has not incurred cash losses in the financial year and in the immediately preceding financial year.

(xi) The company did not have any outstanding dues to any financial institution, banks or debenture holders during the year.

(xii) The company has not granted any loans and advances on the basis of security by way of pledge of shares, debentures and other securities.

(xiii) In our opinion and according to the information and explanations given to us, the company is not a chit fund/ nidhi/ mutual benefit fund/ society.

(xiv) According to the information and explanations given to us, the company is not dealing or trading in shares, securities, debentures and other investments.

(xv) According to the information and explanations given to us, the company has not given any guarantee for loans taken by others from banks or financial institutions.

(xvi) The company did not have any term loans outstanding during the year.

(xvii) The company has not raised any funds on short-term basis.

(xviii) The company has not made any preferential allotment of shares to parties and companies covered in the register maintained under section 301 of the Act.

(xix) The company did not have any outstanding debentures during the year.

(xx) The company has not raised any money by public issues during the year.

(xxi) According to the information and explanations given to us, no material fraud on or by the company has been noticed or reported during the course of our audit.

APPOINTMENT OF AUDITOR

Appointment of First Auditors

i) A Board meeting should be conveyed within one month of the date of registration of the Company and a Resolution should be passed appointing and fixing remuneration of the first auditor who shall hold office until the conclusion of first Annual General Meeting (AGM).

ii) The person being appointed as the first auditors of the company should not hold any security carrying voting right of that company. If the Board fails to appoint first Auditors within one month after the registration then a General Meeting should be held by issuing 21 days notice with relevant Explanatory statement and Auditor can be appointed by passing ordinary resolution.

iii) In case of listed Public Limited Company for such appointment of Auditors in General Meeting, 3 copies of the notice and copy of the proceedings of the General Meeting should be forwarded promptly to the Stock Exchange where such shares of the company are listed.

Appointment of Retiring Auditors

i) An Auditor is normally being reappointed at the A.G.M. Therefore, the Company should obtain a written certificate from the Auditor that the re-appointment, if made, will be in accordance with the limits specified in Section 224(1B).

ii) Though the limits as specified in section 224(1B) does not apply to a Private Company after Companies (Amendment) Act, 2000, as per Institute's Code of Ethics the limit continues to apply, which should be borne in mind while accepting the audit.

iii) The company convening the AGM, (after issuing notices in writing at least 21 days before the meeting along with the Explanatory statement), should pass ordinary resolution in the A.G.M. appointing the retiring Auditor as Auditor of the Company, who shall be holding the office till the conclusion of next A.G.M. and the resolution should also contain details of his remuneration.

iv) Three copies of the notice and proceedings of A.G.M. should be sent to the Stock Exchange, where such shares of the company are listed.

v) Instead of Ordinary Resolution, a Special Resolution by 3/4th majority is required to be passed in case of a company in which not less than 25% of the subscribed share capital is held singly or in any combination by Government Company/Central Government/State Government, Nationalised Banks/Insurance Company/Financial Institution, etc. [Section 224A(1)]

vi) The company should intimate the Auditor about his appointment within 7 days of the passing of the Resolution appointing him.

vii) The Auditor should inform the Registrar of Companies in Form No. 23B within one month of the receipt of the intimation from the company that he has accepted or refused to accept his appointment.

Appointment of Branch Auditor

i) The accounts of the branch office of a Company, if any, is required to be audited by the Company's auditor appointed u/s. 224 or by a person qualified for appointment as auditor u/s. 226. Where the branch office is situated outside India the accounts to be audited either by the Company's auditor or by an accountant duly qualified to act as an auditor in accordance with the laws of that country. The shareholders may authorise the Board to appoint the branch auditors in consultation with the Company's auditors. However the Central Government is empowered to make such rules as it may deem fit for the matters specified in relation to the branch auditors.

ii) Notwithstanding that the accounts of the branch are audited by a person other than the Company's auditor, the Company's auditor shall have the right to visit the branch and have access to the book and accounts and vouchers of the Company. However, in case of a banking Company having a branch outside India, the Company's auditor may have right to access of copies and extracts of the books of account.

iii) The branch auditors shall have the same powers and duties as that of Company's auditors. The branch auditor shall forward his report to the Company's auditors.

Appointment of an Auditor other than the Retiring One

i) The Company must receive a Special Notice from a member/shareholder not less than 14 days before the ensuing A.G.M. indicating his intention to move a resolution for changing the existing Auditor of the Company and for appointing another Auditor in his place.

ii) The Company must send forthwith a copy of such notice to the existing auditor of the Company.

iii) A certificate in writing should be obtained from the proposed new Auditor to the effect that his appointment, if made, will be in accordance with the limits as specified in Sec. 224(1B).

iv) The Company must issue notice in writing at least 21 days before the date of A.G.M. stating about the Special Notice received and proposing the ordinary resolution for change of the Auditor along with Explanatory statement.

v) The retiring Auditor has a right to make representation either in writing to the Company or orally at the A.G.M. If the representation is received from the Auditor the same should be enclosed along with notice. If the representation could not be sent along with the notice for being received late, it should be sent later at any time, being reasonable time, but before the A.G.M.

vi) In case it is not possible to send special notice and representation in the notices of the A.G.M., then the Company should inform the shareholders by advertisement in newspaper having appropriate circulation or by any other mode as allowed by the Articles of Association not less than 7 days before such A.G.M.

vii) However, if a copy of such representation by the retiring auditor is not possible to be sent as aforesaid, because they were received too late or because of the default of the Company, such written representation shall be read out at the meeting. This is without prejudice to the right of the Auditor to be heard orally in the A.G.M. But in certain circumstances the Company Law Board can exempt the Company from sending or reading out such representation of the retiring Auditor on the application either of the Company or of any of the persons, who claims to be aggrieved.

viii) Three copies of such notices to be forwarded to the Stock Exchange, where such shares of the Company are listed.

ix) The Company should then hold a General Meeting and pass a Resolution.

x) Only after such Resolution is passed in the A.G.M. the new Auditor shall be considered as duly appointed in place of the Retiring Auditor.

xi) The new Auditor should inform the concerned Registrar of Companies in Form No. 23B about his accepting the appointment within one month from the receipt of Intimation of his appointment from the Company.

Appointment of Auditors for Listed Companies

i) The Council of ICAI have accepted the recommendation of Securities & Exchange Board of India (SEBI) that audit of listed companies shall be carried out by the auditors who have undergone Peer Review Process and have been issued Peer Review Certificate by the Peer Review Board.

ii) The above decision is effective for accounting periods commencing on or after April 1, 2009.

iii) Consequent to the above decision, all the auditors of Listed Companies are required to undergo Peer Review Process and get Peer Review Certificate issued from the Peer Review Board.

Removal of an Auditor before the Expiry of his Term

i) An Auditor is appointed at the A.G.M. and he holds the position till the conclusion of the next A.G.M. However, circumstances may permit a Company to remove the Auditor before the expiry of his term.

ii) For this, Board of Directors should convene a meeting after giving notice to all the Directors, to approve the draft of the application to be sent to the Central Government for the removal of the Auditor.

iii) Such an application is to be made to the Regional Director of the concerned Region seeking approval of the removal of the Auditor before the expiry of his term. Such application should be made on the letterhead of the Company mentioning the details and reasons.

iv) Necessary formalities of enclosing documents, payment of fees, etc. are to be complied with.

v) The Regional Director after considering the merit of the application and based on facts and circumstances of the case, may approve such removal of the Auditor.

vi) On receipt of such approval a meeting should be called off Board of Directors to fix the date, time, place and agenda of the Meeting where the previous Auditor will be removed and a new Auditor will be appointed in his place.

vii) Notice should be issued in writing at least 21 days before the date of A.G.M. and ordinary resolution should be passed appointing new Auditor in the place of previous Auditor at the A.G.M.

Code of Ethics and Other Provisions on Change of Auditors

i) Part I of the First Schedule of Chartered Accountants Act, 1949 deals with the Code of Ethics of the Profession of Chartered Accountancy. As per clause 8, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he accepts the position of Auditor previously held by another Chartered Accountant without first communicating with him in writing.

ii) It is important to remember that every client has an inherent right to choose his Auditor. But underlying objective of this clause is that besides the professional courtesy the member being removed must have an opportunity to know the reasons for the change in order to be able to safeguard his own interest, the legitimate interest of the public and the independence of the existing Auditor. Therefore the new Auditor, who is being appointed in place of Retiring Auditor should not accept the audit unless he communicates with the previous Auditor and ensure that such communication in writing has reached to the Retiring Auditor. Therefore, a letter under U.P.C. is not considered as effective communication and the same should be sent by Registered Post Acknowledgement Due letter or hand delivery. The professional reasons for not accepting an Audit in place of the Retiring Auditor would be:

a) Non-compliance of the provisions of sections 224 and 225 of the Companies Act;

b) Undercutting of fees;

c) Non-payment of undisputed audit fees by auditees (other than in case of sick units) for carrying out the statutory audit under the Companies Act, 1956 or various other statutes; and

d) Issuance of a qualified report.

iii) No company or its Board of directors shall appoint or re-appoint any person who is in full-time employment elsewhere or firm as its auditors.

iv) Where at an annual general meeting no auditors are appointed or re-appointed, the Central Government may appoint a person to fill the vacancy.

v) The remuneration of the auditors includes any sum paid by the company in respect of the auditors expenses.

QUALIFICATION OF AUDITOR

Only individual, possessing the requisite knowledge and skill, can be appointed as auditor of the company. The auditor should be independent in carrying out his work so that he is able to give an unbiased opinion based on an objective assessment of facts. Thus, he should have no interest, financial or otherwise and whether directly or indirectly, in the company and/or its management.

A person, who is Chartered Accountant within the meaning of Chartered Accountants Act, 1949 and holds a certificate of practice, or a partnership firm where of all the partners are Chartered Accountants holding certificates of practice, may be appointed as auditor of a company. However, in the latter case, the appointment as an auditor may be made in the firm name and any of its partners may act in the name of the firm.

Following persons are qualified to be appointed as auditor of a company:

1. Practicing Chartered Accounts {Sec 226 (1) J}

A person shall not be qualified for appointment as auditor of a company unless he is a chartered accountant within the meaning of the chartered accountant act 1949.

A chartered accountant means a person who is the member of the institute of chartered accountant of Pakistan. He will be deemed to be in practice. When individually or in partnership with other chartered accountants in practice him for consideration received or to be received.

Practice of Accountancy

He engages himself in the practice of accountancy.

Verification

He offers to perform or performs the services involving the auditing or verifications of the financial transactions, books of accounts or records or the preparation, verification or certification of financial accounting and related statement or holds himself out to the public as an accountant.

Professional Services

He renders the professional services or assistance in or about matters of principal or detail relating to accounting procedure to the recording, presentation or certification of financial facts or data.

Renders the Services

Renders the services as, in the opinion of the council are or may be renders by a chartered accountant in practice.

2. Certified Auditor {Sec 226 (2)}

A part from practicing chartered accountants, a person holding a certificate under the restricted auditor's certificate rules, 1965 is also qualified to be appointed as auditor of a company. Such certified auditors are subject to the rules framed in this behalf by the central Government.

The object of the provisions as to qualify is to ensure that only persons of proven worth and standing and under the discipline of a statutory body are appointed as auditor.

Disqualifications of Company Auditor

Section 226(3) of Companies Act reads about disqualifications of company auditor. The following persons are disqualified:

i) Body corporate.

ii) Officer or employee of the company.

iii) Partner or employee of an office or employee of the company.

iv) Insolvent person.

v) Lunatic person.

vi) A person who is indebted to the company for a sum exceeding Rs. 1000/-.

vii) A person who has given guarantee for such sum relating to the company.

viii) If a person is disqualified to Holiday Company, automatically he gets disqualified to its subsidiaries also. In the same way if a person is disqualified to subsidiary company, he gets disqualified to related holding company also.

RIGHTS OF COMPANY AUDITOR

According to section 227 (1) of the Companies Act, 1956, a company auditor has the following rights:

1. Right of Access to Books of Accounts

Every auditor of a Company has a right of access at all times to the books of accounts and vouchers of the company whether kept at the head office of the company or elsewhere. Thus, the auditor may consult all the books, vouchers and documents whenever he so likes. This is his statutory right. He may pay a surprise visit without informing the Directors in advance but in practice, the auditors inform the Directors before they pay their visits.

2. Right to obtain Information and Explanations

Auditor has a right to obtain from the Directors and officers of the company any information and explanation as he thinks necessary for the performance of his duties as an auditor. This is another important power in the hands of the auditor. He will, however, decide as to which information or explanations he thinks necessary to obtain. If the Directors or officers of the company refuse to supply some information on the ground that in their opinion it is not necessary to furnish it, he has a right to mention the fact in his report.

3. Right to Correct any Wrong Statement

The auditor is required to make a report to the members of the company on the accounts examined by him and on every Balance Sheet and Profit and Loss Account and on every other document declared by this Act to be part of or annexed to the Balance Sheet or Profit and Loss Account which are laid before the company in General Meeting during his tenure of office. The Directors have a duty to prepare them and present them to the auditor.

The auditor cannot require but advise the Directors to amend their system of maintaining accounts if it is faulty. If his suggestions are not carried out, he has a right to refer the matter to the members. If the method of accounting is inadequate, he must state the fact in his report that proper books of accounts have not been kept by the company.

4. Right to visit Branches

According to section 228, if a company has a branch office, the accounts of the office shall be audited by the company's auditor appointed under section 224 or by a person qualified for appointment as auditor of the company under section 226. Where the Branch Accounts are not audited by a duly qualified auditor, the auditor has a right of access at all time to the books, accounts and vouchers of the company and thus, may visit the branch, if he deems it necessary.

5. Right to Signature on Audit Report

Under section 229, only the person appointed as auditor of the company, or where a firm is so appointed, only a partner in the firm practicing in India, may sign the auditor's report, or sign or authenticate any other document of the company required by law to be signed or authenticated by the auditor.

6. Right to receive Notice and other Communications relating to General Meeting and attend them

Under section 231 an auditor of a company has a right to receive notices and other communications relating to General Meeting in the same way as a member of the company. He is also entitled to attend any General Meeting which he attends or any part of the business which concerns him as an auditor.

According to the power of the auditor, he may make any statement or explanation with regard to the accounts as he may desire. He need not, however, answer any questions.

Ordinarily, it is not necessary for the auditor to attend every General Meeting, but it will be good for him to attend meetings in the following circumstances:

(a) When his report contains important qualifications directly affecting the management, so that his remarks may not be misunderstood or misinterpreted.

(b) When he has received a notice from the company that someone else is going to be proposed for appointment as auditor of the company at the Annual General Meeting.

(c) When he has been specially asked by the management to be present.

7. Right of being indemnified

Under section 633, an auditor (being an officer of a company), has a right to be indemnified out of the assets of the company against any liability incurred by him defending himself against any civil and criminal proceedings by the company if it is proved that the auditor has acted honestly or the judgement delivered is in his favour.

8. Right to have Legal and Technical Advice

He has a right to seek the opinion of the experts and, thus, take legal and technical advice. This is necessary to give his opinion in his report. He has a right to receive his remuneration provided he has completed the work which he undertook to do.

DUTIES OF COMPANY AUDITOR

1. Duty under Section 227

It is otherwise known as the duty to give report. After completion of audit work, auditor should give a report expressing his opinion. The report may be length or summarized. It may be in the form of letter or statement. Whatever the form may be, it must be addressed to share holders. And it report may be with condition or without condition. Unconditional report is called clean report and conditional report is called qualified report.

Audit report should include the following:

(a) Whether, in his opinion, the Profit and Loss Account referred to in his report exhibits a true and fair view of the profit or loss.

(b) Whether, in his opinion, the Balance Sheet referred to in his report is properly drawn up so as to exhibit a true and fair view of the state of affairs of the business according to the best of the information and explanations given to him as shown by the books of accounts.

(c) Whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit.

(d) Whether, in his opinion, proper books of accounts as required by law have been kept by the company so far as appears from his examination of those books, and proper returns adequate for the purpose of his audit have been received from branches not visited by him.

(e) Whether the report on the accounts of any branch office audited under section 228 by a person other than the company's auditor has been forwarded to him as required by (c) of sub-section (3) of that Section and how he had dealt with the same in preparing the auditor's report.

(f) Whether the company's Balance Sheet and Profit and Loss Account dealt with by the report are in agreement with the books of accounts and returns.

2. Duty under Section 165

It is otherwise known as the duty to certify statutory report. Every public company has to prepare statutory report with regard to statutory general meeting. A copy of statutory report is to be filed with registrar and its copies should be sent to members also. Statutory report includes the following matters:

i) Number of shares issued for cash.

ii) Number of shares issued for consideration other than cash.

iii) Preliminary expenses.

iv) Contracts to be ratified by share holders.

v) Summary of receipts and payments made by the company from date of incorporation to the date seven days before the preparation of this report.

vi) Since all these items are related to accounting records, auditor has to certify statutory report.

3. Duty under Section 240

It is otherwise known as the duty to assist the government inspector. Company auditor has to give his co-operation to govt. inspectors. Otherwise company auditors will be charged with imprisonment up to six months with or without fine.

4. Duty under Section 58 (A) and Section 58 (B)

It is otherwise known as the duty with regard to public deposits. Whenever company wants to accept deposits from public with regard to its capital requirements, the company has to fulfil the formalities specified under 58(A) and 58(B). So here auditor has to conform whether formalities specified under these sections are fulfilled or not.

5. Duty under Section 62 and section 63

It is otherwise known as the duty to certify prospectus. In case of prospectus issued by an existing company, there will be previous three or four year's financial statements. When such prospectus is certified by company auditor and people can rely on the values shown.

6. Duty under Section 227 (1A)

In accordance with this section company auditor has to conduct inquiry with regard to the following matters:

(a) Whether loans and advances made by a company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members.

(b) Whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company.

(c) Where the company is not an investment company within the meaning of section 372 or a banking company, whether so much of the assets of the company, as consists of shares, debentures and other securities have been sold at a price less than at within they were purchased by the company.

(d) Whether loans and advances made by the company have been shown as deposits.

(e) Whether personal expenses have been charged to revenue account.

(f) Whether it is stated in the books and papers 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 account books and the Balance sheet is correct, regular and not misleading.

REVIEW QUESTIONS

Descriptive Type

1. Discuss scope of Audit.
2. Explain branches of Auditing.
3. Discuss the qualities of an Auditor.
4. Explain different types of Audit.
5. Discuss qualification of Auditor.
6. Explain the rights of Company Auditor.

Analytical Type

1. State the characteristics of Auditing.
2. State the objectives of Audit.
3. Discuss the advantages of Auditing.
4. Explain audit Program.
5. Discuss the audit Report.
6. State the disqualifications of Company Auditor.

Conceptual Type

1. Give the meaning of Auditing.
2. Define the term Auditing.
3. State any four characteristics of Auditing.
4. Who is an auditor?
5. State any four objectives of Audit.
6. What is Audit Program?
7. What is Audit Report?
8. State any four duties of Company Auditor.

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Unit 2

INTER CHECK AND VOUCHING

Highlights

- Internal Check
- Objective of Internal Check
- Purposes of Internal Checks
- Vouching
- Definitions of Vouching
- Objectives of Vouching
- Importance of Vouching
- Principles of Vouching
- Vouching of Cash Transactions
- Points to be considered while vouching of Cash Transactions
- Vouching and Routine Checking
- Definitions of Voucher
- Kinds of Vouchers
- Contents of Vouchers
- Points to be noted while examining Vouchers
- Duties of an Auditor in relation to Vouching

INTRODUCTION

Internal check is an element of internal control. Weak internal check mechanisms mandate a greater degree of auditing procedures. An example of internal control is segregating the record keeping for an asset and its physical custody, such as in the case with inventory and cash. No one individual should have complete control over a transaction from beginning to end. Internal checks make it difficult for an employee to steal cash or other assets and concurrently cover up by entering corresponding amounts in the accounts. An example of internal check is the establishment of input and output controls within a data processing department. A group or person has the responsibility of checking control totals provided by the user department with those generated during the processing of the data. Examples of physical controls are guards and gates to restrict access. A division of duties that are not permit one individual to carry out all stages of a transaction. An internal check is intended to prevent fraud and minimize errors.

The whole system established within an entity whereby the work of one employee is automatically checked by another staff ensuring that the processed accounting information is accurate. An internal check system means practically a continuous internal audit carried on by the staff itself, by means of which the work of each individual is independently checked by other members of the staff. The internal check is an arrangement of the duties of the staff members of the accounting functions in such a way that the work performed by a person is automatically checked by another.

INTERNAL CHECK

Internal check means that checks imposed on such a way on day to day transactions that work of one person is checked by other person automatically. In this way the chances of fraud and errors minimizes. Because the mistake made by one person is checked by the other. Matters relating to allocation of powers, division of work and methods of recording transactions are included in the internal check.

Definition

According to ***Spicer and Pegler,*** "A system of internal check is an arrangement of staff duties, whereby no one person is allowed to carry through and to record every aspects of a transaction, so that without collusion between two or more persons, fraud is activated and at the same time the possibilities of errors are reduced to the minimum."

Internal check has been defined by the Institute of Chartered Accountants of England and Wales as "the checks on day to day transactions which operate continuously as part of the routine system, where the work of one person is proved independently or in complementary to the work of another, the object being the prevention or early detection of errors or frauds".

OBJECTIVE OF INTERNAL CHECK

The main objectives of Internal Check are as follows:

i) To minimize the possibility of error, fraud and irregularity.

ii) To prevent the misappropriation of cash and goods.

iii) To allocate duties and responsibility to every clerk in the organization so that, he may be held responsibility for their particular fraud & errors.

iv) To ensure an accurate recording of all business transaction.

v) To enhance the efficiency of the clerk in the organization.

vi) To exercise moral influence over the staff member.

vii) To prepare final account with an ease and efficiency.

IMPORTANCE OF INTERNAL CHECK

The importance of internal check system can be set forth as follows:

i) ***Assigning Responsibility:*** To allocate the duties and responsibilities of every employee in such a manner that they may be identified and held responsible for a particular error or fraud.

ii) ***Minimising Error or Fraud:*** To minimise the possibility of any error or fraud done by any staff member.

iii) ***Detecting Errors or Frauds:*** To detect errors or frauds easily due to independent checking of work done by one employee by another employee.

iv) ***Reducing Clerical Mistakes:*** To minimise the possibility of omission of any transaction from being recorded in the books of accounts.

v) ***Enhancing Work Efficiency:*** To enhance the efficiency of the staff, as the management of duties is based on the principle of division of labour.

PURPOSES OF INTERNAL CHECKS

The main purposes of internal check are:

1. Fraud Prevention

The purpose of internal check is to prevent frauds. The management can achieve this objective through distribution of duties. One employee is allowed to perform one part of the task. Other completes the other parts. In this way many hands complete the work.

2. Assets Protection

The purpose of internal check is to protect the assets. The management can take steps to safe guard the resources. One person maintains the records. The custody is given to another officer. Op-level management makes the purchase and disposal. The assets are used for business purpose. The periodical inspection is necessary to avoid misuse of resource.

3. Errors Prevention

The purpose of internal check is to prevent errors. The management can devise such a system of internal cheek the mistakes are prevented altogether. If there is negligence on the part of one employee, t is pointed out by another employee who can check the work of first person.

4. Fixing Responsibility

The purpose of internal check is to fix the responsibility of employees. The division of duties helps the management to locate the inefficient employees. The pending work provides chance of errors and frauds. The management can replace employees who are negligent of their duties.

5. Moral Check

The purpose of internal check is to develop high values of moral standards. The work of one employee is supervised and checked by another employee. All employees feel sense of responsibility. They complete that work on daily basis. Thus efficiency of workers increases.

6. Recording Facts

The purpose of internal check is to record facts and figures in the books of accounts. The work of recording facts is divided among many employees. In this way it is possible to prepare books of accounts, which can reflect the true and fair view of business work.

7. Accounting System

The purpose of internal check is to devise proper accounting system. It consists of personnel, procedure, records, forms and devices used by an organization in developing and communicating accounting information.

VOUCHING

Vouching is a technical term which refers to the inspection of documentary evidence supporting and substantiating a transaction, by an auditor. It is the essence of Auditing. It is the practice followed 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.

After preparing Audit note book, audit planning, auditing working papers, audit preparations etc., the next step is to proceed with the examination of accounting entries passed in the books of account during the period under review. In this step the auditor has to check the entries with its supporting documents to determine the accuracy and authenticity of the entries passed by verifying the vouchers, bills and other supporting documents. This process of checking the evidence of the entries called vouching. It may relate to cash as well as trading transactions.

Auditor is required to certify the financial statements prepared by the accountant as the statement shows the true and fair view of the results of operations and the state of affairs of the business. Unless he tries to establish the accuracy and authenticity of all the transactions recorded in the books of account, auditor will be falling from discharging his duty. The exercise of establishing and verifying the accuracy and authenticity of the accounting entries passed in the book of account with reliable evidences are technically called 'vouching'. It means vouching is the testing the truth of all the entries made in the book of accounts.

Meaning of Vouching

Vouching means examination of documentary evidence to ascertain the accuracy and authenticity of transactions recorded in the books of accounts. It is a technique used by the auditor to judge the truth of entries appearing in the books of accounts.

Definitions of Vouching

According to ***Lawrence Dicksee,*** “Vouching as an act of comparing entries in the books of accounts with documentary evidence in support thereof”.

According to ***Ronald A. Irish,*** “Vouching is a technical term which refers to the inspection by the auditor of documentary evidence supporting and substantiating a transaction”.

According to ***F R M De Paula,*** “Vouching does not mean merely the inspection of receipts with the cash book, but includes the examination of the transactions of a business together with documentary and other evidence of sufficient validity to satisfy an auditor that such transactions are in order, have been properly authorized and are correctly recorded in the books”.

According to ***Arthur W Holmes,*** “Vouching is the examination of the underlying evidence which is in support of the accuracy of the transaction. The process of vouching is intended to substantiate an entry by providing authority, ownership, existence and accuracy”.

According to ***Joseph Lancaster,*** “It is often thought that vouching consists of the mere examination of the vouchers or documentary evidence with the book entries. This, however, is quite wrong, for vouching comprises such an examination of the ledger entries as will satisfy the auditor, not only that the entry is supported by documentary evidence, but that it has been properly made upon the books of accounts”.

OBJECTIVES OF VOUCHING

Main objective of vouching is to find out the regularity or irregularity of transactions, frauds and errors. Regularity means maintaining record and performing the work compliance with the rules, regulation and law. But irregularity means doing the work crossing to the line of rules, regulation and laws. Some of the major objectives of vouching are given below:

1. To detect errors and frauds

All transactions are to be supported by evidence. Each document should be proved by authorized authority. With the help of vouching we can detect errors and frauds by verifying each transaction. Planned fraud can be detected through vouching.

2. To know the truth of account

Each and every transaction is checked and ratified on the basis of support document. So, we can easily know the truth of account.

3. To find the unrecorded transactions

Each and every transaction is checked and ratified on the basis of document. Vouching helps to find out the unrecorded or missing transactions. If any voucher is found unrecorded, auditor can suggest recording such transactions.

4. To know that all the transactions are authorized

If the transactions are made on the consent of concerned authority, such transactions are known as authorized transactions. If transactions are not authorized, such transactions can be fictitious transactions. So, such fictitious transactions can be found with the help of vouching.

5. To know that only the business transactions are recorded

Sometimes, transactions are performed for individual purpose but payment is made out of business. Such transactions should not be recorded in account of business. If such transactions are recorded, we can find it with the help of vouching. To know the real profit or loss of business, such transactions are to be separated.

PURPOSES OF VOUCHING

The purposes of vouching can be summarised as follows:

1. Proper Evidence

The purpose vouching is to note that proper evidence is available for every entry. The signatures, initials and rubber stamp are evidence that document has been authorized and checked.

2. Proper Authority

The purpose of vouching is to note that there is proper authority behind every transaction. In the absence of any signature of manager the transaction are not acceptable at all.

3. Right Period

The purpose of vouching is to check that date of the vouchers relate to accounting period. The adjustments in books are made on the basis of current year record of transactions.

4. Correct Amount

The purpose of vouching is to check that correct amounts have been recorded in the entry. The vouching is useful to record only correct amounts in the books of accounts.

5. Capitals and Revenue Analysis

The purpose of vouching is to examine the analysis of transaction into capital and revenue. The expense relating to one year is treated as revenue otherwise it is called capital.

6. Purchase for Business

The purpose of vouching is to check that purchase relate to the nature of business. The private purchase cannot be recorded as business due to vouching.

7. Arithmetical Accuracy

The purpose of vouching is to see the arithmetical accuracy of books of accounts. The auditor to confirm that books are accurate can check the total subtotals, casting and posting.

8. Postings

The postings of total from journal to the ledger can be voucher by the auditor. He can see through vouchers that posting are complete and correct.

9. No Error

The purpose of total vouching is to check that there are no errors in the books of accounts. The errors are the result of carelessness or over work. But audit staff is not over loaded so they can locate error.

10. No Fraud

The purpose of vouching is to examine that no fraudulent payments are made. The fraud can be committed due to matching of minds of employees and customer. The auditor can vouch the entries top disclosed such frauds.

11. Castings

The purpose of vouching is to check castings or loads. The auditor can calculate all total by himself. He can compare the totals with books to maintain accuracy.

12. Cast at Bank

The purpose of vouching is to determine true cash at bank. He can vouch receipt and payments. The result is that he can check whether cashbook is correct or not.

13. Cash Balance

The purpose of vouching is to check that cash in hand figures are facts. The cash can be counted. He can compare it with cashbook. He can apply test checking to determine accuracy.

14. Reporting

The purpose of vouching is to form an opinion for the purpose of reporting. In case of true and fair view there is good report. In the absence of such result there may be qualified report.

IMPORTANCE OF VOUCHING

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:

1. 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.

2. 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.

3. 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.

PRINCIPLES OF VOUCHING

The various principles of vouching are:

1. Arranged Voucher

A voucher is helpful to support any transaction, which may be cash memo fill, voucher, ticket or others.

2. Checking of Date

The voucher date can also be checked; it must be related to the current year. The date of the last or future year must not be adopted.

3. Checking of Authority

The vouchers are considers correct only when the proper authority signs on them. For the approval of the dealing the owner or the management must put the signatures for the approval of dealing if the vouchers are without the signatures of the proper authority. They are not considers the true.

4. Cutting or Change

There should be no changes in the vouchers. Any person for making the fraud can change the time, date, amount and name of concern. So, these changes cannot be acceptable till the approval authority has made the signature.

5. Compare the Words and Figures

The auditor should satisfy himself amount written on the vouchers, it figures and words are same or not.

6. Transaction Must Relate to Business

For the correctness of the vouchers it is necessary that it relate with the business. Concern, the vouchers must be in the name of the business and also the manager. If it does not the vouchers are not acceptable and doubtful.

7. Case of Personal Vouchers

The auditor should not accept the voucher in personal name. There is a chance than an officer of the company has purchased any item in his personal capacity.

8. Checking of Account Head

Auditor must be satisfied about the head of account in which cash is deposited and drawn. He should examine the documentary evidence in these regards.

9. Revenue Stamps

For the stamps, the stamps act 1899 is applicable while fixing the revenue stamps. The stamps are required according to the valuation of the amount or cash memo. There is no need of vouchers if amount is less than twenty rupees.

10. Case of Cancelled Voucher

The auditor should not accept the cancelled vouchers because it has already served the purpose of payment. There will be a danger of double payments, if it is accepted.

11. Important Notes

For finding the correct decision, the auditor can also take help from the working papers of the previous year and others paper or note related to business and available with the management.

12. Minutes Book

When the meeting of shareholders is held. All the resolutions and decisions of the directors and shareholders are recorded in the minute's book. This minutes book must be examine by the auditor. He has to check that these decisions have been implemented in the books of accounts or not.

13. By Laws

In case of company the article of association and memorandum are basically the rules and regulations. But on the other hand in the societies and clubs the bylaws are used to determine the powers of management. The auditor goes through these rules and regulations to find the true and fair view.

14. Agreements

The auditor must examine all the related papers of the business such as the agreement, correspondence and others. The basic information can be received to the auditor by such papers.

15. Deed of Mortgage

Sometimes, you are the sale or purchase of any assets, the management can enter into the agreement is prepare in this case. If the agreement is prepare in this case. If the agreement is made for a loan against the immovable property then the mortgage deed is signed. It is compulsory for the auditor to study the content of the deed.

VOUCHING OF CASH TRANSACTIONS

Vouching of cash transaction is the most important job of an auditor. Voucher is a piece of paper or a document that confirms the truth of a happening in the field of accountancy; it confirms either the payment or receipt of money. The voucher is an evidence of occurrence of a transaction that is entered in the books of accounts. It is the authority on the basis of which entries made. Vouching clearly shows the nature of the transaction.

Vouching is extensive examination of documents carried out for the purpose of established the authenticity of the transactions recorded in the books of accounts. Vouching also involves evaluation of internal checks and examination of internal controls relating to recording of transactions. Only on the basis of the conclusions drawn while vouching, auditors determine the nature and extent of their work subsequent to vouching. Therefore, extreme care should be taken while vouching. Important facts obtained from vouchers are date of transaction, name of the party, adherence, nature of the transactions, the amount mentioned in the voucher, and authority.

POINTS TO BE CONSIDERED WHILE VOUCHING OF CASH TRANSACTIONS

The audit normally takes place long after the transactions have taken place, and the auditor, not being in picture at the time, cannot have the benefit of direct experience of the transactions. Vouching of cash transaction is the most important job of an auditor. Before setting the program of vouching, an auditor should inquire carefully into whole system of internal control. An auditor should examine and understand the system and should pay attention in the following points:

1. Responsible officer for cash received and authority to sign check should not be given to the cashier and a copy of counterfoil should be kept for record of office. The receipts should be numbered serially.
2. All the receipt of cash should be recorded in the cash book.
3. Amount of cash received should be deposited into bank daily.
4. The cashier should not have any control over ledgers.
5. Drawer of check should present it to responsible officer to sign.
6. All unused receipt books and check books must be kept under lock.
7. System for recording cash sales and miscellaneous income should be different.
8. All the payments except petty cash expenses must be made by check.

VOUCHING AND ROUTINE CHECKING

Routine Checking is a simple checking which has been described earlier. It involves checking totals of cashbook carry forwards, posting to ledgers, balancing of accounts and transfer of balances to trial balance. For this checking the auditor uses different types of tick marks. From it the correctness of recording can be found out e. g. Whether the entries are correct; whether posting in the ledger has been made in the right account and no changes have been made in the books after checking.

Routine checking becomes important in the respect that without it, the correctness of accounts cannot be verified. Broadly speaking, routine checking is a part of vouching. It includes routine checking. The only difference is that vouching is an intelligent checking of all transactions with the help of proper documentary evidence and the remaining tasks, like recording, posting, balancing and transferring of balances to trial balance form parts of routine checking.

OBJECTIVES OF ROUTINE CHECKING

Following are the objectives of Vouching:

1. To verify that all transactions recorded in the books are supported by documentary evidence.
2. To see that all the transactions recorded in the books relate to the business of the organization, that all vouchers are in the name of the organization and no voucher relates to the personal expenses of the directors.
3. To see that transactions recorded in the books have been authenticated and sanctioned by a responsible official.
4. To see that all the transactions recorded in the books are complete in every respect; the organization has proper vouchers for each transaction and every voucher has been entered.

VOUCHER

The word "Voucher" has been used in the definitions of vouching. The documentary evidence on the basis of which entries are recorded in the books of accounts is called Voucher. This documentary evidence may be a receipt, counterfoil of a receipt, cash memo, pay-in-slip, purchase invoice, sales invoice, minutes of a meeting or a resolution passed in a meeting. All such evidence is known as vouchers. Below are given definitions of a voucher as propounded by great scholars;

Meaning of Voucher

Voucher is a document recording a liability or allowing for the payment of a liability or debt. A voucher would be held by the person or company who will receive payment.

Definitions of Voucher

According to ***Joseph Lancaster,*** "A voucher may be defined as documentary evidence by which the accuracy of book entries may be substantiated".

According to ***J.R. Batliboi,*** "A voucher may be a receipt, an invoice, an agreement, material requisition slip, or in short, any suitable written evidence which confirms a written transaction".

According to ***Arthur W. Holmes,*** "A voucher is documentary evidence in support of a transaction".

KINDS OF VOUCHERS

Vouchers can be classified into two kinds:

1. Primary Vouchers
2. Subsidiary (Collateral) Vouchers

1. Primary Vouchers

Written evidence in original concerning an entry is known as Primary Voucher, e.g. cash memo for cash purchase is a primary voucher.

2. Subsidiary (Collateral) Vouchers

In certain cases, evidence in original regarding a transaction is not available. To prove, the truth and correctness of the transaction, either a copy of the original evidence or some other document which can prove the correctness of that transaction is made available to the auditor for audit purpose. Such evidence is known as Subsidiary or Collateral Voucher. For example, when the receipt for payment of a purchase on credit is lost, carbon copies of sales invoice can be produced as subsidiary evidence.

Sometimes, even when the primary voucher is available the auditor can demand a subsidiary or collateral evidence to remove his doubt. For example, along with a receipt for payment of purchase of goods on credit, the auditor may demand sales invoice, correspondence, copy of the order, or goods inward Book, etc. in order to remove his doubts about discounts etc.

CONTENTS OF VOUCHERS

(i) Name

(ii) Related to business

(iii) Date

(iv) Serial Number

(v) Signature

(vi) Revenue Stamp

(vii) Printed Form

(viii) Amount

(ix) Changed Particulars

POINTS TO BE NOTED WHILE EXAMINING VOUCHERS

The auditor must take care of the following points while examining vouchers:

i) Vouchers are in the name of the organization and pertain to the business.

ii) If the voucher is in the personal name of the partner, director, manager or any other person, it should be seen that it relates to the business.

iii) The voucher must relate to the same financial year.

iv) The voucher should be on the printed form with date and the amount written both in figures and words. A receipt obtained from a party for Rs. 20/- or more should bear the revenue stamp duly signed by the proper person.

v) The description in the voucher and that in the books should tally.

vi) The payment of the voucher should have been sanctioned by a proper authority.

vii) The voucher which has been checked by the auditor should be stamped or tick marked with a special sign so that it may not be used again.

viii) All vouchers should be numbered serially and dated. These should be filed on a certain basis.

ix) The auditor should get a list of missing vouchers. Their copies or subsidiary vouchers should be examined.

x) Doubtful vouchers should be noted down in the diary. The auditor should use special ticks for such vouchers.

xi) As far as possible the checking of vouchers of a book of accounts of a particular period must be completed in one continuous sitting.

xii) Alterations in the vouchers must be supported by the signatures of the concerned officer.

xiii) While vouching, the auditor should not take help from the employees of the client.

xiv) In the case of an unclear voucher, clarifications should be sought from the person preparing the voucher.

xv) The auditor should resort to test checking only when a satisfactory internal control system exists in the organization.

DUTIES OF AN AUDITOR IN RELATION TO VOUCHING

The auditor must give a proper place to vouching in his audit work. It has been made clear earlier that vouching is the backbone of auditing. While vouching, the auditor must pay utmost attention to the fifteen points enumerated above. Only then the auditor will be able to know the truth, correctness, completeness and authenticity of the transactions. So, he must use all his ability and attention in vouching. If the auditor does not give due place to vouching in his audit work and verifies the Balance Sheet and the Profit and Loss Account, he can be charged with negligence on detection of some error in future.

VOUCHING OF CASH BOOK

In the original books of accounts, the cash book is considered to be the most important because the dignity, progress. And honour of the business depends upon its cash and moreover, money is considered to be everything these days. So, the possibility of frauds is maximum here. That is why each auditor uses his utmost care and watchfulness while checking the entries in the cash book. Vouching of the cash book will tell the auditor:

i) Whether all the receipts and payments have been recorded or not.

ii) Whether any improper or fictitious payments have been made.

iii) Whether all the transactions (receipts and payments) entered in the cash book follow correct accounting principles.

iv) Whether the amounts of cash in the bank and cash in hand are verified.

VOUCHING OF RECEIPT SIDE OF CASH BOOK

The vouching of receipt side of the cash book presents more difficulties because the auditors do not get vouchers given by others. So, there are more chances of fraud while cash is received. Spicer and Peglar also expresses the same idea when he says, "From the auditor's point of view the operation of vouching receipts is more difficult than vouching of payments."

The auditor should keep in mind the following points while vouching the receipt side of the cash book:

i) Evaluation of Internal Control System: First of all the auditor should study the internal control system existing in the organization in connection with cash receipts. Vouching of cash receipts will depend upon the strength of the receiving internal control system. After studying the procedure of strength cash, giving receipts, its recording and depositing of cash received in the bank, he should see if there is any possibility of fraud in this procedure. If he is not satisfied with this procedure, he should resort to thorough and detailed checking instead of test checking.

ii) List of Receipts: The auditor must know whether a list of receipts has been prepared or not at the time of opening of letters and whether they have been entered in the cash diary or not. Some of the entries of this cash diary should be compared with entries of the cash book.

iii) Reconciliation of Rough Cash Book and the Cash Book: The auditors generally demand a list of books of accounts maintained in the organization. If he finds that a rough cash book is also maintained, the auditor must compare the entries appearing in the rough cash book with those appearing in the cash book because it is possible that receipts which have been recorded in the rough cash book may have been omitted in the cash book.

iv) Issuing of receipts: If arrangement for issuing receipts is satisfactory, the possibility of fraud is very remote. The following points should be noted in this regard:

a) Whether the receipt has been issued through counterfoil receipt book or through carbon copy.

b) Whether the receipts are printed or not.

c) All the receipts must be serially numbered. Receipt book should also bear serial numbers.

d) Description on the receipt must tally with that in the cash book.

e) Unused (blank) receipt must be kept under lock or in any other safe custody so that they are not available to everybody.

f) If some error has been committed while writing a receipt, it should not be torn off, but cancelled and kept in the receipt book.

g) All receipts must be signed by a competent and authorized officer only.

h) If a receipt is received along with the cash, receipt of one's own organization should also be sent to the customer who marks the payment and the receipt received from him should be returned to him after signing it.

i) Counterfoils or carbon copies of receipts must be maintained.

1. Receipt from the person making the payment: Sometimes the person who makes the payment also sends a receipt from his own behalf, which is sent back to the person after signature of the person who receives the payment. This system should also be checked.

2. System of depositing cash in the bank: The auditor should see that a proper method of depositing cash into the bank is used and a proper record of pay-in-slips is maintained. The cash actually deposited in the bank should be compared with the cash deposited through pay-in-slips.

3. Checking of Cash Discount: Entries regarding discount against cash payment must be checked.

4. Challan filled by the person making the payment: In some organization there exists a system in which the person who makes the payment fills up a challan which contains the item and the cash amount. In such cases the auditor should compare the challan with the entries in the cash book.

5. Rules regarding receipts: If there are rules regarding cash receipts, the auditor should see that the rules have been followed.

EXAMINATION OF SPECIFIC ITEMS

Mainly the following items are written on the receipt side of the cash book; (i) Cash sales (ii) Proceeds from Debtors (iii) Bills received (iv) Interest and dividend (v) Commission received (vi) Rent from House Property (vii) Receipts from other assets (viii) Receipts from the sale of investments (ix) Receipts of income from interest (xi) Receipts from insurance policy (xii) Receipts from subscription (xiii) Receipts from Agents (xiv) Receipts from sale of shares (xv) Other Receipts.

i) Cash Sales

There are more chances of misappropriation in cash sales. The salesman may make the sales but may not make entry for cash received. So, the internal control system regarding cash sale must be very effective. If it is not satisfactory, the client should inform the auditor about it. Cash sales should be checked through the copies of cash memos and these cash memos should be compared with the summary of daily cash sales and the totals of daily summaries of cash sales should be tallied with the entries of the cash book. The auditor should also see whether the carbon copies are numbered or not. According to Lancaster the vouching of sales is more difficult than that of purchases.

Books and Accounts: Rough Cash Book and the Cash Book.

Primary Voucher: Summary of the salesman, statement of the cashier, copy of the cash memo.

Subsidiary Voucher: Order of the purchaser and his correspondence.

ii) Proceeds from Debtors

When cash is received from customer, a cash memo is issued. Its counterfoil or carbon copy is retained by the receiving clerk. The auditor should verify the amount received from these. A fraud may be committed by inserting fewer amounts in the counterfoil than what is actually received. Such cases should be verified from the customers. Counterfoils or carbon copies of receipts should be serially numbered. Amount should be entered in the cash book on the day it is received. Discount allowed to customers should be authorized by a responsible officer. The auditor should see to it that no discount is allowed against rules.

Books and Accounts: Personal Ledgers of Customers and Cash Book.

Primary Voucher: Carbon copy of receipt issued to the customer against cash received or its counterfoil.

Subsidiary Voucher: Statement of Accounts, correspondence, agreement, certificate from a high official etc.

iii) Bills Received

Details regarding bills matured and discounted are available in the bills receivable book. It should be verified by the auditor. He should check the amount received with bank statement. It is possible some bills might have become due but no amount has been received. An enquiry may be made from such a party. It may lead to detection of a fraud, as the amount may be received and misappropriated by the cashier.

A verification of the bills discounted should be made whether entry for discount has been made.

Books and Accounts: Cash Book, Bills receivable book. Discount book.

Primary Vouchers: Counterfoil or carbon copy of the receipt, Bank-pay-in-slip Pass book.

Subsidiary Vouchers: Purchase Order, Copy of the invoice, agreement, correspondence.

iv) Interest and Dividends

Dividend warrants should be checked with their counterfoils. If the dividend is collected through bank, the amount should be checked with the bank statement. Interest earned on deposits in the bank should be checked with the pass book. It should also be checked whether all interest and dividend have been received. These should be checked with related Investment documents. The auditor should see Brokers sale note to know whether dividend from the sale of investments has been properly recorded.

Books and Accounts: Cash Book, Investment Register, Interest Account, Personal Accounts of Organizations.

Primary Vouchers: Bank Statement, Pass Book, Pay-in-slip, carbon copy or counterfoil of the receipt, deposit receipt, etc.

Subsidiary Vouchers: Loan agreement, dividend documents and correspondence.

v) Commission Received

Commission received should be checked with related document. Amount of commission should be calculated according to the rate given in the agreement.

Books and Accounts: Cashbook, Commission Account, Personal Account of the person or the Organization.

Primary Vouchers: Commission Statement, Carbon Copy of the receipt.

Subsidiary Vouchers: Sale-commission-agreement, Correspondence.

vi) Rent from House Property

If the rent roll is used, it should be checked with the cash book. Counterfoils of rent receipts should also be checked with the cash book. In case of heavy rent arrears, the auditor should confirm from the tenant.

Books and Accounts: Cash book, Rent register, Rent account, Personal accounts of tenants.

Primary Vouchers: Counterfoils of rent receipts, statement of the agent.

vii) Receipts from Other Assets

Receipts from other assets should be checked with related documents. If the sale has been affected through auction, it should be checked with the correspondence regarding auction and the related agreement.

Books and Accounts: Cash book, Account of Fixed Assets.

Primary Vouchers: Statement of the Sales agent, carbon copy of the receipt.

Subsidiary Vouchers: Sale agreements and correspondences.

viii) Receipts from sale of Investments

Receipts from the sales of investments should be checked with the sale note. It is also to be seen whether the sale is at cum-dividend price or at ex-dividend price. If there is any written agreement, it should also be checked.

Books and Accounts: Cash book, Investment Accounts, Investment Register.

Primary Vouchers: Statement of Sales Agents, carbon copy of the receipt. Bank Advice, Brokers sold note.

Subsidiary Vouchers: Sales Agreement and correspondence.

ix) Receipts from Hire Purchase Agreement

The auditor should check the receipt from the hire purchase agreement which will provide the necessary details regarding number of installments, rate of interest, duration of agreement and date of payment of installments. Installments received should be checked with the counter foils of receipts issued for the payment of installments, Amount received from such installments should not be entered in the Sales Account.

Books and Accounts: Cash book, Accounts of investments, Investment Register.

Primary Vouchers: Statement of the Sales Agent, Carbon copy of the receipt.

Subsidiary Vouchers: Hire purchase agreement and correspondence.

x) Receipts from Loans to Others

Loan agreement should be examined. Rate of interest and the time of return of the loan should be noted. It is also to be seen that the amount of interest received has been entered in the books at the proper time. The counterfoils of receipts issued for the receipt of interest should be checked. If the amount is deposited in the bank, it should be verified from the bank statement.

Books and Accounts: Cashbook, Investment register, Interest account, Personal accounts of Institutions.

Primary Vouchers: Bank statement, Pass Book, Pay-in-slips, counterfoil or carbon copy of the receipt, Deposit receipt.

Subsidiary Vouchers: Loan-agreement and correspondence.

xi) Insurance Claims

Insurance claims received should be checked with copies of insurance claim lodged, correspondence with the insurance company, insurance policies, and the bank pass book if the amount has been received by the bank.

xii) Receipts from Subscriptions

Receipts from subscriptions should be checked with the register of subscription and counterfoil of receipts issued.

xiii) Receipts from Agents

These receipts should be checked with the statement of accounts submitted by the agents. These statements should be signed by a responsible official.

xiv) Receipts from sale of shares

These receipts should be checked with shareholders register. The person who has purchased the shares should be corresponded with and the minute book should be examined.

xv) Other Receipts

These amounts should be checked with related documents and if the documents are not available, these should be checked through correspondences.

VOUCHING OF PAYMENT SIDE OF CASH BOOK

It is generally thought that only by checking the receipts obtained against cash payment, vouching of payment side of the cashbook is completed. But this is a totally wrong notion. Receipt obtained against payment is only one evidence. Besides this, the auditor has to examine many other things which will confirm that the payment made is proper, correct, according to rules and has been recorded correctly. While vouching the credit (payment) side of the cash book, the auditor should give proper attention to the following points:

i) ***Proper Evidence:*** The organization must have proper evidence (voucher) like a receipt, purchase bill, etc. against each payment.

ii) ***Payment is for the purpose of business:*** The auditor is to see whether a payment made for the personal expenses of an employee or the owner has not been entered as an expenditure of the organization. E.g. entry of personal travel expenses as travel expenses of the firm. Sometimes, vouchers are in the personal names of the partner or the director or the manager of the firm. In such cases, the auditor must use his intelligence.

iii) ***Relating to the period under Audit:*** The auditor should see that the payment relates to the period for which he is conducting the audit. If expenses of some other period have been recorded in this period, the Profit and Loss Account will not show correct and actual profit or loss. Generally this type of irregularity is committed in the beginning or in the end of the financial year. The auditor, therefore, should examine the payments made in the beginning or in the ending months of the year with this point in mind.

iv) ***Genuinness of the Payment:*** After examining the voucher received against payment, the auditor must confirm that the payment has actually been made. It is also possible fictitious payment has been recorded for the purpose of committing a fraud.

v) ***Study of the Internal Control System for Payment:*** First of all the auditor should evaluate the internal control system for payments to see the procedure for making payments and whether there is any chance for committing a fraud.

vi) ***Payment of the actual amount:*** The auditor should see that the amount recorded in the cashbook is the amount appearing in the voucher and that this amount has actually been paid. For this, the auditor should also examine the subsidiary vouchers besides the primary vouchers. The date on which the payment was made should also be checked.

vii) ***Authorized Payment:*** The auditor should see that the payment is duly sanctioned by the authorized person because almost in every business the official passing the voucher for payment and the official for making the payment are specified.

viii) ***Payment to the right person:*** The auditor should confirm that the payment has been made to the right person i.e. the payment has been made to the person or the institution to which the payment was to be made. In this regard, if the auditor is not satisfied with the available voucher, he should seek confirmation from the person receiving the payment. Such a type of irregularity is often committed in payments for wages.

ix) ***Payment according to rules:*** Under the Indian Companies Act, some payments are not allowed e.g. A director has no right to spend the company's money for his personal use. Although the company may be provided with a proper voucher for it and such a payment may be justified from some other considerations. But this is against the rules. So, the auditor must mention such type of payment in his report for the knowledge of the shareholders.

x) ***Payment properly recorded:*** While vouching payments, the auditor must see that each payment has been recorded correctly and properly. He must see that the proper account has been debited with the payment. E.g. Capital expenditure and Revenue expenditure have been entered separately. Amounts given in advance for expenses have not been entered in the Expenses Account, but in the Prepaid Expenses Account. If an error has been committed in writing payments, it will affect the truth of the Profit and Loss Account and the Balance Sheet.

VOUCHING OF THE ITEMS OF PAYMENT SIDE

1. Cash Purchases

Payments made for cash purchase of goods can be checked from the cash-memos obtained from the salesman. It should be ensured that goods purchased are actually received by the storekeeper. This can be verified by comparing the cash memos with goods inward book and the order on the basis of which the goods have been purchased, all purchases should be authorized.

Books and Accounts: Cash book, Goods inward book, Purchase Account.

Primary Vouchers: Cash memos.

Subsidiary Vouchers: Goods received note, copy of the order, purchase authorization, correspondence.

2. Payment to Creditors

Payment to creditors should be checked with the receipts issued by them at the time of payment. Receipts should indicate the purpose for which the payment is made.

Books and Accounts: Cashbook, Accounts of Creditors.

Primary Vouchers: Receipts.

Subsidiary Vouchers: Invoice, Agreement, and Statement of Account, Correspondence

3. Bills Payable

These bills should be cancelled after being paid. These can be checked with bills book. If the payment has been made by bank, bank statement and passbook should be examined to verify the payment.

Books and Accounts: Cash book, Bills payable book, and Discount book.

Primary Vouchers: Invoice, Agreement, Pass Book, Bank Statement, and Correspondence.

4. Purchases of Plant and Machinery

Payments made in connection with these purchases must have some vouchers like invoice etc. received from the supplier. The auditor must note that these are assets expenses and must be debited to the concerned assets account. He should also see that these purchases have been authorized by a proper authority. If they have been purchased in auction, there must be a certificate from the auctioneer and if they have been got under Hire Purchase Agreement, that agreement should be examined.

Books and Accounts: Cash book, plant and machinery account.

Primary Vouchers: Receipt invoice.

Subsidiary Vouchers: Auctioneer's note, Copy of the order, Vouchers regarding purchase and installation expenses, correspondence.

5. Purchase of Land and Building

Property can be had in three ways:

i) ***Free hold basis by paying full amount:*** A conveyance or sale deed is prepared for it. The buyer acquires full rights over the property for ever.

ii) ***Lease hold basis:*** A lease agreement providing for terms and conditions is prepared. The buyer does not have full rights for ever. The rights are limited to some definite period provided in the agreement. The payment made for the property is also as per the agreement.

iii) ***In auction by paying amount of auction:*** The buyer gets full rights for ever.

For vouching the payment, the auditor should examine Sale/Conveyance deed, legal expenses and commission expenses should be checked with the lawyer's certificate. It must also be remembered that all these expenses are Capital Expenses.

For construction of a building the payments should be checked with the agreement with the contractor, contractor's receipt and Architects' receipts and certificate.

Books and Accounts: Cashbook, Land and Building Account.

Primary Voucher: Receipt, Sale deed, Lease deed.

Subsidiary Voucher: Sales note of the Agent or the Auctioneer Vouchers for legal expenses, Agreement and Correspondence.

6. Purchase of Investments

These should be check with the Broker's bought note and his receipt. If these have been purchased through the bank, the note should be compared with the pass book. If the investments are purchased at cum-dividend price, dividend included in the purchase price should be debited in the dividend account and the balance in the investment account.

Books and Accounts: Cashbook, Investment Register, and Investment Accounts.

Primary Vouchers: Receipt, Share Certificate, Bank Counterfoil.

Subsidiary Vouchers: Broker's Note, Bank Pass Book, and Correspondence.

7. Purchase of Patents and Copyrights

The purchase of patents and copyrights should be checked with the agreement, receipt issued by the seller and the agent's note. The auditor should see that this expenditure is considered to be capital expenditure.

Books and Accounts: Cashbook, Patents and Copyright Account.

Primary Voucher: Receipt and Counterfoil of the Cheque.

Subsidiary Voucher: Copyright agreement, statement of the agent's account.

8. Payment of Salaries

Generally the salary of clerks is entered in the salary register. So, the cashbook should be compared with it. The auditor should see the persons to whom the payment of salary has been made have signed the payments. The salary bill should be sanctioned by a responsible officer and the payments should be within the authorized limits. If some clerk has been paid some allowances, etc. in addition to his salary, it should also be sanctioned by a proper authority. The salaries of Chief officials (Chief Accountant, Secretary, and Manager) should be checked with the Director's Minutes book. Agreements relating their services should also be examined.

Books and Accounts: Cash book, Salaries Account, Accounts of the employees (if existing).

Primary Vouchers: Salaries register, Receipt, Counterfoils of Cheques.

Subsidiary Vouchers: Agreements, Appointment letter, Resolutions of Directors meeting, sanction letter.

9. Payment of Wages

While checking payments of wages, the aim of the auditor should be to see whether the payment has actually been made; whether this payment was authorized by the authorities and the total amount of wages was correct. Internal control system is very important in this regard. The auditor should study this system in details. If he finds that the system of internal control with regard to wages is not satisfactory, he should inform the client and should suggest steps to improve it. If his suggestions are not accepted, he can be free from his liability. On the other hand if he finds that the system is working satisfactorily, his task will become simple. The following points should be kept in mind while checking wages:

i) Multiplication results and totals in the wages books or wages sheet are correct.

ii) Totals of weekly or fortnightly wages should be compared with the totals of cheques written in their favour and the postings in the journal of the cashbook and the ledger should be examined.

iii) Names of the workers from the wages book should be checked to locate dummy workers and those who have left the organizations.

iv) Presences of the workers should be checked with the records kept by the gate keeper and the time keeper.

v) Some workers are paid according to the work they have performed. Their work must be checked.

vi) Each work book should be signed by a proper authority. Only then the payment should be made.

vii) Deductions for house rent, insurance policy etc. made from the wages should be entered in the proper account.

viii) Special attention should be given to payments made to casual worker. There is often a possibility of frauds in such wages.

ix) Wages sheet should be prepared by these employees who have nothing to do with the payment of wages.

Books and Accounts: Cash book, Wage Register, Wages Accounts, etc.

Primary Voucher: Wages Register or Table, Receipt or counterfoils of Cheque.

Subsidiary Voucher: Attendance and Work Card, Evidence of the foreman. Appointment letter, Service rules and Pass Book.

10. Interest on Loans

Interest is always paid on loans whether obtained from a bank or from some other institution. Terms and conditions of loan should be studied from the loan agreement and the amount should be verified from the receipt obtained against payment of interest. If interest is paid on debentures, rate of interest should be found out from the debenture interest book. If interest is paid through bank, interest books and pass book should be compared.

Books and Accounts: Cash book, Debentures, Interest book, Interest Account.

Primary Vouchers: Receipt.

Subsidiary Vouchers: Loan Agreement, Term and Conditions of debentures, Interest coupons, Pass book and correspondence.

11. Dividend

Returned dividend warrants should be examined for payment of dividend and if the dividend is paid through bank, dividend papers and pass book should be compared. The amount of dividend to be paid should be equal to the balance in the pass book.

Books and Accounts: Cash book, Dividend Book and Dividend account.

Primary Vouchers: Receipt and Dividend Warrant.

Subsidiary Vouchers: Resolution of the Director's meeting, minutes book of the general body meeting of shareholders, pass book, membership register and correspondence.

12. Directors Fees

Directors receive fees for attending meetings of board of directors. It should be checked with the minutes of the directors meetings, Attendance Register and the receipts given by the directors. The fees to be paid to the directors should be found out from the articles of association. If there is no provision in the articles of association, it should be found out from the resolution of the shareholders where it has been fixed. If this fee is free from income tax, the auditor should see whether this provision has been made in the articles of association by the general body of the company.

Books and Accounts: Cashbook, Minutes book, Attendance Register, etc.

Primary Vouchers: Receipt, Bills, Counterfoils of cheques.

Subsidiary Vouchers: Articles of association, resolution by shareholders.

13. Travelling Agent's Commission and Expenses

Agreements made with the traveling agents should be examined. Commission paid to them should be vouched with the statement of the agent and the receipt issued by them. Voucher for every expenditure should be demanded. If there are some business rules regarding payment of commission, it should also be examined. If commission is paid on the sales, it should be on the actual sales and not on total sales i.e. the returned goods should be deducted from the total goods sold.

Books and Accounts: Cash book, Commission Accounts, Travelling Expenditure Account.

Primary Vouchers: Receipt, Statement of the agent, Travelling Expenses Bills, Counterfoils of cheques.

Subsidiary Vouchers: Agreement and Correspondence.

14. Entertainment Expenses

Expenditure incurred on entertainment to customers and other is a necessary expenditure. But it must be sanctioned by the directors of the company. For small expenses, sanction from some authorized officer such as the manager or the secretary is sufficient. These expenses should be vouched with related vouchers.

15. Freight and Octroi

If rail freight and Octroi are paid by the forwarding agent, these should be examined by comparing the statement of the agents and the receipts. If some vehicle has been used for the sale of goods, the receipts obtained from the owners of vehicles should be examined.

16. Postage Expenses

In big companies a register is maintained for postage expenses. When postage stamps are bought, entries are made in this register. Postage stamps used for sending letters are entered in the register daily. A proper authority of the company should sign the entries. The auditor can vouch postage expenses with this register.

17. Bank Charges

Incidental charges, by the bank, discount on cheques sent for clearing, interest on overdrafts, etc. can be vouched with the bank's statement pass book and the cash book.

18. Insurance

The auditor should examine the following for vouching this expenditure.

i) Insurance policy and the insurance premium receipts.

ii) Renewal receipt if the policy has is renewed.

19. Dishonoured Bills Receivable

Sometimes the bills receivable are encashed from the bank, but due to non receipt of the payment they are dishonoured. The bank debits this amount to the account of the company along with some discounting charges and the interest. After receiving this information from the bank, entries are made in the books of the company. The auditor should examine the pass book, bills receivable register and bank statement, etc. while vouching these expenses.

20. Payment of Bonus to Staff

Payment of bonus should be authorized by some responsible officer; the amount of bonus paid to the staff should be verified from the following decisions and resolutions:

i) Decision of the bonus labour tribunal

ii) Bonus Act 1956 and Bonus Amendment Act

iii) Resolution of the Directors Meeting

The auditor should examine the bonus tables wherein are given the amount paid to each employee and the related calculations. Payment of bonus should be checked with the entries of the cash book and if paid through bank it should be checked with the pass book.

VOUCHING OF PETTY CASH BOOK

While vouching the petty cash book, the following points should be taken into consideration:

(i) The auditor should see the form of the petty cash book to study the entries and the internal check system.

(ii) Whether the vouchers on the basis of which expenditure has been made are sanctioned by the proper officer of the organization.

(iii) Whether the petty cashier has prepared the summary of the expenditure for which no vouchers or receipts have been obtained and has got them sanctioned by the proper authority.

(iv) Whether the amount obtained for imprest has been compared with the main cash book.

(v) Whether the totals of the petty cash book have been checked and signed by the checking clerk and the proper officer from time to time.

(vi) Whether the authorized receipts have been obtained for payments of more than 20 rupees.

(vii) Whether any employee has been granted loan from the Miscellaneous Cash. There is no provision for it.

(viii) If there exist more than one miscellaneous accounts their balances should be checked at the same time.

VOUCHING OF PURCHASE BOOK

Books and Accounts: Purchase Book, Creditors Accounts Goods Inward Book.

Primary Vouchers: Invoice.

Subsidiary Vouchers: Copy of the order, Goods received letter and correspondence.

Procedure

(i) The auditor, first of all, should study the internal check system to see whether there are possibilities of frauds, etc.

(ii) The entries in the purchase book should be compared with the invoice. Some mark should be put on it so that it is not presented again as a voucher.

(iii) The invoice should be compared with the goods inward book and the goods received note to see that all the goods have been received.

(iv) The purchase order should be examined to see that only the ordered goods have been received and the order was placed with the sanction of a proper authority with his signatures.

(v) If some invoices are not available, their entries should be checked with the copies of these invoices.

(vi) General business purchases should not be debited to capital expenditure account.

(vii) To show the profit more or less than the actual, the management may commit some irregularities in the beginning or in the end of the accounting year. The auditor should be more careful while vouching the purchases made in these periods. He should see that the goods according to a particular invoice have been entered and have been actually received in the store and that no goods have been received which have not been recorded. This should be compared with the goods inward book and the goods received note.

(viii) The purchase book should be compared with the purchase ledger and the accounts of the creditors.

(ix) Goods received on consignment and goods received on approval should not be recorded as purchases.

(x) Gross profit of the previous year should be compared with that of the current year.

(xi) Anything not clear should be clarified with the correspondence.

In fact the main aim of vouching of the purchases book is to verify that the organization pays only for the goods which have been actually received by it.

VOUCHING OF PURCHASES RETURN BOOK

Book and Accounts: Purchase return book, goods outward book, Accounts of Creditors.

Primary Vouchers: Received credit note.

Subsidiary Vouchers: Issued Debit Note, Goods dispatched note and correspondence.

Procedure

(i) Entries of purchase return book should be compared with credit notes received from the sellers against purchase returns.

(ii) When the goods are returned, the firm prepares a debit note and sends it to the supplier, the auditor should see that a debit note has been sent and a credit note for all the goods returned has been received from the supplier and it tallies with the purchases return book.

(iii) The auditor should see that the quantity returned as per the return note corresponds with the storekeeper's record, return outward register and gate keeper's outward register.

(iv) The entries of the purchase return book should be compared with the accounts of the creditors.

(v) Each credit note should be stamped or initialed after examination so that it is not produced again.

(vi) The purchase returns of the first month and the last month of the accounting year should be checked carefully to detect any irregularity.

VOUCHING OF SALES BOOK

Books and Accounts: Sales Register, Accounts of debtors and Goods outward book.

Primary Voucher: Copy of the invoice.

Subsidiary Voucher: Order received book, order, goods dispatched note, statement of account and correspondence.

The work of the auditor will be determined by how the transactions have been recorded from the time of the receipt of the order to the time of sending the invoice to the customer.

Procedure

(i) The sales register should be examined with the copies of the sales invoices.

(ii) Rates of trade discounts allowed to the customers should be checked. This rate should be according to the rules of the organization and according to the agreement reached with the customer.

(iii) The kind and quantity of goods recorded in the goods dispatched note and the goods outward book should be compared with the copies of the invoices.

(iv) Sales of first and the last weeks of the year should be checked very carefully. It is to be seen that the invoiced goods have actually been dispatched and that there are no goods, which have not been invoiced.

(v) Checking of the entries of the sales register should be done with the accounts of the debtors.

(vi) The statement of accounts should be verified by getting confirmation from the customers.

(vii) Goods sent on consignment and on approval should not be regarded as actual sales. The auditor should see that these goods are not recorded in the sales register.

VOUCHING OF SALES RETURN BOOK

Books of Accounts: Sales Return Book, Debtor's Accounts, and Goods Inward Book.

Primary Vouchers: Issued Credit Note.

Subsidiary Vouchers: Debit note, goods received note, account Statement, copy of the original invoice and correspondence.

On receiving the sales return, its entries should be made in the goods receiving book by the gate keeper. Then a credit note should be issued to the customer. The credit note should be issued only after obtaining sanction from the responsible officer. Before issuing the credit note, return inward register and stores records should be verified.

Procedure

(i) Copies of credit notes should be compared with the sales return book.

(ii) Debit notes sent by the customer, goods inward book, goods received notes and the credit notes should be compared with one another.

(iii) Credit notes should be signed by the employees who prepare and examine them. They should also be signed by a proper official.

(iv) Entries of the sales return register should be compared with the debtor's accounts.

(v) Statement of accounts sent from time to time should also be examined.

(vi) The original invoice by which the goods received were sent should be checked to see that the goods returned were actually sold by the firm. The quality, quantity and the rates of goods returned must also be verified.

(vii) Entries of the first and the last weeks of the year should be thoroughly checked.

VOUCHING OF BILLS RECEIVABLE BOOK

Books and Accounts: Bills Receivable Book, Cash Book, Accounts of debtors.

Primary Vouchers: Counterfoil of bills receivable and counterfoil of pay-in-slips.

Subsidiary Vouchers: Statement of Accounts, Passbook, Receipt and correspondence.

Procedure

(i) Entries of bills receivable book should be compared with the accounts of debtors.

(ii) Entries of bills receivable book should be compared with the counterfoils of bills receivable.

(iii) Statement of bills due date should be examined with the cash book and the bank pay-in-slip.

(iv) The bills which have been discounted before the due date should be examined with the pass book.

(v) If the payment of the bill has been received before the due date, the cash should be examined with the cashbook and the propriety of the discount should also be examined.

(vi) Sometimes the bill is not paid on the due date. In such cases, the entry of the dishonour of bill should be examined. If the dishonoured bill is issued again, interest and other expenses should be examined.

(vii) In each case, the correctness of the entries should be examined.

VOUCHING OF BILL PAYABLE BOOK

Books and Accounts: Bills Payable Bank, Cash book, Accounts of the creditors.

Primary Vouchers: Bills Payable, Receipts.

Subsidiary Vouchers: Counterfoils of cheques, passbook, accounts statements and correspondence.

Procedure

(i) Bills payable book and the Creditors accounts should be compared.

(ii) Entries of vouching receipts of the bills paid, cash book, counterfoils of cheques, and bills payable book should be compared with one another.

(iii) If the bills payable have been paid before the due date, it should be examined whether the received discount is adequate or not.

(iv) The amount of remaining bills payable at the end of the year should be examined with the statement of accounts.

(v) The entries of dishonoured bills should be examined.

JOURNAL PROPER

Besides the above mentioned books-cashbook, sales book, purchase book. Sales return book or purchase return book, etc. businessmen use another book. This subsidiary book is known as Journal Proper. All these transactions which are not covered by the above mentioned books are recorded in the journal proper. Adjustment entries, Transfer entries, Reconciliation entries, Opening and Closing entries, Challan entries, etc. are recorded in the Journal Proper. The auditor should examine this book properly. The entries recorded in the Journal Proper are explained below:

1. ***Opening Entries:*** These entries are examined through the balance sheet of the last year. If an old business of a new firm has been purchased, these entries should be examined with the agreements reached with the seller, Articles of Association of the firm and the minutes of the meetings of board of directors.

2. ***Closing Entries:*** These include all those entries which are recorded to close the accounts. Often these entries are transferred to goods account and Profit and Loss Account. It should be checked whether closing balances are drawn correctly and the entries are transferred to the proper accounts.

3. ***Bad Debts:*** Bad Debts should be examined with the notice issued to the debtor, correspondence and other documentary evidence. It should also be checked that the debt which has been declared bad has the sanction of a high official. Full investigation is required in case of a doubt.

4. ***Provision for doubtful debts:*** This should be checked with the sanction by some responsible officer. The amount or the doubtful debts should also be examined.

5. ***Depreciation:*** It should be seen that the amount of depreciation is in accordance with the tradition of the firm, that there is no appreciable difference in the rates of depreciation in comparison to previous years. Rates of depreciation should be vouched by examining the sanction of the owner, partner, director or any other officer.

6. ***Adjusting Entries:*** It is to be seen that a proper procedure has been followed for unpaid and prepaid expenditure and income. A thorough examination is needed.

7. ***Rectification Entries:*** All rectification entries should be authorized by some high officials of the firm. It should also be examined that principles of accounting system has been followed or not. Related accounts should also be checked.

8. ***Transfer Entries:*** Reasons for transfer of accounts from one ledger to another should be found out. Enquiry form the sanctioning authority should also be made. Related vouchers, if any, should also be examined. Truth should be found out by correspondence in the absence of vouchers.

9. ***Entries for goods sold on Approval:*** A separate record should be maintained for goods sold on approval basis. It should not be treated as sales unless the customer has sent his approval. After the approval by the customer, it should be recorded in the sales register. The goods sent on approval basis should be taken in the closing stock as stock with the customer if no intimation has been received from the customer.

10. ***Entries of Consignment Transactions:*** Goods sent on challan/consignment should be examined with consignment note, goods received note by the agent and the agent's statement. Entries should be made after receiving the full statement from the agents. This statement should include total sales, commission, expenses, etc. If these goods have been shown at a higher price than the cost, its adjustment entries should be checked. The goods sent on consignment still lying with the agent should be taken into closing stock. Its value should be calculated after taking into account the expenses incurred on dispatching it to the agent. The auditor should also satisfy him that its profit has been calculated properly. Similarly, the vouching of goods received on consignment should be made with the copies of sales statements sent by the firm to the client. It should be checked whether the commission receivable on the sale of such goods has been debited to the client at the predetermined rates and whether expenses incurred in connection with the consignment have also been debited to the client. Such sales should not be taken as sales of the business and such stock should not be taken as stock of the business. Transfer entries and entries of dishonored bills should also be checked.

VOUCHING OF LEDGER BOOKS

Bought (purchase) Ledger or Creditor Ledger

Bought (Purchase) Ledger or Creditor Ledger contains accounts of firms from which goods are purchased on credit. The following procedure should be adopted while vouching it:

(i) Primary balances (opening balances) should be verified from the balances of previous ledger.

(ii) The posting to the purchase ledger should be verified from cashbook, purchase register, return outward book, journal and other relevant books. The auditor should see that correct amounts have been posted to the correct account on the correct side and no posting in the ledger has been made directly.

(iii) All the accounts in the ledger should be checked carefully. No posting should remain unticked. Totals and balances of accounts should also be checked.

(iv) If a transfer entry has been made from one account to another, this transfer should also be through the journal or any other transfer book.

(v) List of closing balances should be prepared and these should be verified from the balances of some of the creditor's accounts in the general ledger.

(vi) Old credit balances should be carefully examined to find out if it shows some liability. The balances can be checked by correspondence with the creditors.

(vii) If the balance shown in the statement of the creditors does not tally with the balance shown in the account, the difference should be carefully checked. It is possible some purchase has not been recorded to inflate the profit. So, postings of some later weeks should be checked with goods inward book.

Sales Ledger or Debtors Ledger

Sales ledger contains the personal accounts of those debtors to whom goods have been sold on credit. The following procedure should be adopted while vouching it:

(i) The opening balances of sales ledger should be compared with the sales ledger of the previous year.

(ii) The totals and balances of various accounts should be checked.

(iii) No posting in the ledger should be made directly.

(iv) These postings should come from the cash book, sales register, bills receivable book, sales return register and the journal, etc. These should be verified from these books.

(v) It should be made sure that no account remains unticked.

(vi) Transfer entries from one account to another should be made through the journal.

(vii) All the bad debts should be recorded after complete sanction from the authorities.

(viii) Balances should be compared with the debtor's statement. If they do not tally, the difference should be checked with the goods outward book of some late weeks.

REVIEW QUESTIONS

Descriptive Questions

1. Explain the importance of Internal Check.
2. Discuss the purposes of Vouching.
3. Explain various principles of Vouching.
4. Discuss various types of Vouchers.
5. Explain the duties of an auditor in relation to Vouching.
6. Discuss vouching of Payment side of Cash Book.
7. Explain vouching of Purchase Book.
8. Discuss vouching of Purchases Return Book.
9. Explain vouching of Bills Receivable Book.
10. Discuss vouching of Bill Payable Book.

Analytical Questions

1. State the objective of Internal Check.
2. Discuss the purposes of Internal Checks.
3. State various objectives of Vouching.
4. Discuss importance of Vouching.
5. Explain vouching of Cash Transactions.
6. Discuss vouching and Routine Checking.
7. State the various contents of Vouchers.
8. State vouching of Cash Book.

Conceptual Questions

1. What is Internal Check?
2. State any two objective of Internal Check.
3. Give the meaning of Vouching.
4. Define the term Vouching?
5. What is Voucher?
6. What is Primary Voucher?

7. Give the meaning of Subsidiary Voucher.

8. What is Cash Book?

9. What is Sales Book?

10. Give the meaning of Ledger Book.

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Unit 3

VEIFICATION AND VALUATION OF ASSETS AND LIABILITIES

Highlights

- ◈ Meaning of Verification
- ◈ Definitions of Verification
- ◈ Scope of Verification
- ◈ Objects of Verification
- ◈ Principles of Verification
- ◈ Techniques of Verification
- ◈ Verification of Assets
- ◈ Procedures of Verification of Assets
- ◈ Verification of Goodwill
- ◈ Verification of Stock-in-Trade, Stock
- ◈ Verification of Investments, Liabilities
- ◈ Verification of Capital
- ◈ Auditor's duty to verify Contingent Liabilities
- ◈ Valuation of Assets
- ◈ Methods of Valuation of Assets
- ◈ Valuation of Goodwill
- ◈ Valuation of Stock-in-Trade
- ◈ Valuation of Investments
- ◈ Problem in the valuation of Assets
- ◈ Valuation of Liabilities

INTRODUCTION

Verification means proving the correctness. It is the act of assuring the correctness of value of assets and liabilities, title and their existence in the organization. An auditor should be satisfied himself about the actual existence of assets and liabilities appearing in the balance sheet is correct. If balance sheet incorporates the incorrect assets, both profit and loss account and balance sheet do not present true and fair views. Thus, verification means to confirm the truth or accuracy and to substantiate. It is a process by which the auditor satisfies himself not only about the actual existence, possession, ownership and the basis of valuation but also ensures that the assets are free from any charge.

One of the most important duties of an auditor in connection with the audit of the accounts of a concern is to verity the assets and liabilities appearing the in the balance sheet. He has not only to examine the arithmetical accuracy and bona fide of the transactions in the books of account by vouching only, as has already been explained in one of the previous chapters, but he has also to see that the assets as recorded in the balance sheet actually exits. The fact that there is an entity regarding the purchase of an asset and which entry has been found to be correctly recorded, is not a proof that the asset is in the possession of the concern at the date of the balance sheet.

Meaning of Verification

Verification is a process by which an auditor satisfies himself about the accuracy of the assets and liabilities appearing in the Balance Sheet by inspection of the documentary evidence available. Verification means proving the truth, or confirmation of the assets and liabilities appearing in the Balance Sheet.

Verification includes following:

i) The existence of the assets

ii) Legal ownership and possession of the assets

iii) Ascertaining that the asset is free from any charge, and

iv) Correct valuation

Definitions of Verification

According to ***Spicer and Pegler,*** "Verification as it implies an inquiry into the value, ownership and title, existence and possession and the presence of any charge on the assets".

VARIOUS TIPS TO BE CONSIDERED WHILE CONDUCTING VERIFICATION

While conducting verification following tips should be considered by the auditor:

i) Possession: The auditor has to verify that the assets are in the possession of the company on the date of balance sheet.

ii) Ownership: The auditor should confirm that the asset is legally owned by the company.

iii) ***Existence:*** The auditor should confirm that all the assets of the company physically exist on the date of balance sheet.

iv) ***Charge or lien:*** The auditor has to verify whether the asset is subject to any charge or lien.

v) ***Record:*** The auditor should confirm that all the assets and liabilities are recorded in the books of account and there is no omission of asset or liability.

vi) ***Audit report:*** Under CARO the auditor has to report whether the management has conducted physical verification of fixed assets and stock the difference, if any, between the physical inventory and the inventory as per the book.

vii) ***Event after balance sheet date:*** The auditor should find out whether any event after the date of balance sheet has affected any items of assets and liabilities.

SCOPE OF VERIFICATION

The scope of verification can be summarised as follows:

1. The assets were in existence on the date of the balance sheet.
2. The assets had been acquired for the purpose of business only.
3. The assets had been acquired under a proper authority.
4. The right of ownership of the assets vested in the organization.
5. The assets were free from any charge.
6. The assets were properly valued and disclosed in the balance sheet.

OBJECTS OF VERIFICATION

Following are the objects of verification of assets and liabilities:

1. To show correct valuation of assets and liabilities.
2. To know whether the balance sheet exhibits a true and fair view of the state of affairs of the business.
3. To find out the ownership and title of the assets.
4. To find out whether assets were in existence.
5. To detect frauds and errors, if any
6. To find out whether there is an adequate internal control regarding acquisition, utilisation and disposal of assets.
7. To verify the arithmetic accuracy of the accounts.
8. To ensure that the assets have been recorded properly.

PRINCIPLES OF VERIFICATION

1. Confirm that the assets were in existence on the date of the balance sheet.
2. Ascertain that the assets had been acquired for the purpose of the business and under proper authority.
3. Confirm that ownership of the asset rests with the organization.
4. Ascertain that no charge has been created on the asset.
5. Ensure that the current book value of the asset is determined after providing correct amount of depreciation for various years.
6. Ensure that values reflect current physical condition of the asset.
7. Ensure that disclosures regarding assets are adequate.

ADVANTAGES OF VERIFICATION

Advantages of verification are as under:

1. It avoids manipulation of accounts.
2. It guards against improper use of assets.
3. It ensures proper recording and valuation of assets.
4. It exhibits true and fair view of the state of affairs of the company.

Techniques of Verification

1. ***Inspection:*** It means physical inspection of the assets i.e. company cash in the cash box, physical inventory, inspection of shares certificates, documents etc.
2. ***Observation:*** The auditor may observe or witness the inspection of assets done by others.
3. ***Confirmation:*** It means obtaining written evidence from outside parties regarding existence of assets.

VERIFICATION OF ASSETS

Verification of assets is more responsible job of an auditor. The auditor should visit the business house at the close of the financial period or on the following morning and actually count the cash in hand and compare it with the balance in hand as shown by the cash book. This should be done in the presence of the cashier and if there is any shortage his certificate should be obtained. To verify cash at bank, the auditor should examine the Bank pass Book and compare it with the balance as shown by the bank column of the cashbook. The auditor should also see that the 'cheques outstanding' and 'cheques not yet collected' are genuine and not made up in order to conceal the deficiency. If some of these cheques are more than six months old, he should make enquiries.

Sometimes verification is confused with vouching but they differ from each other on the nature and depth of the examination involved. The fact of the presence of any entry regarding the acquisition of asset does not prove that the particular asset actually exists on the balance sheet date; rather it purports to prove that the asset ought to exist. On the other hand, verification through physical examination and confirmation proves whether a particular asset actually exists without having any charge on the date of the balance Sheet.

Verification of assets involves the following steps:

1. Enquiry into the value placed on assets;
2. Examination of the ownership and title deeds of assets;
3. Physical inspection of the tangible assets; and
4. Confirmations regarding the charge on assets;
5. Ensuring that the assets are disclosed, classified and presented in accordance with recognized accounting policies and legal requirements.

PROCEDURES OF VERIFICATION OF ASSETS

1. The auditor should verify the records (accounting books) with reference to the documentary evidence. Physical verification of fixed assets is the primarily the responsibility of the management.
2. The opening balance is to be verified from schedule of fixed assets, ledger or fixed asset register.
3. Assets acquired during the year or improvements done during the year should be verified on the basis of purchase orders, invoices, material receipt notes, and title deeds.
4. Capital assets built inside (self-constructed fixed assets) and capital work-in-progress should be verified by reference to work-order records, contractor bills.
5. For fixed assets fully depreciated during the year of acquisition, the auditor has to examine whether they were recorded in the fixed assets register.
6. In the case fixed assets registered, the auditor should examine (i) the authorisation procedure (ii) sales process (calling for quotations etc.) (iii) adjustments to the account of the asset (iv) accounting for the proceeds of the sale and (v) adjustment for the gain or loss on the sale.
7. Ownership of assets such as land and buildings should be verified by examining the title deeds. In case the title deeds are with other parties such as bankers (mortages or safe custody) and solicitors, confirmation should be obtained directly by the auditor through a request mailed to the concerned persons signed by the client.
8. Physical verification is the responsibility of the management and they need to ensure that it is carried out at appropriate intervals in order to ensure assets are in existence. The auditor has to ensure that physical verification was done. For this purpose, he should observe the verification being conducted. He should examine the instructions given by the management for

physical verification and working papers of physical verification. It is to be ascertained that the persons carrying out the physical verification has the necessary competence.

VERIFICATION OF GOODWILL

1. Whenever the company has purchased or acquired a running business and has paid for it an amount, in excess of the book value of its net assets, the excess is called `Goodwill'. It can be verified from the vendor's agreement and the auditor has to see whether there is a specific sum which is paid or whether it is the excess of price paid over the tangible assets and see that it is properly recorded.
2. When the company has written up the values of all its assets on a revaluation and has raised a Goodwill Account in the books, the Goodwill appears in the Balance Sheet. In this case, the auditor has to see the basis of valuation and get satisfied about the same. If he is not satisfied, the fact should be reported to the shareholders.
3. He has to see that such excess is credited to a Capital Reserve or Revaluation Reserve and no dividend is being declared from it.
4. He has also to see the disclosure requirement of Schedule VI and ensure that the fact is disclosed for 5 years subsequent to the date of revaluation.
5. Sometimes, Goodwill which is written off earlier may be brought back in the books of account to adjust the debit balance of Profit and Loss account. In this case, the auditor should investigate the fact and satisfy in full before approving such method of creating Goodwill. He should also refer to the board resolution. In case he is not satisfied, the fact should be reported to the shareholders.
6. If Goodwill has been created by any other means, the auditor should see that all relevant facts are properly disclosed and are supported by documentary evidence.

VERIFICATION OF STOCK-IN-TRADE

According to Accounting Standard 2, Stock is a tangible property held for:

(a) Sale in the ordinary course of business or

(b) In the process of production for such sale or

(c) For consumption in the production of goods (i.e. consumable stores).

VERIFICATION OF STOCK

Verification of stock means physical counting, measuring and to verify so as to determine the quantity of stock to be considered for stock valuation. Verification of Stock-in Trade is more difficult than of any other asset due to the following reasons:

(a) It is subject to frequent changes and constitutes the largest current asset of the business.

(b) Numerous methods of pricing the stock-in-trade are in existence.

(c) The determination of its value directly influences the sales and income of the year.

(d) It is exposed to greater risk of defalcation or manipulation.

Objectives of Verification of stock-in trade

Objectives of verification of stock-in trade are:

(a) Ascertainment of the correct profit/loss made during the accounting year.

(b) Disclosure of True and Fair financial position of the business.

(c) Preparation of correct statement of claims for loss of stock, if any, due to fire, flood etc.

(d) Determination of the value of stock on consignment.

(e) Determination of value of stock sold on `Sale or return basis'.

(f) Ascertainment of ownership of stock.

(g) Ascertainment of the fact whether the stock is free from any charge.

AUDITOR'S DUTY AS REGARDS VERIFICATION OF STOCK

As the correctness of the profit of a business depends to a great extent on the accuracy of the valuation placed on the closing stock, it will be readily appreciated that the verification of this asset forms one of the most important part of an auditor's duty. While verifying the stock-in-trade the auditor has the following duties:

(a) Ascertain the method of stock-taking and the basis of valuation.

(b) Ensure that the stock-sheets have been subjected to a good internal check, e.g. they are certified as to have taken prices, extension and additions while determining the stock and also generally approved as correct by managing director.

(c) Check calculations and additions.

(d) Check a few of the important items with actual invoices as to prices.

(e) Examine some of the quantities in stock-sheets with those shown by the stock books, if such stock books are kept.

(f) Ascertain that the stock is valued on the same basis as in the previous year.

(g) Ascertain that obsolete and unsalable stock is shown at fair market prices.

(g) Compare the percentage of gross profit on turnover with that of the previous period and also enquire into the cause of any notable fluctuation.

(i) Ensure that the goods entered as sold and not delivered are not included.

(j) Ensure that the goods bought and not entered in the invoice book are included.

(k) Ascertain that the value of unfinished goods is taken at actual cost and the basis of valuation is the cost of the materials consumed and the wages spent thereon upon the date of the balance sheet.

(l) The goods sold on approval basis are properly included in closing stock.

(m) The stock held does not include goods held on consignment as an agent.

(n) Examine carefully the stock sheets and ensure that the stock includes only the goods dealt with by the client and does not include any asset purchased.

(o) Confirm that stock has been valued at cost or market price, whichever is less.

(p) Obtain from a responsible officer of the organization a certificate regarding the procedure followed in valuation of stock.

According to the Statement on Auditing Practices issued by the Institute of Chartered Accountants of India (ICAI) the auditor is expected to verify the inventories in the following manner:

1. Obtain a certificate from the management regarding physical inventory. However, the auditor must take reasonable care to satisfy himself that:

   (i) The procedures of stock taking were reasonable and would justify the certificate given by the management and

   (ii) The procedures were actually followed.

2. The auditor should check the original physical stock sheets. If possible he should be present at least for sometime during the stock taking and conduct a few sample checks.

3. The auditor should ensure that the book stocks were adjusted for any excess or shortage found on physical verification.

4. In respect of stocks which are not lying with the concern (goods sent for processing, goods on consignment etc) the auditor must obtain and examine the confirmations from the parties holding the stock.

Thus, the above decisions settled the principles as under:

(a) The stock basically belongs to the shareholders and hence it is the duty of the management to physically verify them. Most of the time an auditor has no requisite staff or technical qualification to verify them properly. Hence, the auditor is not responsible for not verifying physical stock of a company existing at the Balance sheet date. In other words, it is not a part of auditor's duty to take stock.

(b) An auditor can rely on the certificate given by the management regarding the verification and valuation of stock existing on the date of the Balance Sheet, after properly scrutinizing the relevant documents available in this matter.

VERIFICATION OF INVESTMENTS

Investment may be a share certificate, government bond certificate, government loan certificate, debenture certificate, etc. For verification of such securities, the following procedure is adopted:

1. Obtain a schedule of investments in hand at the beginning of the audit period. Obtain the details of description of investments together with distinctive number of face value, date of purchase, book value, market value, rate of interest, date of payment of interest or, date around which dividend is declared, etc., with also the details of interest or dividend received along with tax deducted at source.
2. Add to the above list, purchase made during the year and delete the investments sold during the year with all the above details.
3. Balance this schedule and compare the balance with general ledger and Balance sheet.
4. Check the market value of investments with reference to stock exchange quotations or other suitable method, on Balance Sheet date and see that the values are disclosed in the Balance sheet.
5. Inspect the certificates or securities physically on the Balance Sheet date.
6. Compare the income received with amount due and adjust the accrued income.
7. Confirm the uncalled liability on partly paid shares held as investment shown as contingent liability by way of a note to the Balance Sheet.
8. See that adequate provision is made for any shortfall in the book value of investment shown in the Balance Sheet.
9. See that, regarding the investment in subsidiaries, disclosure requirement of section 212 of Schedule VI of the Companies Act, 1956 are complied with.
10. For investment in the capital of partnership, the partnership deed and copy of accounts of partnership firms, is to be verified. Also adjust the share of profit and loss for the partnership period.
11. Investments which stand in the name of persons other than that of the company are to be confirmed with appropriate sanction.
12. For investment lodged with others as security or lying with banks or share brokers, obtain a certificate from the parties concerned.
13. In case of application money paid for shares which are still to be allotted, that fact is to be specially disclosed in the Balance Sheet.

VERIFICATION OF LIABILITIES

Verification of liabilities is also as important as the verification of assets. If the liabilities are overstated or understated the balance sheet shall not represent a true and fair view of the state of affairs of company. Similarly the profit and loss account will be incorrect. The verification of the liabilities is much easier than their valuation. The verification of liabilities implies an enquiry into the nature, extent and existence of liabilities. It involves ensuring the following:

1. That all the liabilities have been clearly stated on the liability side of the Balance Sheet.
2. That all the liabilities relate to the business itself.

3. That they are correct and authorized.

4. That they are shown in the Balance sheet at their actual figures.

It is an important duty of an auditor to verify the liabilities appearing in the Balance Sheet of the company. The object of verification of liabilities is to ascertain whether there is any improper inflation or deflation of values or improper creation of an imaginary liability in the books. This form of manipulation is done in most cases to inflate or deflate the profits of the concern and thus make the position of the business appear stronger than what actually is, to create a secret reserve. As a result of such manipulation, the Profit and Loss Account and the Balance Sheet prove to be incorrect and thus the Balance Sheet does not exhibit a true and fair view of the state of affairs of the concern. So, the auditor must take all possible steps to ensure that all liabilities are recorded properly in the books of accounts of the business. It is advisable that the auditor should, besides verifying the liabilities as shown in the Balance Sheet, get a certificate from the management that all liabilities of any nature have been included in the books of accounts and the contingent liabilities have been shown by way of a foot-note to the Balance Sheet or have been provided for.

VERIFICATION OF SUNDRY CREDITOR

Sundry creditor is the miscellaneous small or infrequent suppliers that are not assigned individual ledger accounts but are classified as a group.

Verification of Trade Creditors

Auditor shall verify the trade creditors of the following way:

1. The auditor will check the accounts of the creditors and will compare it with the purchase ledger.
2. He will compare the accounts with the invoices, receipts, credit notes and the statements.
3. He will verify their balances and will trace them to the list of creditors.
4. Auditor will check the addition in list.
5. He will find the differences if any between figures of the creditors statement and the balance of ledger.
6. For the confirmation of balances, auditor may send the balance statements to the creditors.
7. Auditor will also check the entries of the goods inward book and compare it with the purchase ledger.

VERIFICATION OF LOANS

Auditor should check the agreement documents for getting loan. In case of bank loans and over draft auditor should examine the agreement with bank. Following procedure should be followed by the auditor:

1. To find out the borrowing powers of the firm auditor should examine the legal documents of the company.

2. Auditor should check the resolution of directors of the company for obtaining the loan.
3. Examine the rate of interest, repayment plan and duration.
4. Confirmation of loan should also be checked by the auditor.
5. He should prepare the movement of accounts during the year.
6. He should also verify the interest paid and payable.

VERIFICATION OF TRADE DEBTORS

Auditor will adopt the following procedure for the verification of debtors:

1. Postings in debtor's ledger should be verified by the auditor from the other records.
2. While auditing the book debts auditor should ask the debtors to send the debt statements directly to him.
3. Auditor should obtain a certificate directly from the bank regarding the balances.
4. He may examine the bank ledger by himself.
5. The object of the auditor should be to satisfy himself about the bonafied debts shown in the balance sheet.
6. He should also verify that all bad debts are written off by the authorized person.
7. He should obtain the list overdue accounts.
8. Auditor should compare the ledger accounts with the list of sundry debtors balances.
9. Auditor should note down all the undue advances and allowances given and enquire about them.

VERIFICATION OF CAPITAL

Although capital is not the liability of a company, still it should be verified to enable an auditor to give a certificate in regard to the correctness of the balance sheet. The auditor should examine the Memorandum of Association and the Articles of Association of the company. He should also examine the Cash Book, Pass Book and Minutes Book of the Board of Directors to find out the number and different classes of shares issued.

VERIFICATION OF INVESTMENT

i) The auditor should ascertain the power of the enterprise to make investments by examining the Memorandum of Association in case of investment by a company to ensure that the investments are not ultra-vires the company.

ii) He should also ascertain that all the legal formalities relating to purchase of investments have been duly complied.

iii) Where investments are in large numbers, the auditor should obtain the schedule of securities certified by a senior officer of the company. The statement must include the name of the investment, the book value, the market price, date of purchase etc.

iv) The auditor must verify the whole of the investment at one time. Investments are of a negotiable character and their verification at the same time removes the danger of their substitution for others.

Examples:

(i) Share Capital

Though capital is not a liability of the company the auditor is required to verify it so that he can report on the genuineness of the balance sheet.

The duties of the auditor can be enumerated as follows:

1. If it is the first year of existence of the company

(a) He should examine the Memorandum of Association and Articles of Association.

(b) He should check the Cash Book, Pass Book, Director's Minute Book to find out the number of shares, the various classes of shares, the amount received thereon and the amount due from the shareholders.

(c) If some shares have been allotted to the vendors, he should examine the agreement between the vendors and the company.

(d) In case shares are issued at a premium he should ensure that the premium on issue should be credited to a separate account.

(e) Allotment and call money should be verified.

(f) He should check the forfeiture and reissue of shares, if any

(h) He should ensure that all the relevant provisions of the Companies Act are complied with.

(2) If it is not the first year of the company

(a) The share capital would be the same as in the previous year unless there are some alterations or addition by way of fresh issue or otherwise. He should ensure that the relevant legal provision is fulfilled.

(b) Similarly for reduction of share capital, he should see the provisions of the Act as specified in Sec. 100.

(c) In case bonus shares are issued, the auditor should check whether the permission from concerned authorities is taken, whether proper resolution is passed and whether the capitalization entries are correctly passed.

(d) In case rights shares are issued the auditor should check the bank book, bank statements. He should ensure that the required resolutions are passed and that the permission of the concerned authorities is taken, with particular reference to Sec. 81.

(ii) Reserves and Surplus

Reserves may be general or specific in nature. Sinking fund, Capital Redemption Reserve, Reserve for Contingencies are specific reserves. Auditor's duty in verification of reserves is as follows:

(1) He should check the Profit and Loss Appropriation account for transfer to reserves, to see the provisions of transfer of profit to reserve are complied with.

(2) He should check the board resolution for transferring the profit to the respective reserves.

(3) He should ensure that the movement in the reserve accounts i.e. additions to/deductions from previous year's balance are properly disclosed as per the requirements of the law.

(4) Ensure that reserves are properly utilized as required by law.

(5) See that the reserves are properly disclosed in the balance sheet as per the law.

(iii) Loans Borrowed

For verification of loans, the auditor should consider the following points:

1. The auditor should examine the Memorandum and Articles of the Company to find out the powers of the Company to borrow money.
2. The auditor should examine the agreement and correspondence regarding the loan.
3. The auditor should vouch the receipts of cash on account of loan, with the receipts issued in respect of the loan and the corresponding entries in the cash book.
4. The auditor should examine the certificate of registration issued by the Registrar of Companies, if the loan has been secured by mortgaging any property.
5. The auditor should vouch the payment of interest with the counterfoils of the receipts issued to the vendors and the corresponding entries in the Cash Book.
6. He should also check the repayment of loan with the counterfoils of the cheque books, the bank pass book and the cash book.

(iv) Trade Creditors

1. The auditor should ask for a schedule of creditors and check the same with the purchase ledger as that is already examined by him.
2. He should ensure that all purchase made during the year especially at the end of the year are included in the accounts of the creditors.
3. In case of suspicion about any creditors, the auditor with the consent of the client can ask the statement of account to be sent and verify the same by scrutinizing ledger accounts.
4. He should see the various debits given for discount, goods returned etc, and confirm that the same are genuine.
5. The auditor should ask for the reason for not paying any overdue creditors.

(v) Contingent Liabilities

Contingent liabilities are those liabilities which may or may not arise in the future for payment. The auditor's duty is to see that all known and unknown liabilities have been brought into the accounts at the date of the Balance Sheet and have been shown in the Balance Sheet separately as such:

1. Liabilities on Bills Receivable discounted and not matured: If the bills receivable are discounted with a bank and the money so received from it is made use of, the entire money will be refunded to the bank if the acceptor does not make payment on the date of its maturity. This is why such a contingent liability is distinctly shown in the Balance Sheet by way of a footnote.
2. Liabilities for calls on partly paid shares: The amount called on shares held and paid should be verified from the cash book and the liability for the amount uncalled should be ascertained.
3. Liability under a guarantee: The auditor should ascertain the liability for a guarantee given by the client for a loan or overdraft to his friend or partner. In case of non payment of such a loan, the possible liability should be ascertained.
4. Liability for cases against the company not acknowledged as debts: It is a liability in a disputed case where damages may have to be paid. A contingent liability should be ascertained and a note should be made at the foot of the Balance Sheet.
5. Liability in respect of arrears of Dividend on Cumulative preference Shares: The auditor should examine the Articles of Association which should lay down rules in this regard and due provision should be made for such a liability.

Auditor's duty to verify Contingent Liabilities

The auditor should very carefully check the various contingent liabilities named above. There may be some such liabilities for which no provision has been made in the books but merely a note has been made at the foot of the Balance Sheet, e.g. Bills Receivable which has been discounted and which has not matured at the date of the Balance Sheet, arrears of fixed cumulative dividends, etc. For liabilities in respect of which provision has to be made in the Balance Sheet, viz a suit, etc., the auditor should examine such cases and ascertain the amount to be specifically reserved for the purpose.

The auditor should examine the Director's Minute Book, correspondence made with the legal advisers and the information obtained from the officials of the business. He has to ensure that proper provision has been made for all such liabilities and if he is not satisfied, he should mention the fact in his report. It is to be remembered that the requirements of the Companies Act regarding the contingent liability should be complied with in the Balance Sheet on the liabilities side.

(vi) Provision for Taxation

1. In case of a limited company it is compulsory that the taxation provision is to be made. But it cannot be ascertained accurately because the final liability on this account can be known only when the assessment is completed. Therefore, a fair estimate for providing this liability is

necessary. Hence, the auditor has to verifty the calculation done to arrive at the provision expected to be made.

2. However, when finally the assessment is over, the auditor should see that the excess or short provision is properly adjusted in the books.
3. Where any appeal is pending and the liability challenged, the same is a contingent liability. Hence the same is to be properly ascertained and disclosed in the Balance sheet.

(vii) Employees' Deposits

Normally, in commercial and industrial ventures, the employees who deal with cash or stores are required to deposit cash security as a safeguard against some possible mis-appropriation or pilferage. Sometimes, the employees instead of paying cash endorse trustee securities in favour of the employers. It should be remembered in this connection that :

1. Such a security in cash or in securities should be deposited separately in the bank.
2. It should be shown distinctly on the liabilities side of the Balance Sheet.
3. He should verify the amount of deposits by reference to the certified schedule received from the client.

(viii) Reserve for Bad and doubtful Debts

The verification should be done as follows:

1. The auditor should obtain a certificate from some responsible officer of the business and then check the amount provided for bad and doubtful debts.
2. The schedule of debtors should be compared with the balance of ledger accounts to ascertain the possible amount of bad and doubtful debts.
3. The adequacy of such a reserve has specially to be checked. He should examine the nature, the circumstance of a particular business and the necessary rules in practice in this connection.

(ix) Bills Payable

The auditor should verify the Bills Payable in the following ways:

1. The Bills Payable Book should be checked with the Bills Payable Account.
2. The Bills Payable already paid should be checked from the Cash Book and the returned Bills Payables should be examined.
3. To verify the Bills Payables which have not yet matured at the year end, the auditor should examine the Bills Payable book and should check the Cash Book of the succeeding years to see whether any payment has been made in respect of such bills. In case of any doubt, the auditor may ask the drawers for the confirmation of the bill.
4. The auditor should see if any charge has been created on the assets of the concern by accepting the bill and he should see that the facts are disclosed in the balance sheet.

(x) Proposed Dividend

1. The auditor should ensure that the dividend proposed complies with the provisions of the Companies Act, the decisions of the Court, especially in the matters of provision for depreciation, distribution of capital profits, transfer to reserves etc.
2. The auditor should verifty the board resolution and the entry in the Profit and Loss Appropriation account.
3. The auditor should ensure that as per the requirements of the Companies Act, 1956 gross dividend has been provided for.
4. To ensure completeness, the auditor should cross-check the names in the dividend list with those in the register of shareholders.

(xi) Outstanding Expenses

The auditor should obtain a certificate from a responsible officer to the effect that all the outstanding expenses have been included in the current year's accounts. The amount paid on various accounts should be verified from the entries in the Cash Book. It should be ensured that the outstanding expenses included that part which is unpaid at the date of the Balance Sheet. The following points should be noted.

1. He should carefully note that all expenses, e.g. rent, rates, interest, wages, salary, audit fee, legal expenses, etc., have been accounted for in the books.
2. He should check entries in the books passed on the basis of invoices to ensure that they are not related to the year under audit.
3. He should compare all the paid and unpaid expenses of the current year with those of the previous year to see that there is not much difference.
4. It should be ensured that all outstanding wages and salaries have subsequently been paid.

(xii) Bank Overdraft

The verification of bank overdraft will be on the same lines as that of loans and advances. The difference is that it is the financial assistance obtained from the bank. The auditor should examine the Bank Pass book and call for a statement of mortgaged assets. It is to be remembered that the assets so mortgaged should be clearly stated as such in the Balance Sheet.

(xiii) Debentures

1. The auditor has to examine the provisions regarding the power of the company to issue debentures as contained in Memorandum and Articles of Association.
2. If the debenture is issued as mortgage debenture, he has to verify the registration certificate issued by the Registrar.
3. He should carefully examine the terms of debentures issue as contained in Trust Deed and ensure that the same have been properly complied with.

4. The auditor should vouch the cash received on this account with the cash book.
5. The auditor should verify whether the interest on debentures is paid or provided, properly at regular intervals or not.
6. In case the debentures have been redeemed during the year the same is to be confirmed with the Minutes of Board of directors. Bank Pass book and Cash book, returned debenture certificate etc.
7. If the debentures have been issued as a collateral security, then he should see that the fact is properly disclosed in the Balance Sheet.

(xiv) Unclaimed Dividend

For verifying unclaimed dividend, the auditor should follow the following procedure:

1. See that the Bank Account from which dividend is paid is properly reconciled. See that dividend account is opened for each year to avoid mistake of one year's dividend getting mixed up with next year's dividend. See that no entries remain in these Bank Accounts reconciliation like accounts debited by bank but not accounted in books, etc. because then the Unclaimed Dividend shown in the books will be wrong.
2. See that wherever dividend is declared on shares, where calls are in arrears and directors have decided to adjust the dividend payable against calls in arrears, the appropriate entries have been booked.
3. See that a full list of shareholders who have not claimed dividend is prepared. This is necessary firstly to prove that there are no mistakes committed while reconciling the Bank Account and secondly to prove the accuracy of the Member's Register. The auditor should compare this list with the Member's Register to see that unclaimed dividend for every shareholder is matching with the number of shares held by him as per Share Register. This will also disclose if any dividend is paid to a shareholder who has already transferred his shares provided he has not encashed his dividend warrant.
4. See that if the statutory time limit of 3 years is over, the money being in Unclaimed Dividend Account is transferred to the Central Government with details of shareholders who have not claimed the dividend.

(xv) Calls in Arrears

The auditor should verify Calls in Arrears as under:

1. Find out whether calls in arrears are arising on account of capital issued during the year or is continuing on account of capital issued in earlier years.
2. If it is on account of capital issued during the year, see that correct amount has been arrived at towards call in arrears by referring to the application form money paid towards application, shares allotted, total share money payable, calls made, calls money payable and calls paid. For this he will have to conduct share allotment audit to arrive at all the relevant data.

3. In case calls are in arrears from earlier years, see that reminders have been sent to the shareholders for payment of calls. If the Board has decided to charge interest on such calls in arrears see that reminder contains the request to pay the calls in arrears with interest. If any part of the calls in arrears has been received during the year on which interest was payable see that such call moneys are received with interest.
4. If any transfer application has been received for shares on which some calls are in arrears, see that no transfer has been affected without arrears having been paid first.
5. If the Directors have declared dividend, see that dividend payable on such shares is proportionately reduced and if the directors have decided to appropriate dividend on such shares where calls are in arrears see that dividend is not physically paid out but appropriate accounting entries crediting calls in arrears and debiting dividend payable is passed.
6. If the Board has passed any Resolution forfeiting shares on which calls are in arrears, the same is reflected properly in the accounts by passing of necessary entries and such shares are not continued to be shown as part of capital at full value and calls in arrears continued to be deducted there from.

(xvi) Fixed Deposits

The auditor should keep in mind the following points while conducting fixed deposit verification:

1. Fixed Deposits should be accepted according to Section 58A of Companies Act, 1956 and Reserve Bank of India's guidelines.
2. Fixed deposits from director for less than six months (but exceeding 3 months) should not exceed 10% of paid up share capital and free reserves.
3. Total fixed deposits should not exceed 25% of paid-up share capital and free reserves.
4. Fixed deposit should not be accepted if the period exceeds 36 months.
5. Interest on fixed deposits cannot exceed 15% p.a.
6. Brokerage can be paid subject to limits mentioned below:

   (a) Up to 1 year – not to exceed 1% of amount of deposits.

   (b) 1 to 2 years – not to exceed 1.25% of amount of deposits.

   (c) 2 to 3 years – not to exceed 1.50% of amount of deposits.
7. Liquid assets should be maintained at not less than 10% of deposits maturing 31st March.
8. Receipts should be issued to the deposit holders.
9. Fixed Deposit Register should be maintained.
10. Return of fixed deposits should be sent to the Registrar before 30th June. In case it is not sent, auditor should mention it in the Auditor's Report as per Section 45 MA of Reserve Bank of India Act, 1934.

11. Interest accrued but not due should be provided and it should be shown under Current Liabilities.
12. Fixed Deposits received along with accrued and due interest would be shown under Unsecured Loans.

VALUATION

Valuation is the act of determining the value of assets and critical examination of these values on the basis of normally accepted accounting standard. Valuation of assets is to be made by the authorized officer and the duty of auditor is to see whether they have been properly valued or not. For ensuring the proper valuation, auditor should obtain the certificates of professionals, approved values and other competent persons. Auditor can rely upon the valuation of concerned officer but it must be clearly stated in the report because an auditor is not a technical person.

VALUATION OF ASSETS

Valuation of assets means determining the fair value of the assets shown in the Balance Sheet on the basis of generally accepted accounting principles. The valuation of assets is very important because over-statement or under-statement of the value of assets in the Balance sheet not only distorts the true and fair view of the financial position but also gives wrong position of profitability.

The valuation of the assets is the primary duty of the officials of the company. The auditor is required to verify whether the value ascertained is fair one or not. For this, he may rely on the technical certificate issued by the experts in the field.

Valuation of assets means not only checking value of the assets owned by an organization as on Balance Sheet date, but also critical examination of the value of these assets.

The auditor has also to see that the principle of valuation of assets is consistently adopted and is based on established principles of accountancy.

For the purpose of convenience, those assets are classified as under to determine their value:

1. Fixed Assets
2. Current Assets or Floating Assets
3. Wasting Assets
4. Intangible Assets
5. Fictitious Assets.

1. Fixed Assets

Fixed Assets are usually valued at `going concern value' which means cost less depreciation. Cost here means purchase price of the assets plus all incidental manufacturing, buying and installation expenses incurred to bring the assets in use. Depreciation is the provision made for the reduction in the value of the assets on account of their usage, natural wear and tear and obsolescence etc. The depreciation provided should be fair, otherwise the value of fixed assets may not be fair. What is a fixed asset depends on the nature of the business organization.

2. Current Assets or Floating Assets

These are usually converted into cash at the earliest opportunity in the process of business activity, e.g. stocks, bills receivables, sundry debtors, etc. Based on conservatism principle, usually current asset are valued at original value (cost price) or market value (realizable value) whichever is lower. Because they are intended to be converted into cash at the earliest possible time, hence what value we may realize is important. This method is adopted to strengthen the financial position of a concern by indirectly providing for expected loss by way of fall in the market value of the assets. This principle is held by the conservatism convention of accounting, i.e. do not expect profits but provide for anticipated losses.

3. Wasting Assets

Wasting Assets means those which lose their value gradually upon their use, e.g. a mine, a quarry etc. To value these assets firstly we should determine the usefulness of the assets in terms of units of production etc. and as per their actual use the value is to be reduced on proportionate basis. If in a particular period this type of asset is not used then the value may not diminish also. Thus, these assets are to be reduced on the basis of consumption. But sometimes it may be difficult to adopt this method, then the `cost less depreciation' principle may have to be applied.

4. Intangible Assets

Usually intangible assets like goodwill, patent rights, know how, etc. are valued on cost basis. But if the same are acquired by a non-cash transaction, then the fair market value is to be taken as the value of intangible assets. Auditor should also see the period of time and till it is fully written off, they are shown as assets because they do not have any realizable value. They are to be valued at actual cost less amount written off as depreciation up to Balance Sheet date.

5. Fictitious Assets

Certain lump sum expenses giving benefit for more than one year when incurred are written off over a period of time, and till it is fully written off, it is shown as an asset in the Balance Sheet e.g. preliminary expenses, discount on issue of shares etc. These are all fictitious assets because they do not have any realizable value. They are to be valued at actual cost less amount written off up to the Balance Sheet date.

METHODS OF VALUATION OF ASSETS

Valuation of various assets can be made by using different methods. Valuation of fixed assets can be made in different ways. Some of the major methods are as follows:

1. Cost Method

In this method, valuation of assets is made on the basis of purchase price of the assets. It is very simple method of valuation of assets. Sometimes, existence of one asset depends on the existence of another. Then it is difficult to use this method.

2. Market Value Method

Valuation of assets can be made on the basis of market price of such assets. But if same nature of assets is not available in the market, it is very difficult to determine the value of such assets. So, there are two methods related to it. They are:

i. Replacement Value Method

If same asset is to be purchased then on the basis of same value, valuation of assets can be done.

ii. Net Realizable Value

It refers to the price in which such asset can be sold in the market. But expenditure incurred at the sale of such asset should be deducted.

3. Base Stock Method

Under this method of valuation, company should maintain certain level of stock and valuation of stock is made on the basis of valuation of base stock.

4. Standard Cost Method

Some of the business organizations fix the standard cost on the basis of their past experience. On the basis of standard cost, they make valuation of assets and present in the balance sheet.

5. Average Cost Method

It is a simple method for the valuation of such assets which cannot be distinguished. Like petrol, petrol is kept in the tank but cannot separate its stock on the basis of lot. So, valuation of stock is made adding to all the cost and dividing by the quantity.

6. Scrap Value

Assets which are useless for the enterprise may be sold as scrap in the market. The value, for which such assets can be disposed of as scrap, is called as scrap value of assets.

AUDITOR'S POSITION REGARDING VALUATION OF ASSETS

So far as the valuation aspect of audit is conceded, the auditor's position is somewhat different from the other aspects of audit. It has already been pointed out that the auditor is not supposed to have technical knowledge regarding the valuation of assets. Therefore, he has to depend upon the valuation made by the directors, expererts, surveyors, etc, to a great extent.

The reply is definitely no, because the auditor cannot give a guarantee for absolute correctness or the state of affairs when he has to depend upon others, and also where assets are valued according to the estimated depreciation. He has to see that the management tries to show the fairest possible estimate of the position of the state of affairs of the concern.

Under these circumstances, the auditor should see that assets are valued according to certain accepted principles of accountancy. He should check the estimation in a reasonable manner. The auditor in any case should thoroughly examine the available papers and documents to arrive at the correct value of assets. In case of a little suspicion as regards the valuation of assets he should probe into the matter.

VALUATION OF GOODWILL

Goodwill is defined as the assessed value of the reputation of a business or as the difference between the purchase price and the net assets which are purchased and the excess amount so paid, represents the goodwill acquired by the business. It is intangible asset. It value depends upon the earning capacity of the business and fluctuates accordingly. In case the Directors have debited the profit and loss account and credited the amount to the goodwill account, the auditor should object to this step especially when the action taken is likely to prejudice the interest on any class of shareholders. He should mention this fact in his report to the shareholders if such a step has been taken.

VALUATION OF STOCK-IN-TRADE

Valuation of stock-in-trade means finding out the proper value of the closing stock for recording in the books and disclosure in the account.

Auditor's duty as regards stock valuation

1. The auditor should ensure that there is no change in the method of valuation.
2. In case there is a change in method of valuation of stocks as compared to the previous year, the auditor should disclose this fact in his report and ensure that the method is proper and recognized.
3. The auditor should ensure that the stock is valued and recorded according to the generally accepted principles of evaluation. He should ensure that the valuation is done in confirmation with the guidelines issued by the ICAI.
4. The auditor should check the computational accuracy of stocks by testing a few calculations involved in valuation.
5. The auditor should ensure that there is no over/under valuation of stock which will distort the true and fair view of the accounts.
6. The auditor should see that as required by the Schedule VI to the Companies Act, 1956, the values of stores and spare parts, loose tools, stock-in-trade and work-in-progress must be disclosed separately.
7. Under MAOCARO, 1988 a company auditor has to report whether:

   (a) He is satisfied on the basis of the examination of stocks, that such valuation is fair and proper in accordance with normally accepted accounting principles.

   (b) The basis of valuation of stocks is same as in the preceding year. If there is any change in the basis of valuation the auditor has to report the effect of such change.

   (c) Any unserviceable or damaged stores, raw materials or finished goods were determined on physical verification and the provision for loss made and

(d) In the case of a trading company any damaged goods have been determined and the provision for loss made.

8. As required by CARO, the auditor should ensure that the valuation of stocks is fair and proper in accordance with the normally accepted accounting principles.

VALUATION OF INVESTMENTS

Having verified the existence of the investments the auditor should now proceed to find out whether they are properly valued at the date of the balance sheet. The basis of the valuation of investments in the balance sheet will, to a large extent, depend upon the purpose for which they are held. If they are held by Trust Company, the object of which is to earn dividends and interest and distribute such dividends and interest amongst the shareholders, such investments are to be treated as fixed assets and, therefore, even permanent fall in their value may be ignored, of course, subject to Articles of Association and the Memorandum of Association of the trust Company.

PROBLEM IN THE VALUATION OF ASSETS

The accuracy of the balance sheet and the estimated profits of a concern depend upon the correct valuation of the assets and liabilities. The valuation of the assets is made by the proprietors or officials of the company or the firm. The auditor has simply to apply certain tests regarding the valuation of the assets. He is entitled to rely upon the certificates of competent persons such as values, surveyors, etc. If he does so he must mention this fact in his report. He cannot be expected to possess the technical knowledge to find out the value of the assets. Under such conditions, he should also refer to the invoices to find out the price at which such assets were acquired. Of course, he cannot guarantee the correctness of the valuation of the assets.

The assets should be valued as for a going concern concept. Therefore, the assets are valued taking into consideration the following: Their original cost, the probable working life of the assets, the wear and tear of the assets, break-Up value of the assets, and the chances of the assets becoming obsolete. The duty of the auditor in such a case to see that the basis of valuation and the calculations are correct and that all contingencies are provided for.

VALUATION OF ASSETS DURING INFLATIONARY PERIOD

A problem which confirms an auditor is as to how to value the assets during the Inflationary period, e.g.

1. Valuation of stock is not sufficient to meet the cost of replacing the same quantity of stock.

2. The depreciation charges based on the historical cost of fixed assets will not provide sufficient amount required to meet the cost of replacing those assets if they are needed to be replaced later on.

3. If depreciation is provide on the historical cost of the assets and similarly if the stock in trade is also valued accordingly, the profits shown by the profit and loss account will not reflect an increase or decrease in terms of the purchasing power of the money.

To solve the above problems, the following suggestion has been made:

1. The fixed assets should be valued at replacement cost.
2. The fixed assets should be written up according to the market price of the assets prevailing on the balance sheet date.
3. The stock-in-trade should be valued at the market price and depreciation should be provided on the value of the stock so arrived at.
4. The index method of adjusting the accounts to reflect the changes in the purchasing power of money should be followed.

AUDITOR'S POSITION AS REGARDS THE VALUATION OF ASSETS

The auditor is not fearlessness or a technical hand to estimate the value of an asset. He has to depend a great extend on the valuation by a directors, partners, experts, surveyors, etc. But does it mean that he is absolved from his liability if assets are overvalued by the directors, etc, and if he entirely depends upon them? Does he guarantees the absolute correctness of the balance sheet under such circumstances? The answer is no. He must see that the assets are valued according to certain principles of accountancy. In certain case, the market value of assets is available, e.g., in case of investment, when he should see that the assets are valued accordingly. The auditor has to see whether the valuation is accordingly to the accepted principles of accountancy.

A method of assessing the worth of a company, real property, security, antique or other item of worth. Asset valuation is commonly performed prior to the sale of an asset or prior to purchasing insurance for an asset.

Asset valuation may consist of both subjective and objective measurements. For example, in valuing a company, there is no number on the company's financial statements that tells how much its brand name is worth; this aspect of asset valuation must be subjective. On the other hand, net profit is an objective measurement based on the company's income and expense figures. Common methods for determining an asset's value include comparing it to similar assets and evaluating its cash flow potential. Acquisition cost, replacement cost and deprival value are also methods of asset valuation.

Valuation of Liabilities

The valuation of traditional investment fund holdings essentially relies solely upon a valuation of the asset side of the balance sheet because such funds do not carry debt. Hedge funds, however, use a variety of leverage instruments to boost their returns. Unless these liabilities are valued, it would create a mismatch for the net asset value of the fund by marking the asset side of the balance sheet to market but leaving the liabilities at cost.

Valuation Methods

The Introduction to the International Valuation Standards (IVSs) states that the standards apply to the valuation of both assets and liabilities. The definition of Market Value in the IVSs specifically includes liabilities in addition to assets. The IVS Framework identifies the three principal valuation approaches, the Market Approach, the Income Approach and the Cost Approach. Within each approach, there are various methods that have evolved and that are used to a greater or lesser extent for different types of asset/liability or in different markets. The Board believes that all three approaches are applicable to the valuation of liabilities.

The method of valuation of Liabilities consists of the following:

1. As indicated in section 1 a liability can be extinguished by a holder in a number of ways. It can be fulfilled, transferred to a third party or settled with the beneficiary. Different methods can be used to replicate these different scenarios. As in the case of assets, it is often prudent to use more than one method to estimate the value of a liability, although not all methods will be appropriate or applicable to all scenarios.

2. A holder of a liability would rationally seek to mitigate or eliminate a liability to the greatest extent possible. This would mean that the holder would adopt the lowest of the costs involved in fulfilling, transferring or settling the liability.

3. While fulfilment is normally an option under most scenarios, transfer or settlement does require a willing counterparty or market participant. For some types of liability there may be no market into which a transfer could be negotiated at any price, thus meaning methods that are predicated on transaction data have no relevance. Settlement would require agreement with counterparty, a situation that would not exist in the case of a statutory liability.

4. The Market Approach provides an indication of value by comparing the subject liability with identical or similar liabilities which are actively traded and for which price information is available. If financial instruments, insurance and pension liabilities are excluded there are few liabilities for which an active market exists and for which price information is available.

5. The Board believes that the market approach has little application to the valuation of liabilities falling within the proposed project scope, although would be interested to learn that any liabilities that are traded in an active market can be commonly applied.

6. The Discounted Cash Flow method is a very common method under the Income Approach and has many detailed variations. The IVSC's discounted Cash Flow Method provides guidance on the principles involved in building a cash flow model. The Board is interested in exploring the diversity that exists when this method is applied in the valuation of liabilities in order to identify where supplementary guidance may be appropriate.

7. The Board is interested in learning which inputs are commonly used in projected cash flows to fulfil, transfer or settle the underlying liabilities.

8. The Board is aware that there is significant diversity in the approach adopted for deriving the discount rate when applying a discounted cash flow method to the valuation of a liability. IVSC the discounted Cash Flow Method indicates that the discount rate should reflect the time value of money and the relative risks associated with the cash flow. Those risks are comprised of market (or systematic) risks and asset or entity specific risks. The discount rate also has to reflect the nature of the cash flows to which it is being applied. Some apply these principles to the value of liabilities.

9. However, many argue that when valuing a liability the systematic and market risks that are associated with a corresponding asset are of little or no relevance. Whereas an increased risk to an investor in an asset is rewarded by an increase in the required return and a corresponding reduction in the capital value, an increase in the risk associated with a liability should increase the negative value of the liability, not decrease it. Also, the risk faced by a holder of a liability is that the cost of fulfilling the liability when it becomes due exceeds the sum set aside to meet it and is correlated with the nature of the liability rather than the nature of the asset. For example, the risk associated with accepting a sum today to reflect future cost of remediating a contaminated industrial site is correlated with the risks associated with the contamination and the procedures necessary for its remediation, not with the risks associated with investment in uncontaminated industrial land. For this reason it is argued that the risks associated with a liability are often better reflected in the cash flows than in the discount rate.

10. The Board is also interested to learn that the extent to which techniques such as option pricing and Monte Carlo simulation are used to estimate the current value of liabilities which are dependent upon uncertain future events.

REVIEW QUESTIONS

Descriptive Type

1. Discuss various tips to be considered while conducting verification.
2. Explain principles of Verification.
3. Discuss various techniques of Verification.
4. Explain procedures of Verification of Assets.
5. Discuss auditor's duty as regards verification of stock.
6. Explain verification of Capital.
7. Discuss valuation of Assets.
8. Discuss problem in the valuation of Assets.

Analytical Type

1. Discuss the scope of Verification.
2. State various objects of Verification.
3. Explain various advantages of Verification.
4. Discuss verification of Goodwill.
5. Explain verification of Stock-in-Trade.
6. Discuss objectives of verification of stock-in trade.
7. Explain verification of Investment.
8. Discuss verification of Capital.
9. Explain various types of Assets.
10. Discuss methods of Valuation of Assets.

Conceptual Type

1. Give the meaning of Verification.
2. State any two objects of Verification.
3. State any two advantages of Verification.
4. What is Goodwill?
5. What is Stock?
6. What do you mean by Valuation?

7. What is Fixed Asset?
8. Give the meaning of Current Asset?
9. What is Wasting Asset?
10. What is Intangible Asset?

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Unit 4

AUDIT OF DIFFERENT ORGANISATIONS

Highlights

- Meaning of Sole Trader
- Characteristics of Sole Trader
- Audit for Sole Trader
- Definition of Partnership
- Characteristics of Partnership Firm
- Audit of Partnership Firm
- Audit Procedure
- Advantages of Audit of Partnership Firm
- Auditor’s Duty Regarding Audit of Partnership Firm
- Co-Operative Societies
- Characteristics of Co-operative Organization
- Audit of Income
- Audit of Expenditure
- Education Institutions
- Audit of Educational Institutions

INTRODUCTION

An organizational audit is a procedure for examining the educational practices, procedures, programs and policies of an agency. There are different types of business organisations from the point of view of their formation and legal aspects. Amongst the different types of business organisations the important types are the sole-Trader business and partnership business forms of organisation. Unlike company form of organisation, there is no compulsion in conducting audit for these two types of organisations as a matter of legal requirement, because under these two types of organisations, the owners have direct control over the day-to-day management and accounts are being prepared under the direct control and supervision of the owners.

The various activities under organisational audit:

i) Interview at least two people who work in the agency. One should be a top administrator of either the total agency or of a particular unit being examined. The second should be a person working to actually deliver services of some sort to clients, students, or trainees, such as a program planner, trainer, teacher, counsellor, or coordinator. Additional people can be interviewed depending on time, availability, and permission of agency administrators.

ii) Observations within the agency, such as of on-going classes or programs, media centres, resource centres, and library materials. It also should include an examination of any learning and/or training resource materials.

iii) Acquiring available literature, documents, and reports that describe the policies, philosophy, and procedures of an agency or a particular unit being examined.

iv) Touring the facilities, including training centres, workshop cites classrooms, tutorial rooms, etc.

Additional activities that would seem appropriate to help you acquire a good understanding of what the unit does in delivering continuing education or training programs, courses, or resources can be developed on site and with the support of agency administrators. For example, although it is frequently difficult, interviews with learners or trainees or past students sometimes can be quite informative. Reading evaluative reports from students and others also can be useful if available. The purpose of this particular audit is to obtain information about existing programs or opportunities for self-directed, individualized adult learning.

Meaning of Sole Trader

Sole Trader refers to a business structure in which an individual and his/her company are considered a single entity for tax and liability purposes.

Definitions of Sole Trader

According to *Glos & Baker,* "A sole Trader is a business owned by one person who is entitled to all of its profits".

According to *Reed & Conover,* "The sole Trader is a business owned and controlled by one man even though he may have many other persons working for him".

CHARACTERISTICS OF SOLE TRADER

i) ***Single Parson:*** This is run by an individual. He will be the monarch of the situation. He enjoys all profits and suffers all losses.

ii) ***Capital Contribution:*** The capital is contributed by the individual. It may be own or borrowed.

iii) ***Management and Control:*** The whole show is run by the individual. He or she takes the decision and faces the consequences. The complete control of the unit will be in one hand. It can be managed in any way.

iv) ***Profit or Loss:*** The profit or loss of the concern is borne by the individual alone and will not be shared by any one.

v) ***Economic Risk:*** Even the business risk is to be borne by the individual alone and cannot be shared by any other person.

vi) ***No special Law:*** This is not governed by any law. One can start the business at one's will and dissolve it at any time when one wants. This is not covered by any other legislation. General business laws are also applicable to them. Any person competent to enter into a contract can start the sole trading concerns. An insolvent cannot run the business in his name.

AUDIT FOR SOLE TRADER

A sole trader may be just one individual providing services or the individual may have any number of employees working for them. For many reasons a business may be structured as a sole trade. It may depend on the age or size of the business or a professional service provider may be required to operate as a non limited liability entity. Tax efficiency reasons can often play a role as well.

Sole trader accounts will be required for tax purposes as well as being used for decision making and management purposes. Accounts will also be needed for dealings with external bodies such as banks, government grant providers, etc.

A sole trader is under no legal obligation to have his accounts audited. However, many such individuals get their financial statement audited due to regulatory requirement such as stock brokers or on specific instructions of the bank for approved of loans etc. The auditor can determine the scope of the audit as well as the conditions under which it will be carried out.

Meaning of Partnership

A partnership is an association of two or more persons to carry on, as co-owners, a business and to share its profits and losses. The partnership may come into existence either as a result of the expansion of the sole-trading concern or by means of an agreement between two or more persons desirous of forming a partnership.

Definition of Partnership

Under Section 4 of the Partnership Act 1952, "The relation between persons who have agreed to share profits of a business carried on by all or any one of them acting for all".

CHARACTERISTICS OF PARTNERSHIP FIRM

1. ***Association of Two or More Persons:*** In partnership firm as discussed earlier there must be at least two persons. Partnership is the outcome of a contract, so there must be two or more persons. The persons becoming partners must be competent to enter into a contract. Minors cannot form a partnership firms they are incompetent to enter into a contract.

2. ***Contractual Relation:*** The persons joining the partnership enter into a contract for running a business. According to Partnership Act, the relation of partnership arises from the contract and not from status. The contract may be oral or written but in practice written agreement is made because it helps to settle disputes if they arise later on.

3. ***Earning of Profits:*** The purpose of the business should be to make profits and distribute them among partners. If a work is done for charity purposes or to serve the society it will not be called partnership. So, the motive of the business should be to earn profits. It doesn't mean that there will not be loses but the emotive should be the earning of profits.

4. ***Existence of Business:*** Partnership can only be for some kind of business. The term "Business" includes any trade, profession or occupation. By business we mean all activities concerning production, distribution and rendering of services for the purpose of earning profits. If the work is related to social service, we do not call it a business and hence, no partnership.

5. ***Implied Authority:*** There is implied authority that any partner can act on behalf of the firm. The business will be bound by the acts of partners.

6. ***Unlimited Liability:*** As the case of sole-trade business liability of the partners of a firm is unlimited. In case some obligation arises then not only the partnership assets but also the private property of the partners can be taken for the payment of liabilities of the firm to the third parties.

7. ***Principal and Agent Relationship:*** In partnership the relationship of principal and agent exists. It is not necessary that all partners should work in the business. Any one or more partners can act on behalf or other partners. Each partner is thereby an agent and can hence bind the firm through his activities and thereby bind other partners too.

8. ***Utmost Good Faith:*** The very basis of the partnership business is good faith and mutual trust. Every partner should act honestly and give proper accounts to other partner. The partnership cannot run if there is suspicion among other partners. It is very important that the partners should act as trustees and for the common good of all. Distrust and suspicion among partners may lead to the failure of many firms.

9. ***Restriction to Transfer of Shares:*** No partner can sell or transfer his shares to anybody else

without the consent of the other partners. In case any partner does not want to continue in the partnership, he can give a notice for dissolution of firm.

10. ***Common Management:*** Every partner has right to take part in the running of the business. It is not necessary for all partners to participate in the day-to-day activities of the business but they are entitled to participate. Even if partnership business is run by some partners, the consent of all other partners is necessary for taking important decisions.

11. ***Partners and Partnership are one:*** A partnership firm has no separate entity from the partners. A firm is only a name to the collective name of partners. No firm can exist without partners. The rights and liabilities of partners are the rights and liabilities of the firm. Partners have implied authority to bind the firm for their acts.

12. ***Capital Contribution:*** The partners contribute to the capital of the firm. It is not necessary to have capital in profit sharing ratio. A partner can be admitted to the firm even without contribution of capital. It is not essential that the partners should contribute to the firm's capital.

13. ***Protection of Minority Interest:*** All important decisions are generally taken by consensus. It ensures protection of those who may not agree to the majority view point. A partner may even ask for the dissolution of partnership if he feels aggrieved.

14. ***Continuity:*** There is no true limit for the continuity of a partnership firm. It goes on up to the time the partners want it to go. Any misunderstanding among partners, death or insolvency of a partner may dissolve the partnership. Dissolution of partnership does not necessarily mean dissolution of the firm. The remaining partners may continue the firm after meeting the claims of the outgoing partner.

AUDIT OF PARTNERSHIP FIRM

Audit of partnership firm is not compulsory & even the Partnership Act 1932 is silent about this. But introduction of the Finance Bill 1984, Section 44 AB made it compulsory to get the accounts audited for those assessee firms who sales turnover exceeds Rs 20 lakh per year.

It is better to get the accounts audited even if it is not compulsory, because joint ownership of a firm by two or more persons may lead to friction & dissatisfaction among the partners. In such a situation an independent auditor's report on the accuracy of accounts becomes desirable.

Following are the important points in the audit of accounts of a partnership firm:

(1) Appointment of auditor- The partners of the firm appoint the auditor.

(2) Rights and duties of auditor- Since the audit has to be undertaken by the mutual consent of the auditor and the partners of the firm, rights and duties are also fixed by the partners of the firm.

(3) Scope of the audit- The partners of the firm also fix scope of the audit.

(4) Remuneration of the auditor- The firm also fixes remuneration of the audit.

(5) Report of the audit- Auditor submits his report to the partners of the firm.

The audit of the partnership firm is not governed by any law. Therefore all the terms of the audit have to be fixed by the partners of the firm. There should be a clear understanding between the auditor and the partners of the firm to avoid any future problem.

Letter of Engagement -It is advisable that the auditor should obtain a letter of engagement from the partnership firm. It will contain all the agreed terms between the parties. This will avoid all future disputes.

AUDIT PROCEDURE

1. *Partnership deed* – Auditor must study the partnership deed before starting the audit. The clauses containing the working of the firm should be carefully studied.
2. *Explanations* – If the partnership deed is silent about any important matter, it should be clarified with the partners of the firm.
3. *Powers and duties of partners* – Auditor should inquire about the powers and duties of the partners. It should be checked that they work within their powers.
4. *Division of work* – Division of work among the partners should be studied carefully. It should be checked that the partners work for the allotted work to them.
5. *Study the financial clauses* – Auditor should carefully study the clauses of the deed regarding the salary of partners, interest on the capital, and interest on drawings.
6. *Checking of the books of account* – After studying the special points in the partnership deed, auditor can start checking the books of account as in any other routine audit.
7. *Report of the audit* – Auditor should submit the report to the partners of the firm.

ADVANTAGES OF AUDIT OF PARTNERSHIP FIRM

1. Auditing the accounts of a partnership firm helps in detecting errors & frauds & verification of financial statements.
2. Disputes, if any between any partners in the matter of accounts can be settled with the help of audited accounts.
3. Banks & financial institutions lend money to the firms only on the basis of audited accounts.
4. As per the requirements of section 44 AB of the Finance Bill 1984 audit of accounts of the firm is compulsory if its gross sales exceed Rs 20 lakh per year. So for Income Tax Assessments audited accounts are helpful.
5. Periodical visits & suggestions by the auditor will be helpful in improving the management of the firm.
6. For settling accounts between partners at the time of admission, death, retirement, insolvency, insanity, etc audited accounts are accepted by those concerned who have dealings with the firm.

AUDITOR'S DUTY REGARDING AUDIT OF PARTNERSHIP FIRM

1. The auditor should get definite instructions in writing as to the work to be performed by him.
2. It must be clear, whether the work to be performed by him is in the nature of accountancy or auditing. In case of auditing he should be clarified whether it is "Partial Audit" or "Complete Audit." In the absence of instruction complete audit is implied. If he does not conduct complete audit he will be held liable for damages.
3. Sometimes, the auditor is asked to prepare Income Tax Returns on behalf of the firm. In this case the auditor should report the accounts as prescribed by the Central Board of Revenue.
4. According to the form prescribed by the Central Board of Revenue, the auditor should mention:
   a) In what capacity did he works
   b) Whether the records of the firm appear to be correct and reliable
   c) Whether he was able to obtain all information and explanation necessary for his work
   d) Whether any restriction was imposed upon him
5. The auditor should read the partnership agreement and note the following provisions:
   a) Nature of the business of the firm
   b) Amount of capital contributed by each partner
   c) Interest – in respect of additional capital contributed
   d) Duration of partnership
   e) Drawings allowed to the partners
   f) Salaries, commission etc payable to partners
   g) Borrowing powers of the firm
   h) Rights and duties of partners
   i) Method of valuation of goodwill
   j) Method of settlement of accounts between partners at the time of admission, retirement, admission etc.
   k) Any loans advanced by the partners – 6% interest
   l) Profit sharing ratio
6. If there is any doubt about interpretation of the agreement he should consult the client's solicitor.
7. If partners maintain minute book he refer it for any resolution passed regarding the accounts.
8. He should study the internal check system in operation.

9. He should a list of the members and staff with their powers and duties.
10. He should examine the contract entered into by the firm with the third parties.

CO-OPERATIVE SOCIETIES

The Co-operative movement has been necessitated to protect the interests of weaker sections of society. The primary objective of this movement is "how to protect economically the weaker sections of the society from the oppression of economically strong segment of the society?" In all forms of organization, be i.e., sole trading, partnership, joint Stock form of organization the primary motive was profit making where as Co-operative societies voluntary associations are started with the aim of service to members for serving their own interests. It is self help through mutual help. The philosophy behind Co-operative movement is 'all for each and each for all".

Definition of Co-Operative Societies

According to Section 4 of the Co-operatives Societies Act, "Co-operative society is those which have an objective to promote the economic interests of members in accordance with the co-operative principles."

CHARACTERISTICS OF CO-OPERATIVE ORGANIZATION

1. ***Voluntary Membership:*** Everyone is at liberty to enter or leave the co-operative society as and when he likes. Nobody is compelled to join co-operative society. The members are also free to use or not to use the services of society. The members are also free to use or not to use services of the society. The members are also free to use or not to use the services of the society. Though there is no limit on the membership of the societies, sometimes certain limits are imposed to keep the society as a workable group.

   Consumer co-operatives do not restrict the membership but marketing co-operatives producers' co-operatives, insurance societies etc.

2. ***Political and Religious Neutrality:*** The membership of a co-operative society is open to all irrespective of religion, caste, creed, color or political affiliation. The co-operative movement can attract a large membership only by staying out of politics where people have divided opinions. Co-operatives represent universal brotherhood and it should not lose its path in political contradictions. There is no place of caste or discrimination.

3. ***Democratic Management:*** The management of Co-operative societies is always on democratic lines. All the members of a society elect a body of persons to conduct and control the day-to-day working of the society. The members frequently meet and give guidelines to its executive. The management is elected through 'one-man, one vote' system. The day-to-day work is conducted by expert persons but the ultimate control lies with the members.

4. ***One Man, One Vote:*** In co-operative societies every member is given on devote irrespective of his contribution towards the capital. In joint stock companies, the voting rights are given on the basis of number of shares held by a person. So persons having large number of shares control shares held by a person. So persons having large number of shares control the organization.

5. ***Service Motive:*** The primary objective of co-operative societies is to provide service to their members. The aim is not to earn profits as is the case in all other forms of organizations. The service of members is the fundamental objective of co-operative societies. The societies earn a small amount of profit to cover up administrative expenses. The profit is generally earned when goods are sold to non-members.

6. ***Distribution of Surplus:*** The societies earn surplus from their services. This surplus is not divided according to capital contributions. It is distributed according to purchase made by members in case of consumer co-operative and according to goods delivered to the society for the sale in case of producers' co-operatives. The Indian Co-operative Societies Act has provided certain guidelines for the distribution of surplus.

7. ***Cash Trading:*** Another principle of co-operative societies is trading on 'cash basis'. Co-operative societies are trading on 'cash basis'. Co-operatives flourish only when cash trading principle is strictly followed. Cash trading ensures economy for the co-operatives. It eliminates bad debts and collection expenses. Credit system reduces working capital of societies.

8. ***Limited Interest on Investments:*** The pioneers of Co-operative movement wanted to give certain percentage on capital contributions in the form of dividend. This is an incentive to members for keeping money with the society as deposits. In India, a maximum of 9 percent per annum can be paid as interest as contribution to society.

ADVANTAGES OF AUDIT OF CO-OPERATIVE SOCIETIES

1. Auditing the accounts of a co-operative society helps in detecting errors & frauds & verification of financial statements.
2. Auditing the accounts of a co-operative society ensures that no member is holding more than 20% of the total shares or that the value of shares doesn't exceeds Rs 1000.
3. Periodical visits and suggestions by the auditor will be helpful in improving the management of the co-operative society.

AUDITOR'S DUTY REGARDING AUDIT OF CO-OPERATIVE SOCIETIES

1. The auditor should study the Co – operative Societies Act and the Bye Laws of the society concerned.
2. The auditor should thoroughly examine the membership register in order to ascertain the number of shares held by each member. He should also check whether the shares held by any member exceeds prescribed limits i.e. 20% of the total number of shares or share value exceeds Rs 1000.
3. He should assess the internal control system in operation in the society to find out the strengths and weaknesses of the system.
4. Cash in hand at the end of the year should be counted by the auditor to verify the balance.

5. The auditor should see that reserve has been created with at least 25% of the profits of the society.
6. The auditor should also whether surplus funds if any, have been invested in approved securities.
7. The auditor should find out & report whether the objectives for which the society under audit was formed are being accomplished in the course of its working.

AUDIT OF INCOME

1. The auditor should vouch cash received on account of share capital with the Registrar of Members.
2. Cash received against sales should be vouched with cash memos, sales account & invoices issued to customers.
3. Receipt of cash in respect of interest received & repayment of loans advanced by the society should be vouched with the loan agreements.

AUDIT OF EXPENDITURE

1. The auditor should vouch capital expenditure with reference to authorization from the Managing Committee, bills received from parties, enteries in the pass book along with counterfoils of cheques.
2. The auditor should pay special attention to the loans given by the society to its members. The auditor should vouch this item with the help of resolution passed by the managing committee, cheques issued to members & enteries in cash book.
3. The auditor should verify payments of dividends made to the members of the society.

EDUCATION INSTITUTIONS

An educational institution is a place where people of different ages gain an education, including preschools, childcare, elementary schools, and universities.

AUDIT OF EDUCATIONAL INSTITUTIONS

Audit of books of educational institutions like school, college, universities etc. or other such institutions which are engaged in the educational field is known as audit of educational institutions. Auditor should check income and expenditure account and balance sheet of such institutes in order to verify and report the true and fairness of results presented by income statements and financial position presented by the balance sheet. Generally, the methods and procedures for vouching and auditing are same even though an auditor of educational institution should perform following tasks:

1. The auditor should go through the University Act. Trust deeds and should note the rules and regulations relating to accounts. The governing body may pass resolutions from time to time in respect to accounts. A copy of minutes books should be made available to him so that he

may be able to confirm whether the decision of the government body have been compiled with.

2. Auditor should obtain a copy of budget or financial statements to study of different heads of income and expenditure.
3. Auditor should thoroughly assess the strength of internal check.
4. Auditor should vouch the grant-in-aid from the government carefully.
5. Auditor should verify the receipts of monthly fees from students, from counterfoils or carbon copy of the receipts. He should also see whether cash received has been banked daily or not.
6. Other charges from the students such as examination fees, laboratory fees, fines etc. should be carefully verified.
7. Any fees received in advance should be properly adjusted.
8. The concession of fees and other charges should be duly authorised by the proper authority. Any charges becoming irrecoverable should be written off only after proper authority has recommended.
9. Any grant-in-aid or funds received for a particular purpose must be utilised for the same.
10. The donations and other subscriptions from the various authorities have been accounted for and acknowledged.
11. The income from property, investment etc., should be properly verified from the vouchers.
12. Auditor should vouch the amount of salaries paid with the Salary Register. Any increment given to an employee shall be duly sanctioned.
13. The staff provident fund should be verified and it should be seen that it is invested as per the rules.
14. The establishment expenses must be carefully vouched and it should be seen that capital expenditure has not been treated as revenue expenditure or vice versa.
15. The payment of scholarship should be verified with the receipt from students and Scholarship Register.
16. All the assets and liabilities should be properly exhibited in the balance sheet.
17. The stock of equipment, stationary, furniture should be carefully verified.
18. While making payment of staff salaries, income tax should be deducted at source and shall be duly deposited with the Income Tax Department.

ADVANTAGES OF AUDIT OF EDUCATIONAL INSTITUTIONS

1. Auditing the accounts of an educational institution helps in detecting errors and frauds and verification of financial statements.
2. To see that the contributions to the provident fund both by the management and the staff are collected as per directions of the government and is properly invested in approved securities.
3. To see that the capital and revenue items are properly distinguished.
4. To see if the regulations and policies made are followed properly.
5. Periodical visits and suggestions by the auditor will be helpful in improving the management of the institution.

AUDITOR'S DUTY REGARDING AUDIT OF EDUCATIONAL INSTITUTIONS

1. The auditor should examine the Charter, Trust deed or Regulations etc in the case of schools or colleges in order to find out the provisions thereof, especially those related to the system of keeping accounts.
2. In the case of a university, the auditor should go through the Act of Legislature under which the institution has been set up & also the rules framed there under.
3. The auditor should also check whether his letter of appointment is in order specially mentioning the scope of his examination.
4. The auditor should go through the minutes of the meetings of the Managing Committee, governing body or Executive Council of the institution in order to find out the resolution regarding the system of maintaining books of accounts, method of operation of bank accounts, etc.
5. He should thoroughly assess the internal control system in operation in order to confirm the strengths and weaknesses of the system.

AUDIT OF INCOME

1. A fee from students is the main source of income for an educational institution. The auditor should check students fees register for each term or month depending on the basis for collection with the respective roll number of students from each class.
2. He should test check entries in the fees register with reference to tuition fees, library fees, building fund, etc to see whether each item have been properly computed and demanded from students.
3. Counterfoils or carbon copies of the receipts issued should be checked along with the serial number, safe custody of receipt books etc.
4. He should check whether the daily cash receipts are deposited into the bank or not.

5. In case of free scholarship or fees concessions to any student then the auditor should examine the authorization by a responsible officer and see that it is as per the decision of the Managing Committee.
6. He should check late payments of fees along with fines if any with the entries in the fees register.
7. Donations, grants from the government and other subscriptions from various authorities should be vouched by the auditor.
8. Examination fees collected should be checked by referring the notifications from the university education board.
9. Fees paid in advance if any should be properly verified.
10. Parking fees paid by the student should be properly verified.
11. Income from property if any should be properly accounted & verified.
12. Investments in the form of shares, securities, bank deposits etc should be physically verified.
13. If the investments are in the custody of a person or bank then confirmation should be obtained from them.
14. Income from investments as dividend or interest should be vouched with relevant vouchers.
15. He should see that the capital and revenue items are properly distinguished.

AUDIT OF EXPENDITURE

1. The auditor should vouch all expenditures of capital nature with the resolutions of the Managing Committee authorizing the same, relevant vouchers & entries in the cash book.
2. Preliminary expenses should be checked as to the reasonableness of the amount spent. If an unduly heavy expenditure is spent for any item, he should enquire the reasons.
3. If the expenditure on any item exceeds the budgeted sum, the auditor should check whether the Managing Committee has duly authorized the same.
4. All the purchases and issue of materials should be properly authorized by a responsible official.
5. Stock of stationery, equipments, etc should be physically verified by the auditor.
6. The auditor should vouch the amount of salaries paid with the salary register.
7. He should see that the contributions to the provident fund both by the management and the staff are collected as per directions of the government and is properly invested in approved securities.

REVIEW QUESTIONS

Descriptive Type

1. Discuss Audit for Sole Trader.
2. Explain Audit procedure of Partnership Firm.
3. Discuss Auditor's Duty Regarding Audit of Partnership Firm.
4. Explain the advantages of Audit of Co – operative Societies.
5. Discuss auditor's Duty Regarding Audit of Co – operative Societies.
6. Explain Audit of Educational Institutions.

Analytical Type

1. State various characteristics of Sole Trader.
2. State various characteristics of Partnership Firm.
3. Discuss audit of partnership firm.
4. Explain the advantages of audit of partnership firm.
5. State various characteristics of Co-operative Organization.
6. Explain Audit of Income.
7. Discuss Audit of Expenditure.
8. Explain the Indian Educational Institutions.

Conceptual Type

1. What is Sole Trader?
2. Define the term Sole Trader.
3. State any two characteristics of Sole Trader.
4. What is Partnership?
5. Define the term Partnership.
6. State any two characteristics of Partnership Firm.
7. What is co-operative Society?
8. State any two characteristics of Co-operative society.

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Unit 5

AUDITING UNDER COMPUTERIZED ENVIRONMENT

Highlights

- Introduction
- History of information technology auditing
- Features of EDP System
- Approaches to Computer Auditing
- Characteristics of Computer Information System Environment
- Auditors Computer program Approach (ACPA)
- Advantages of Computerized Information System (CIS)
- Computer Frauds and Computer Virus
- Steps involved in using Accounting Software to prevent frauds
- Accounting Information
- Important components of accounting information system
- Computer Virus
- Classifications of Viruses
- Types of Viruses
- Detrimental Effects of Viruses
- Types of Computer Crimes
- Computer Security
- Fraud Prevention
- Characteristics of Computer Fraud
- Detection of Computer Frauds
- Collection of Evidence
- Prevention of Frauds under Computerized Environment

INTRODUCTION

Electronic Data Processing (EDP) can refer to the use of automated methods to process commercial data. Typically, this uses relatively simple, repetitive activities to process large volumes of similar information. For example: stock updates applied to an inventory, banking transactions applied to account and customer master files, booking and ticketing transactions to an airline's reservation system, billing for utility services.

Use of computers in maintaining the accounts of the business have brought new dimensions to the field of modern auditing. The computer technology has revolutionized the methods of accounting with speed of recording and processing the accounting data. The use of computers, these days has even covering the small areas of clerical works and hence it became imperative to the auditors to equip themselves with the knowledge of computer auditing and proficiency in computer programs.

Computerization of accounting records significantly affects the organization, flow of information, flow of documents, control systems and the manner of information processing. This necessitates the auditor to adopt a suitable approach and techniques to be followed for successful audit of accounts under EDP environment.

The auditor has to adopt different methods or techniques to audit the accounts maintained under EDP system. Techniques adopted in this way with the help of computer are called as 'computer-assisted audit techniques' (CAAT), which are broadly classified as under:

1. Use of 'audit software', which are specially designed for audit purpose and to examine contents of enterprise's computer files;
2. Use of 'test data' by the auditor to test computer data and its processing system along with the operation of the enterprise's computer programs.

Ron Weber defines It as, "EDP auditing is the process of collecting and evaluating evidence to determine whether a computer system safeguards assets, maintains data integrity, achieves organizational goals effectively, and consumes resources effectively."

To deal efficiently with the electronic data processing system, the understanding of the various components of a computer is very necessary. The components have been classified as follows:

a. Input device	b. Storage devices
c. Output devices	d. Other devices

a. *Input devices*- It refers to those devices through which data can be fed into computer.

b. *Storage devices*- The storage unit consists of magnetic discs for storing the programme of instructions and the data to be manipulated. These devices provide memory to the computer.

c. *Output devices*- It refers to those devices through which the computer can communicate the end product of any data processing exercise.

d. *Other devices*- It refers to a central processor which performs the arithmetical, logical and control operations and is connected with input, storage and output devices.

HISTORY OF INFORMATION TECHNOLOGY AUDITING

This article includes a list of references, related reading or external links, but its sources remain unclear because it lacks inline citations. Information Technology Auditing (IT auditing) began as Electronic Data Process (EDP) Auditing and developed largely as a result of the rise in technology in accounting systems, the need for IT control, and the impact of computers on the ability to perform attestation services. The last few years have been an exciting time in the world of IT auditing as a result of the accounting scandals and increased regulation. IT auditing has had a relatively short yet rich history when compared to auditing as a whole and remains an ever changing field.

The introduction of computer technology into accounting systems changed the way data was stored, retrieved and controlled. It is believed that the first use of a computerized accounting system was at General Electric in 1954. During the time period of 1954 to the mid-1960s, the auditing profession was still auditing around the computer. At this time only mainframe computers were used and few people had the skills and abilities to program computers. This began to change in the mid-1960s with the introduction of new, smaller and less expensive machines. This increased the use of computers in businesses and with it came the need for auditors to become familiar with EDP concepts in business. Along with the increase in computer use, came the rise of different types of accounting systems. The industry soon realized that they needed to develop their own software and the first of the generalized audit software (GAS) was developed. In 1968, the American Institute of Certified Public Accountants (AICPA) had the Big Eight (now the Big Four) accounting firms participate in the development of EDP auditing. The result of this was the release of Auditing and EDP.

FEATURES OF EDP SYSTEM

Computers and other mechanized devices are part of accounting under EDP system. Most computers have vast capacity of receiving, storing, processing and communicating the information. An EDP system basically consisting of the following:

1. Computer system

A computer system comprises two elements; the hardware and software. Computer hardware which is the physical component or part is the computer system. The main components of computer hardware are:

a. Input devices, which transfer data or information into the computer system and the most common input devices are keyboard, etc.

b. Storage devices, which can receive data and programs and retain them for retrieval and further use subsequently.

c. Output devices, which the processed data is displayed. The main function of this device is to convert the machine language to the human language, as all processing done in computer is in machine language, some of the output devices are monitors, printers, etc.

Computer software which runs the computer and helps in storing, processing and analyzing the accounting data and information. Hence, Software is a set of instructions, which will make the computer do the desired job. There are two types of software available:

a) System software, which is also called as Operating system (OS) is to operate the system,

b) Application software is software, which is used for carrying specified application. The application software can be further classified as:

   * Packages, designed for specific task as required by the end user. Ex. accounting package for hospitals, hotels, etc.

   * Language, which is a means of communication, a computer language used for communication between user and the computer.

Storing devises

Several storage devises are used to store and safeguard the accounting information. However, the important storage and memory devises are:

a. *RAM:* Random Access Memory is a volatile memory as it looses its content as soon as computer is switched off due to any reason.

b. *ROM:* Read Only Memory is non- volatile memory as it retains all the information stored in it even as the computer is switched off and switched on. ROM consists of set of instruction, which ensures that the rest of the computer memory are working fine, check for other hardware device attached to the computer, and finally check for the operating system available on computers disk drive.

c. *Hard disk:* This is a basic storage device associates with a computer with varied memory capacity.

d. *Floppy Disk:* Floppy disk stores the data in the similar manner the way hard disk stores. The only difference is that these can be carried separately and is cost effective.

e. *Compact Disk:* The most popular storing devise is compact disk, which may be CD-ROM, Writable CD (CD-R), Re-Writable CD (CD-RW), DVD- (Digital Video Disk), etc.

f. This is a serially accessed memory unlike others, which are randomly accessed. They were most popular secondary storage devices used in first three generations.

Processing system

On the basis of method of information processed in EDP, it can be classified as under:

a. ***Batch Processing System:*** Under this, transactions are accumulated and processed in batches. For example, the sale invoices for a day may be fed into the computer at the end of the day. Batch processing systems are relatively simple.

b. ***Real time Processing System:*** Under this data processing system, the transactions are entered in the computer system as they occur and are processed immediately. A railway reservation system is an example of a real-time data processing system. Real-time processing systems are more complex compare to batch processing system. Generally, real-time processing system is carried out with networking computer system.

APPROACHES TO COMPUTER AUDITING

The approach followed by the auditor to audit the accounts maintained under EDP system does change the overall objective and scope of audit. However, the auditor can adopt any of the following approaches to audit accounts under EDP system:

1. ***Audit around the computer (Black Box System):*** Under this approach, the auditor verifies the documents used for recording transactions in the computer and output documents such as purchase invoices, sales invoices, monthly statements, etc, to complete the audit work. The auditor never go through the files recorded and stored in the computer but can clarify himself about the accuracy of the computer system by sample checking of the transactions recorded therein.

2. ***Audit through the computer:*** Under this method, the auditor checks the files recorded in the computer and verifies them through audit software and other Computer Assisted Audit Techniques (CAAT). Here, the auditor is literally go through the computer system and verifies the programs and the files stored in the computer. The auditor verifies the input and output data and the manner these data was processed in the computer system. As in the case of audit of manual accounts, the audit of computerized accounts is divided in to the following steps:

   a. Review of Internal Controls: This is a significant step to be undertaken by the auditor under EDP environment. This step is required due to absence of audit trail, lack of visible output, etc, in an EDP environment of accounting. Review of internal controls by auditor involves ascertaining the system, testing compliance through the performance of compliance procedures, and finally, making an evaluation of the system.

   b. Examination of Records Produced: by Data Processing System: After satisfying with the reliance on the internal controls, the auditor should proceed to the next step that is to select and examine the records produced by the data processing system with a view to assess their accuracy, validity and completeness. In such case, the auditor should select and examine the problem peculiar to EDP system, viz., and lack of a complete and visible audit trail. The auditor should satisfy himself with the test conducted and significant errors or findings must be dealt with properly before commencing the regular audit of transactions recorded under EDP environment.

DISTINCTION BETWEEN MANUAL ACCOUNTING AUDIT AND COMPUTERIZED ACCOUNTING AUDIT (CAA)

It is often emphasized that the approach of a computer audit is no different from that of a manual audit. In so far as this refers to the objective of the auditor to ascertain that the final statements give a true and fair view of the position of a business and the transactions over a period, this is correct. It is also necessary to employ the same methods as are used in systems-based auditing, evaluation, compliance and substantive tests still being applied with a careful follow through of the whole internal control system. The following table shows the general flow of work where the accounting has been computerized.

The techniques employed in the computer audit will, however, vary since greater reliability can be placed on the arithmetical accuracy of the accounting records. On the other hand greater attention will have to be given to the operation of the internal control system. Obviously the system is tested in non-computer audits, but where a manual system prevails, the diversity of operations in different sections of a business and the wider spread of personnel means that the internal control can be more difficult for individual members of staff to circumvent than in the case of a computerized system where there are only a few staff involves, in highly technical activities.

Manual Accounting Audit	**Computerized Accounting Audit (CAA)**
1. Docuementary evidence is often available in manual control procedures.	1. Many Procedures in a computer system do not give rise to the creation of documents, a fact which leads to what is termed "Loss of audit trial" and therefore necessitates the use of differing compliance tests.
2. In manual controls are subject to human error on a random basis.	2. Where as in computer controls are sound, greater reliability may be placed on computers since uniform control is exercised over all data processed.
3. Information is readily visible in manual systems.	3. While files and records in an EDP system can only be read by means of the computer itself.
4. As information and documents are dealt manually in Manual Systems, errors would be more easily discovered.	4. The reduced number of staff involved in handling computer transactions can lead to the obscuring of errors.
5. A manual audit may be conducted at any time during an accounting period or even historically.	5. Whereas computers often produce quite a lot of information on documents, which are only retained for a short time.
6. Alterations can be made very easily in manual system.	6. Alterations in a computerized system are difficult and expensive.
7. In manual systems additional expertise and training is not required for auditing.	7. In EDP sufficiently skilled and trained employees only can take audit.

CHARACTERISTICS OF COMPUTER INFORMATION SYSTEM ENVIRONMENT

An auditor, before commencing his audit work has to ensure and understand the environment of EDP system of the client. The following have a bearing on the work of the auditor while auditing under an EDP environment:

a. ***Organisational Structure of EDP:*** A few persons are involved in data processing under EDP comparing to manual system. Hence, certain data processing persons by virtue of their personalized knowledge may be intimately connected with the input preparation, processing, and distribution and use of the output. Hence, they may be in a position to alter the data or programs during processing or storage and therefore an auditor should be careful.

b. ***Absence of Input Document:*** Some times the input documents such as voucher, etc., may not be available in EDP system and the transactions are directly entered into the system. For example, sale order directly entered into online system, charging of interest, commissions, etc, directly by the computer software, etc, should be carefully verified and confirmed by the auditor.

c. ***Lack of Visible Audit Trail:*** Under manual accounting system, normally an accounting procedure or trail begins with the preparation of voucher and followed by journal entry and preparation and posting in to ledger. This work has been divided and assigned to two or more persons to prevent and find out errors and frauds. However, under EDP, all these activities may be performed at one instance by the computer and hence an auditor should be very alert in dealing with transactions of the client. Moreover, in a computerized system, the auditor may often find that the audit trail is mostly in machine-readable form. So, an auditor should use CAAT to test the audit trail of EDP system before commencing actual work.

d. ***Lack of Visible Work:*** Under EDP system, most of the data may be retained on the files, which are readable, by the computer only. The end results are printed in summary form for the specific end users and hence the auditor should depend on the files stored in the computer only.

e. ***Programmed Controls:*** Under EDP, many internal control procedures are incorporated in computer programs and these can be designed to provide controls with limited visibility. For example, unauthorized access to the data can be prevented through the use of passwords, etc. Other controls such as error reporting, etc, can be implemented.

f. ***Use of Codes:*** Code numbers are extensively used to represent names and descriptions in a computer system to make the people responsible for their work. Auditor may have to familiarize himself with such codes.

g. ***Vulnerability of Data and Program Storage Media:*** A large number of data and programs may be stored in fixed or portable storage media such as magnetic tape, compact disc, etc, which are vulnerable to theft, loss, or easy copy into another such storage devises which makes a danger of leakage of information to un-authorized persons.

h. ***Consistent Performance:*** Computer systems are more accurate and reliable than the manual system as these performs exactly as programmed. However, a faulty program may affect the entire process of transactions or the data.

AUDITORS COMPUTER PROGRAM APPROACH (ACPA)

This is a record Approach to auditing with a computer. It must be remembered, however, that the auditor's computer program and the test data approach are complimentary rather than mutually exclusive. The auditor's computer program approach is generally sued to test correctness of output of the system of EDP. The auditor performs many different kinds of tests and other functions with a computer program if the client data are in a machine language. These include the following:

1. Verification of Extensions and footings.
2. Examination of Records.
3. Comparison of data on separate files.
4. Summarizing or Resequencing and analyzing data.
5. Comparison of Audit data with company Records.
6. Selecting Audit samples.
7. Printing confirmation requests.

Advantages of Computerized Information System (CIS)

- Easy in operation, storing large volumes of data, retrieving data as and when required and analyze the data.
- Consistency in performance, so more reliable.
- Reduces monotony of auditor.
- Reports can be generated easily and effectively.
- The system generates multiple files for entry in single transaction with automatic updating facility.

Disadvantages of Computerized Information System (CIS)

- Concentration of programs and data at one/ few location(s) leading to unauthorized access/ alteration of data.
- Absence of input documents like vouchers, invoice, receipt etc. In other words key data is fed into the system without supporting documents.
- Lack of visible transaction trail, which involves successive stages in recording transactions normally followed in manual accounting system. It makes tracing the wrong entry/ posting quite difficult.
- Lack of visible output, i.e. in some CIS systems the results of processing may not be printed or printed in summarized form that results in access to data only through computers.
- If data is not properly protected, unscrupulous elements may creep in and resort to unauthorized alteration.

- The data and programs in CIS system are highly vulnerable to theft, loss, destruction, virus or alteration.
- A single erroneous entry leads to creation of multiple wrong records.

COMPUTER FRAUDS AND COMPUTER VIRUS

Precautions to be taken in Computerized Information System (CIS):

- The auditor must go through the accounting package used by the company.
- He must check the effectiveness of internal control systems in the organization.
- He must ensure that all the data are fed by authorized person(s) only and any adjustment or contra entries must be duly authorized by competent authorities.
- He must examine the journal vouchers in detail to detect manipulation, if any.

Control in Computerized Information System (CIS):

Accounting in CIS system necessitates installation of adequate internal controls to cope with the problems inherent to system and conduct the work smoothly and effectively.

The internal control system encompasses:

A) General CIS controls and

B) Application controls

A. General CIS controls

- Division of responsibility to minimize the scope for occurrence of errors and committing frauds.
- Control over development and, maintenance of software, that is the system and application software must be acquired/ developed as per predetermined standards.
- Control over operators who operate system/feed data by proper work scheduling to avoid duplication and wastage of time.
- Restrict data and program access only to authorize persons to prevent misuse/unauthorized alteration.
- Editing of data must be permitted only for rectifying mistakes with due authorization from competent authorities.
- The storage devices like CDs, Floppy Disk, and HD etc. must be properly labeled and suitable description for system files must be given for easy retrieval of data.
- Procure Hardware form genuine suppliers and avoid assembled versions to prevent faulty functioning of equipment. Techniques like echo check may be used to check proper functioning of equipment.

B. Application Control

They may be explained as below:

- ***Input control i.e. checks the accuracy and authenticity of input being fed in the system. The auditor should thoroughly check:***

  o The authorization for all input data referring to necessary instructions, signatures, enclosures such as transmittal or route slip.

  o Check batch numbering.

  o Preprocessing review i.e. checking the accuracy of data before processing.

- ***Processing Controls to ensure:***

  o Transactions are properly processed by computer.

  o Transactions are not lost, duplicated or modified.

  o Processing errors are detected and rectified on timely basis.

- ***Output controls to ensure that:***

  o Results are accurate.

  o Restricted access to computer.

  o Output is provided to authorize persons on timely basis.

COMPUTER ASSISTED AUDITING TECHNIQUES (CAAT)

The techniques of computer system in auditing include:

- ***Test Data:*** Under this technique, the auditor applies valid and invalid conditions and the response to such invalid conditions will be checked. Finally the test applications must be removed so that the relevant data in the system is not affected.

- ***Controlled processing:*** Controlled processing, i.e. the processing is done in the presence of auditor or repeated in his presence to enable the auditor check the efficiency of particular program.

Computer audit programs help the auditor in saving time, reduce monotony, and enhance efficiency and reliability, and lowering the audit cost. However they do not replace the professional knowledge or the judgment of auditor. Application of CAAT requires good computer knowledge and experience of auditor.

STEPS INVOLVED IN USING ACCOUNTING SOFTWARE TO PREVENT FRAUDS

They are briefly explained as below:

- Verifying company information with details including name and address of company, CST and RST numbers and so on.

- Verifying groups of accounts such as cash, bank, capital account, current assets and liabilities, direct and indirect expenses, investments, loans and advances etc. However the transactions must be carried on individual ledger.

- Verify individual ledger and attach each ledger to concerned group.
- Designing vouchers, carefully choosing between manual and auto numbering. Auto number is given by default and can be changed in to manual numbering by deleting the vouchers and reentering the same.
- Verify vouchers for various account heads like sales voucher including cash and credit sales, purchase vouchers in similar lines, Receipts and payment vouchers, journal vouchers and so on.
- Generating reports using software like MS Excel that facilitates tabular and graphical presentation of data, cross analysis, and arriving at right conclusions.

TALLYING

Tallying accounts was a tedious job under manual accounting system. But it is made easier with the advent of various accounting software packages like Tally and the like. The user must ensure that the data entered to the system is accurate. The system detects certain mistakes committed by the operator while entering the data. For instance, a debit entry without corresponding credit will not save by the system since the system automatically updates accounts heads after saving each voucher. However the error of omission, commission or the compensating errors can't be detected by the system, hence great care should be taken while keying in the data.

ACCOUNTING INFORMATION

Accounting information systems are based on Double Entry Book keeping System, and the recent accounting concepts such as responsibility accounting, profitability accounting.

Computer based accounting systems record all financial transactions, funds flow into the organization, and report the affairs of the company by producing Balance Sheet and Profit & Loss Account.

IMPORTANT COMPONENTS OF ACCOUNTING INFORMATION SYSTEM

- *Order processing:* Accepts and processes customers' orders and produces customer invoices.
- *Inventory control:* Provides information as to inventory levels, receipts, issues, values, reorder point and so on to help maintain optimum levels of inventory.
- *Accounts receivable:* It tracks the dues, collections, balances, and produces monthly customer statements and credit management reports.
- *Accounts payable:* Records purchases, amounts paid to and payable to various suppliers, and produces credit management reports.
- *Payroll:* It tracks the salaries, wages, allowances payable to employees, deductions, and produces paychecks and other payroll documents.

- *General Ledger:* It consolidates data from other accounting systems and produces periodic financial reports statements.

ESSENTIALS OF GOOD ACCOUNTING SOFTWARE

- Must fit the company's needs requirements.
- Must integrate various components of the system and provide a comprehensive view of the affairs of the company.
- Must be flexible to amend to suit to the changing requirements.
- Must be reasonably complex to prevent unauthorized operation.
- Must be user friendly.

COMPUTER VIRUS

A computer virus is a program, a block of executable codes, which attach it to, overwrite or otherwise replace another program in order to reproduce itself without knowledge of a PC user.

Computer virus is one of the biggest menaces against which computers have to fight. It is a so dangerous problem, which threatens the proper functioning of the computer. It is an illicit software code, which can infest other important programs by including a copy of itself into that program. The virus is a self-replicating program, which can be multiplied so fast and destroys important executable files. Computer virus is a computer program, which is a collection of coded instructions. The virus program has the capacity of executing itself and there is no command required to activate it. There may be a great loss of data due to the spread of virus. A virus can corrupt the most sensitive area of the hard disk-the file allocation table. (FAT) It enters the executable files and modifies them. The size of these files becomes so large that the required program is not executable.

CLASSIFICATIONS OF VIRUSES

Viruses can be divided into classes according to the environment. Viruses can be divided into file, boot, macro and network viruses:

1. File Viruses either infect executables in various ways (Parasitic-the most common type of viruses) or create file doubles (companion viruses) or use file system specific features (link viruses).
2. Boot Viruses either save themselves in disk boot sector or to the Master Boot Record or change the pointer to an active boot sector.
3. Macro Viruses infect document files, electronic spreadsheets and databases of several popular software packages.
4. Network viruses use protocols and commands of computer network or email to spread themselves.

HOW DOES VIRUS SPREAD?

More frequently the virus spreads through pirated copy of commercial package which might have been tampered. It may also spread by using infected floppies on the system. When an infected floppy disk is inserted in the drive and if the same is used to boot the computer, the virus could hide itself in Random Access Memory (RAM) of the computer. It is multiplied and attacks later. In previous lines you have already read that a virus can badly affect system files such as COMMAND.COM and EXE files. Some times it is also checks some more conditions like:

-certain time of the day

-certain date

-computer restart/reboot

-certain job is running

-after cloning itself

Which one of the above condition happens to occur, the hidden virus is replicated and causes damage for which it was designed.

LIFE CYCLE OF A VIRUS

The life cycle of a virus starts when it is created and ends when completely vanished. The following outline describes each stage.

1. *Creation*- Until recently, creating a virus required knowledge of a computer programming language. Today anyone with basic programming knowledge can create a virus.
2. *Replication*- Viruses typically replicate for a long period of time before they activate, allowing plenty of time to spread.
3. *Activation*- Viruses with damage routines will activate when certain conditions are met, for example, on a certain date or when the infected user performs a particular action. Viruses without damage routines do not activate, instead causing damage by stealing storage space.
4. *Discovery*- When a virus is detected and isolated, it is sent to the ICSA in Washington D.C., to be documented and distributed to antivirus software developers. Discovery normally takes place at least one year before the virus might have become a threat to the computing community.
5. *Assimilation*- At this point, antivirus software developers modify their software, so that it could detect the new virus. This can take anywhere from one day to six months, depending on the developer and the type of virus.
6. *Eradication*- With up-to-date virus protection software, any virus can be wiped out. So far no viruses have disappeared completely, but some have long ceased to be a major threat. Antivirus software should be upgraded at regular intervals.

TYPES OF VIRUSES

Viruses are of various types. Some of the viruses which frequently occur are discussed below:

1. Brain Virus
2. Friday 13th
3. Raindrops Virus
4. Happy Birthday 30th
5. April 1st Virus

List of Some other Viruses:

1. 1701,1704,17744
2. Jeruselum
3. 648 Virus
4. Lee Hard Virus
5. Frodo
6. Liberty
7. Form
8. Taiwan
9. V2000
10. Monkey

Safety from Viruses

To secure the important data and other program, it is very important to save all these data from infection of viruses. Virus of any type is dangerous to the data. In case if the system is affected by the infection of virus, it becomes necessary to remove it and clean the disk. A good anti-virus program is required to check whether the system is safe. The anti viral programs can perform the following functions:

1. Prevention of the system
2. Detection of the virus
3. Vaccination
4. Inoculation
5. Damage control

To prevent the infection of the virus, the following precautionary measures should be adopted:

1. Use of pirated software should be avoided.

2. Write-Protect tags should be used on disks.
3. There should be no unauthorized access to the system.
4. Outside floppies should not be used.
5. Used Floppies should be reformatted.
6. Duplicate copy of the data should be kept.
7. Avoid booting of the system from many a floppy (If it does not have hard disk). Keep only one floppy for the purpose.
8. Check the floppy disks at regular intervals of time and remove infected programs immediately by cleaning them by some anti-virus programs such as smart dog.
9. Avoid swapping of floppies (If your system has two drives).
10. Last but not the least, buy authenticate software. Do not use illegitimate copies of software.

HOW PROFESSIONAL DETECT VIRUSES?

1. They check the actual size of executable, batch or command files. If there is any increase in the size of executable files, there is chance that the files might have been corrupted by some virus.
2. They have latest updates of anti virus programs and run regularly on their computers and can detect the virus if any on the systems.
3. When the computer behaves indifferently, there may be a chance of any virus resident on it.
4. When computer shows signs of halting, shows different outputs than the desired ones, there may be a virus on the system.

DETRIMENTAL EFFECTS OF VIRUSES

1. They can damage particular software or all computer programs in the computer system.
2. They can stop computer system from booting.
3. They can even damage hardware components like RAM chips, hard disks processors.
4. Some viruses may not obviously damage program on computer system but particular program may produce different outputs.
5. Virus program may occupy unnecessary memory space in your computer system thereby blocking precious disk space.

TYPES OF COMPUTER CRIMES

There are many times of computer crimes ranging from pirating software, stealing information and sabotaging systems.

1. ***Software Piracy:*** Piracy or the illegal duplication of copyrighted software is the most common computer crime. Millions of computer users have made copies of program that they have not legally bought. Now that most software companies have given in to user demands and removed physical copy protection from their products, copying software is as easy as duplicating a cassette tape or photocopying a book.

2. ***Software/Hardware sabotage:*** Another type of computer crime is sabotage of hardware or software. The word sabotage comes from the early days of industrial revolution. However, modern computer saboteurs use software rather than other destructive activities. They use viruses, worms, logic bombs and Trojan horses to destroy the computer hardware and software.

3. ***Hacking and Electronic Trespassing:*** In the late 1970's, time sharing computers at Stanford University and Massachusetts Institute of Technology attracted informal communities of computer fanatics who called themselves hackers. In those days a hacker was a person who enjoyed learning the details of computer systems and writing clever programs-referred to as hacks. Hackers were, for most part, curious, enthusiastic, intelligent, idealistic, eccentric and harmless.

But today's hackers are not so innocent and have very ominous intentions. They enter corporate and government computers using stolen passwords and security loopholes and steal very important information, transfer money to their accounts, and do a lot of other criminal activities. Some times they use modems to dial up the target computers directly; in other cases they 'travel' to their destinations through the Internet and other networks. Many hackers cover their tracks and leave without a trace; but many leave logic bombs.

COMPUTER SECURITY

Computer Security refers to protecting computer systems and the information they contain against unwanted access, damage, modification or destruction.

With a computer crimes on the rise, computer security has become an important concern for system administrators and computer alike.

Any computer can do only what it is programmed to do, it cannot protect itself from either malfunctions or deliberate attacks unless such events have been specifically anticipated and countered with appropriate programming. In the following paragraphs we will see some of the computer security methods.

1. ***Physical Access Restrictions:*** One way to reduce the risk of security breaches is to make sure that only authorized personnel has access to computer equipment. Organizations use a number of tools and techniques to identify authorized personnel. The computer can perform some of these security checks; others are used by human security guards. Depending on the security system you might be granted access to a computer based on your identity card, used name

and password, your voice print, retinal scans, fingerprints and so on. Since many of these security measures can be compromises, many systems use a combination of more than one control.

2. ***Passwords:*** Passwords are the most common tool for restricting access to computer systems. Passwords are effective only if they are chosen carefully. Most computer users choose passwords that are easy to guess thus making the job of the unauthorized user easy.

3. ***Firewalls, codes, shields and Audits:*** Many data thieves do their work without breaking into computer systems; they intercept messages as they travel between computers on networks. Passwords are of little use of hiding e-mail messages while they are traveling through Internet links. Still internet communication is far too important to sacrifice in the name of security.

   For the most sensitive information, passwords, firewalls, and encryption are not enough. A diligent spy can 'listen to' the electromagnetic signals that emanate from the computer hardware and in some cases read sensitive information. To prevent spies from using these spurious broadcasts, the pentagon has a program called Tempest to develop specially shielded machines.

   Audit Control Software is used to monitor and record computer transactions as they happen, so auditors can trace and identity suspicious computer activity. Effective audit control software forces every user, legitimate or otherwise, to leave a trail of electronic footprints. Of course, this kind of software is of little value unless someone in the organization monitors and interprets the output.

4. ***Backups:*** Even the tightest security can't guarantee absolute protection of data. Sabotage, human errors, power losses, machine failure, fire flood, lighting and earthquakes can damage or destroy computer data along with hardware. Any complete security system must include some kind of plan for recovering from disasters. For mainframes and PCs alike, most widely used data recovery insurance is a system of making regular backups. For many systems, data and software are backed up automatically into disks or tapes, usually at end of each working day. Most data processing shops keep several generations of backups so they can, if necessary, go back several days, weeks, or years to reconstruct data files.

5. ***Internet:*** Each internet computer, called a host is independent. Its operators can chose which internet services to use and which local services to make available to the global internet community.

FRAUD PREVENTION

In light of the corporate scandals over the past several years and stronger state and federal legislation, management and governance boards are under increasing obligation to ensure that systems are in place to provide the detection and reporting of fraudulent activities.

Fraud takes many forms. Some examples include embezzlement, kickbacks, theft, fraudulent financial reporting, environmental crimes, software piracy, computer related crime, identity theft, credit card fraud, Cheque fraud, fraudulent workers compensation claims, ghost employee schemes, expense report schemes," dummy" vendors, unreported conflicts of interest, etc.

What makes fraudulent activity more likely to occur?

The risk of employee fraud occurring in an organization is contingent upon a combination of factors:

- Motive – usually caused by personal financial pressures.
- Opportunity – caused by poor internal controls.
- Personal integral of the employee.

Poor internal controls contribute to an environment where it is easier to rationalize that “if I take something it is okay because it is an unofficial perk of the job". This perception often results when organizations do not actively promote sound internal control concepts and business ethics.

Who is responsible for fraud prevention?

It is important to distinguish between Auditor’s role and management role concerning employee fraud and other forms of employee misconduct. Many individuals believe that frauds and other transactions are only the concern of auditor’s. However this is incorrect. Management is responsible for maintaining an adequate system of internal control designed to prevent or detect improper operating activities. Auditor’s role is to independently evaluate the adequate of the existing system of internal control by analyzing and testing. We also perform fraud investigations and promote a positive control environment throughout the organization.

How can we decrease the risk of a fraud occurring in organization?

There are two approaches to help reduce fraud risk:

Prevention and detection

The best approach is to prevent illegal and inappropriate acts from occurring in the first place.

As an employee everyone is responsible for ensuring safety of funds, property and equipment are safeguarded from loss. One important underlying concept which must be accepted is the reality that a fraud is possible in the organization. They do not believe fraud is possible. We will not identify it .even if it is clearly evident very often fraud symptoms are viewed as administrative errors because individuals cannot conceive of the existence of fraud particularly in organizations where there is a long time affiliation with co-workers.

The following procedures should be adopted to help reduce the risk of fraudulent activity occurring within the organization:

Establish a positive internal control environment

A genuine interest and concern related to implementing sound internal controls should be conveyed to all personnel. The major tenets of an internal control system include:

i) Separation of duties;

ii) Physical safeguards over assets;

iii) Proper documentation;

iv) Proper authorizations;

v) Adequate supervision and

vi) Independent validation of transaction accuracy.

Identify organization assets for which we have responsibility

It includes budgeted funds, supplies, computers, office equipment and organization assets, Petty cash, and amounts collected as revenue.

Identify the risks associated with safeguarding these assets

Ask our self

i) How could they be improperly used or stolen?

ii) If these assets were misused or stolen?

iii) How could we know?

iv) What internal controls (policies or procedures and / or checks and balances) exist to prevent or detect any inappropriate use or loss of assets?

v) What additional controls are necessary to ensure that Assets are adequate protected from loss?

CHARACTERISTICS OF COMPUTER FRAUD

Computer fraud covers a variety of activity that is harmful to organization. Computer fraud is using the computer in some way to commit dishonesty by obtaining an advantage or causing loss of something of value. This could take form in a number of ways, including program fraud, hacking, e-mail hoaxes, auction and retail sales schemes, and investment schemes.

1. In an ideal situation, where information systems have all the necessary controls, which are properly integrated with other manual controls and maintained, there will be generally no cause of worry. It is however, not so. Not only, most system controls are not perfect, people also try to manipulate systems for variety of motives from games playing, ego, peer pressure, hatred for the organization, emotional maladjustment. Such people could be insiders, outsiders as well as vendors, competitors in fact any one.

2. Computer frauds gain their criticality as they are easy to commit, difficult to detect and even harder to prove. The most important type of such frauds is committing the fraud by manipulation of input, output or throughput of a computer system. While in input manipulation, input data such as deposit amounts in ledgers, limits in accounts or face value of cheques are changed; output manipulation is achieved by affecting the output of the system, such as use of stolen or falsified cards in ATM machines. Throughput manipulation could be by rounding off sums credited to different accounts and siphoning of the rounded digits to another account. No system is foolproof and fraudulent transfers can occur in even highly automated and secure funds transfer systems.

3. Other types of such frauds or crimes could be unauthorized access to computers by hacking into systems or stealing passwords, deliberate damage caused to computer data or programs, computer forgery (changing of data or images stored in computers) and un-authorized reproduction / modification of computer programs.

4. Various studies have revealed that disgruntled employees have committed most of the frauds, whether current or former. The reason is that they have a good understanding of the systems and weaknesses of controls and hence, are in a position to exploit the loopholes therein. In some cases, system administrators have also perpetrated frauds. Other important causes of such frauds are lack of employee awareness, poor implementation of security policies and segregation of duties, vendor products with weak security controls, outsourced service providers and hackers (many as young as school students). Computer frauds in such cases are generally for economic benefit to the fraudster and corresponding loss to the organization (one may give it various names such as embezzlement, asset misappropriation, payroll abuse etc.). Other sources of computer crimes are terrorists, organized criminals and groups hating the organization.

DETECTION OF COMPUTER FRAUDS

1. Despite all such measures, as technology is taking rapid strides (for fraudsters as well as organizations), system security administrators are discovering that they have to constantly improve upon the technological tools. However, security can only reduce the possibility of fraud and not totally rule it out.

2. Frauds often begin with an innocent error committed or observed by an employee that somehow slips undetected past internal controls. A typical fraud starts by the fraudster first 'testing the waters' by fraudulently drawing a small amount. Once the controls have been breached successfully and such losses are not detected fraudster finds the temptation too great to resist and continues to commit the same "error" until they are caught. In a computerized environment, the perpetrators of fraud also expect their crime to be near impossible to detect among the thousands or millions of transactions processed by the organization. Hence to reduce the losses, timely detection of the frauds plays an important role.

3. Auditors worldwide are discovering that their most effective tool to combat fraud is data inquiry, analysis, and reporting software. As the success of the fraudster depends on how fast their crime is detected among very large number of transactions processed by the organization, auditors and fraud investigators find that computers are their best tools for detection of fraud. Powerful, interactive software that quickly sifts through mountains of electronic data enables auditors to effectively detect and prevent fraud throughout an organization. The benefit is speed. Searches of electronic documents and data can be conducted many times faster than in the case of paper documents. Sophisticated software tools enable investigators to uncover data in seconds, which would have otherwise taken months.

4. One such tool is the General Audit Software (like ACL - Audit Command Language and IDEA - Interactive Data Extraction & Analysis). Such tools can quickly compare and analyze data to identify patterns and trends that often reveal fraudulent activity. One can use it to process normal data as well as exception reports and audit trails. Although such powerful software tools effectively replace many of the manual processes, auditors must remember that such

interactive (exchange of information between computer and user) tools demand flexibility and creativity on the part of auditor. As such, auditors should be prepared to revise their queries in response to results of earlier queries.

5. Further, auditors must combine their formal training with learned sleuthing strategies and data analysis tools. For effectively detecting and preventing fraud, one must be able to recognize fraud and its symptoms. Auditors have been trained to look for anomalies and a data analysis tool can highlight anomalies quickly. However, while gathering evidence for fraud, one will have to be little creative and examine closely any indication of fraud, however, small. In other words, to uncover a fraud, one must think like a thief and not as an auditor.

6. Often, the challenge for investigators of computer frauds is that actions undertaken by them may change the data during the course of investigations itself. Hence, investigators must ensure that their activities do not inadvertently change the materials they are examining. Now, investigators are using imaging techniques combined with armory of sophisticated software tools. Imaging involves making a replica of a system, including all hidden areas and deleted files that are examined for evidence. For example, one software-tool allows files to be examined and searches carried out regardless of where information has been stored. An employee may have hidden sensitive information within the code of a picture file, e-mailed it to competitor and then deleted it from system. Conventional searches may not find such data; however, this software could locate it and determine its source. Computer imaging is also now admissible in courts and is becoming a powerful tool against fraud.

7. It may be added here that realization of the losses due to such crimes is even more difficult. In fact, as such crimes can be committed by comparatively with much less investment and gains to fraudsters may be beyond geographic boundaries, recovery becomes a Sisyphean (endless and fruitless) task. It is, hence, far better to devise a number of preventive measures to avert potential perpetrators of fraud than to face complex problems after fraud has been committed.

8. Another way to use such software for prevention of fraud could be identifying organizations risks and exposures and assembling fraud profiles for targeted audits. These processes can then be automated using programmes or batches (series of commands run in a logical manner for desired result) and then proactive continuous surveillance and monitoring of data to catch frauds earlier in the fraud cycle and prevent greater loss in future.

9. Auditors cannot ignore the trends that characterize this rapid technological evolution, which is rapidly replacing paper transactions. Auditors, who possess the flexibility to adapt to change and are able to recognize the trends occurring around them, will be better prepared to identify unmistakable patterns of fraudulent activity in and around their organizations. Hence, besides having auditing skills, it is important and beneficial for the auditors to have intimate knowledge of computerized systems to understand the possible modes of frauds so that they can isolate all types of risks to safeguard the interests of the organization.

10. In a nutshell, one should not forget that, in a computerized environment, frauds increase, as fraudsters believe their action near impossible to detect, if detected near impossible to prove, if proved nearly impossible to convict and if convicted, amounts nearly impossible to recover.

The problem is compounded in networked banks operating in different nations with different laws. Despite this, it has been observed that frauds perpetrated from across the globe have been detected and amounts recovered by proper combination of technology and sleuthing skills. Hence, while security administrators continually watch incidences and plug the holes, fraud investigators improve their skills and actively liaise with authorities to improve the legal framework.

COLLECTION OF EVIDENCE

Cyber crime is a crime committed with the help of a computer. The computer may have been used to carry out a cyber attack, to send malicious e-mail, to store company confidential files before sending them across, or to commit financial fraud. If you know that a particular computer was used for criminal activities, how do you preserve all the telltale signs?

Computer forensics is a new branch of criminal investigation. The computer evidence is very fragile. It can very easily lose its credibility. Normal methods of taking backup do not work here as the date and time stamps associated with the last access to a computer file change in the next backup. The evidence thus collected will not be accepted in the court. Special software is used to make a complete bit-by-bit image of the disk without altering a single bit of information. The entire process of collecting evidence has to be documented and witnessed. Multiple copies of the evidence should be made so that one copy is always maintained in safe custody while the investigation could be done using other copies. The concern here is to ensure that the evidence is admissible in the court the quality and completeness of evidence is beyond doubt and you are really able to nail the cyber criminal.

Apart from adherence to procedural aspects of security, also ensure that periodic technical compliance checks are done. This may require conducting tools-based vulnerability testing as well as penetration testing. For best results, ask knowledgeable and trustworthy outsiders to carry out these tests. Technical compliance gives additional assurance that all the security holes have been plugged.

Indian IT Act 2000 is also very clear on the issue of computer crime. As per section 70 (3): Any person who secures access or attempts to secure access, to a protected system, in contravention of the provisions of this section shall be punished with imprisonment of either description, for a term that may extend ten years, and shall also be liable to fine."

PREVENTION OF FRAUDS UNDER COMPUTERIZED ENVIRONMENT

Computerization has brought advantages of efficiency, speed and economy in all spheres of life. It is a very powerful tool and provides opportunities of efficiency and speed to everybody using it. Further, the vast increase in the memory (whether RAM or storage) and processing speeds as well as availability of wide range of software, particularly Internet and web-based applications i.e. connectivity, have made them pervade all aspects of our lives. This has also brought large economy of scale particularly in our economic environment and we are becoming more and more dependent on computers and their networks for the services such systems deliver.

1. While the proliferation of computer networks enables such convenience; it also provides ample opportunities for their misuse particularly for economic or financial gains. This is as computers networks can also be used to commit crimes from geographically far places. Such

computer frauds are known by various names such as cyber crimes or e-crimes and we can describe them as an act involving computer equipment, software or data that results in an unauthorized financial advantage. Worldwide frauds in computerized environment cause losses running into very large sums. Although in India, frauds committed so far have not revealed any extensive manipulation of computer systems, it is no doubt a potentially high-risk area, which should be addressed carefully and in timely manner. According to a recent survey, companies in India have not addressed security issues appropriately.

2. Frauds committed using computers vary from complex financial frauds where large amounts are illegally transferred between accounts by sophisticated hackers, to the simpler frauds where computer is only a tool that a criminal uses to commit a crime. The latter are no different from crimes without computers. For example, using a computer, a scanner, graphics software, and a high-quality colour laser printer for forgery or counterfeiting is the same crime as using an old-fashioned printing press with ink. Here the perpetrator of the crime is just using computer as a tool. Similarly, stealing a laptop computer with proprietary information stored on the hard disk inside the computer is the same crime as stealing a briefcase that contains papers with proprietary information. Although such crimes may also cause financial damage, they may be considered outside the scope of this paper. Here we are basically concerned about computer frauds committed by an unauthorized user (whether insider or outsider) to the computer networks, which aims at causing economic or financial gains to the user by this act or an economic or financial loss to the information system (i.e. hardware, software and data) owner.

3. Let us try to understand what unauthorized use. Information system controls in financial organizations are established on the two basic principles, the principle of least privilege and that of maker and checker. The principle of least privilege means that every individual is given access to the sensitive information strictly on the need to know basis and is given only those rights to access data and programmes, which are in line with his job duties and nothing more. While giving lesser rights than required may decrease the efficiency of working, giving more rights has associated risks of misuse or possible frauds. The principle of maker and checker means that for each transaction, there must be at least two individuals necessary for its validation. While one individual may create a transaction, the other individual should be involved in confirmation or authorization of the same. Here the segregation of duties plays an important role. In this way, strict control is kept over system software and data keeping in mind functional division of labor between all classes of employees. Vendors are also allowed access to use information system resources particularly when the hardware, software or data is outsourced. A strict control over their usage as well as taking out of the any devices for maintenance should be observed, as devices may carry important data, which can be misused.

4. Many times access is also allowed to users to download or upload the data using wide area networks or Internet. Similarly, access may also allowed to outsiders (not necessary customers) through Internet or dial-up connections and this access may be either for information on products or direct access to services through computer systems as decided by business policy of the organization.

5. Hence, information system assets of organizations may be open for use by almost everybody from desk-level staff working in organization to database/system/network managers, senior/ top management, different type of vendors, internal/external auditors, customers, general public etc. Normally user rights for each category will have to properly defined and appropriately incorporated in the software systems (operating systems, database management systems and application software) to prevent their misuse. It is, however, easier said than done.

REVIEW QUESTIONS

Descriptive Type

1. Explain Features of EDP System.
2. Mention the Approaches of Computer Auditing?
3. Distinction between Manual Accounting Audit and Computerized Accounting Audit.
4. What are the advantages and disadvantages of CIS?
5. Explain different types of viruses.
6. Write a note on computer crimes.
7. What are the safety measures to avoid Virus infections?
8. How to detect computer frauds?

Analytical Type

1. Discuss history of information technology auditing.
2. State characteristics of Computer Information System Environment.
3. Explain Auditors Computer program Approach (ACPA).
4. Explain Computer Frauds and Computer Virus.
5. Write note on: Tally.
6. Discuss important components of accounting information system.
7. Discuss essentials of good accounting software.
8. Explain computer Security.

Conceptual Type

1. What is EDP?
2. What is Computer Auditing?
3. What is Computer Information System?
4. What is Auditors Computer program Approach (ACPA)?
5. Give the meaning of Computer Frauds.
6. What is Computer Virus?

*****

Skill Development

Skill Development 1

Draw Specimen of Vouchers-at least three Vouchers for different purposes.

EXERCISE No.1 : SCHOOL FEES RECEIPT

ESTD: 1966 Phone: 23238608

SRI VANI EDUCATION CENTRE

C.A. Site No.1, 4th 'B' Main, 3rd Stage

BASAVESWARANAGAR, Bangalore- 560 079.

FEE RECEIPT

NO. B Date: 30-01-2008.

Name: - PRATHEEK P. Std: II

Father's Name: Dr. P. Paramashivaiah

NO.	PARTICULARS	Rs.	Rs.
1.	Development Fund….	600	00
2.	Registration Fee	—	—
3.	Admission Fee	10,500	00
4.	……………….		
5.	……………….		
	TOTAL	11,100-00	

(Rupees Eleven thousand and one hundred only)

For Sri. Vani Education Centre

EXERCISE No.2 : Magazine Subscription Receipt

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Date: 10-01-2008

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Bangalore- 560 040.

Rupees Five hundred only

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Rs.500/-

(Cheque Subject to Realisation)

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In all your correspondence.

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Chamarajpet, Bangalore- 560 018.

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1815 **TAX INVOICE**

VANI SCHOOL

CASH MEMO NO.

Date:

Name:

Class/Roll No.:

SL.NO.	PARTICULARS	PRICE	COPIES	VAT	AMOUNT(Rs.)

TOTAL

(Rupees………………………………………….)

E & O. E.

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EXERCISE No.4: BILL SHOWING CASH/CREDIT BILL OF AN FIRM

Ph : 23145524

CASH/CREDIT ✓

TAX INVOICE

ORIGINAL

TIN : 29630707620
CST : 29630707620

SIL
HARDWARES & ALUMINIUM

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M/s. Shadakshari Swamy
Bangalore

Invoice No. : 469

Date : 27.6.07

Time of Sale :

Party's TIN No. 29850064 292

Your Order No. .... Dated ....

Sl. No.	Particulars	Quantity	Rate	Amount Rs.	Ps.
✓	Pc Butt Hinges 3"	520	6	3120	–
✓	Gate Hook 4"	600	10	6000	–
✓	Toyota Handle Pc 3"	600	4.50	2700	–
✓	Gate Hook 2½"	600	5	3000	–
✓	Bush ½"	300	2	600	–
✓	Pc Tower Bolt 3" (H)	300	10.50	3150	–
	Delivery at Sakaleshpura Hassan Dt.				

Value	Rs. 18570–	TOTAL		18570	–
Vat	Rs. 2321–	Vat 4% / 12.5% /		2321	–
Amount	Rs. 20891–	Grand Total		20891	–

(Rupees Twenty thousand eight hundred & ninety one Only)

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(ENGINEERS & CONSULTANTS)

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Date 04-10-07 **RECEIPT** No. **131**

Received with thanks from M/s Shri Shadakushi Swamy

In full / ~~part~~ payment towards Inv No 189 *Dated* 26-09-07

By Cheque / ~~Cash~~ (Rupees Twenty Nine thousand seven Hundred and Forty Four vide Chq No 253364 dt 7/10/07 on KBL)

Rs. 29,744/-

Pd directly to Aquapub Engineering on our Behalf

For JVB COMPONENTS

Signature

This receipt is valid subject to realisation of cheque

® REGISTERED TRADE MARK OF AQUASUB ENGINEERING & AQUAPUMP INDUSTRIES, COIMBATORE FOR **TEXMO** BRAND PRODUCTS LISTED.

EXERCISE No.6: SPECIMEN OF PAYMENT VOUVHER

B.S. SHADAKSHARI SWAMY

232/A, 7th 'D' Main, 17th 'C' Cross, 4th Stage, 3rd Block, Basaveshwaranagar, Bangalore - 560 079.

PAYMENT VOUCHER

V. No. ....

Date : ....

Head of Account ....

Paid to ....

sum of Rs. ....

towards ....

by Cash / Cheque No. ....

Received the Amount

Signature of the Payee

Rs. __________

Skill Development 2

CASE LAW ON DEPRECIATION- FACTS AND JUDGEMENTS

JUDGEMENT GIVEN BY HIGH COURT OF JAMMU AND KASHMIR IN THE YEAR 2000.

HIGH COURT OF JAMMU & KASHMIR

I.T.R. 23 1983

Date Of decision :17-11-2000

Commissioner of Income-tax, Amritsar Versus Agya Wanti & others.

Coram:

The Hon'ble Mr. Justice Dr. B. P. Saraf, Chief Justice.

The Hon'ble Mr. Justice Syed Bashir-ud-Din, Judge.

Mr. Anil Bhan, Senior Central Government Standing Counsel.

JUDGEMENT AND ORDER

Per Dr. B. P. Saraf, Chief Justice By this reference under section 256 (1) of the Income-tax Act, 1961 ("Act"), the Income-tax Appellate Tribunal, Amritsar Bench, Amritsar ("Tribunal") has referred the following questions of law to this Court for opinion at the instance of the revenue:

> ***Assessment year 1975-76:***
>
> 1. Whether on the facts and in the circumstances of the case, the Tribunal is right in law in holding that the order made by the ITO under section154 allowing thereunder the depreciation due in respect of the Truck is not an order to rectify a mistake apparent from the records and is, therefore, unsustainable?
>
> ***Assessment year 1976-77:***
>
> 1. Whether on the facts and in the circumstances of the case, the tribunal has misdirected itself in law in holding that the assessee had not furnished the particulars as required under section 34 of the Income-tax Act, 1961 for the allowance of depreciation in respect of the Truck?
>
> 2. Whether on the facts and in the circumstances of the case, the Tribunal is right in law in holding that the ITO is not justified in allowing the depreciation in respect of the Truck?"

The material facts of the case, briefly stated, are as follows. The assessee submitted the return of its income under the Income-tax Act for the assessment year 1975-76. In the return, the assessee did not claim depreciation on the truck owned by him and used for the purpose of his business. The Income-tax Officer assessed the income of the assessee on the basis of the return under section 143(1) of the Act and determined the taxable income at Rs.19,067/-. Later, the Income-tax Officer rectified the order under section 154 of the Act as he found that depreciation had not been allowed in the assessment on truck No.127 even though the particulars were available on the file. The Income-tax Officer, therefore, allowed depreciation of Rs.16,170/- on that truck and re-determined the taxable income of the assessee at Rs.2,900/. Aggrieved by the order of rectification of the Income-tax Officer by which he allowed depreciation in respect of the truck which he did not claim in his return, the assessee appealed to the Appellate Assistant Commissioner of Income-tax.

3. Question Nos. 2 and 3 pertain to the assessment year 1976-77. In that year, though in its return of income, the assessee did not claim any depreciation in respect of the truck in question, in the order of assessment under section 143(1) of the Act, the Income-tax Officer allowed depreciation on the written-down value of the truck which could have been arrived at after allowing depreciation for the earlier year .He did not accept the plea of the assessee that depreciation cannot be allowed in the absence of a claim made by the assessee in that regard. The Income-tax Officer found that the particulars required for allowance of depreciation having been available in the return, depreciation was allowable to the assessee. He, therefore, suo moto, allowed depreciation in respect of the truck which the assessee did not claim. This action of the Income-tax Officer was challenged by the assessee before the Appellate Assistant Commissioner.

4. We have given our careful consideration to the questions referred to us. The controversy in the first question is about the power of the Income-tax Officer to rectify the assessment under section 154 of the Act and grant depreciation to the assessee in respect of the truck which the assessee did not claim in its return. The rectification was challenged by the assessee on various grounds. The first ground of challenge was that the assessee having not claimed depreciation in its return, the Income-tax Officer could not have granted it by rectifying the assessment. The second ground was that the rectification had the effect of increasing the liability of the assessee in the next assessment year. The same could not have been done without giving notice to the assessee of its intention to do so and allowing the assessee a reasonable opportunity of being heard.

5. We have given our careful consideration to the questions referred to us. Section 154 of the Act provides for rectification of mistake apparent from the record. The power under section 154 of the Act, therefore, can be exercised only if there is a mistake in the order and the mistake is apparent from the record. Law is well settled that only a glaring and obvious mistake of law can be corrected under section 154 of the Act. A decision on a debatable point of law cannot be corrected by way of rectification. If the rectification was made at a time when the issue was debatable it cannot be supported by reference to the Supreme Court's decision settling the issue which is rendered after the rectification.

6. In the instant case, there is no dispute about the fact that at the time when the rectification was made, there was a sharp cleavage of opinion between different High Courts on the point. The controversy was set at rest recently by the Supreme Court by its judgment dated 15th March, 2000 in CIT v Mahindra Mills [2000] 243 ITR 56. In that case, the Supreme Court held that the provision of section 34 of the Act to claim depreciation being for the benefit of the assessee, if the assessee does not wish to avail of that benefit for some reason, the benefit cannot be forced upon him. In view of the above, we are of the clear opinion that on the facts and in the circumstances of the case, the Tribunal was right in law in holding that the order of the Income-tax Officer under section 154 of the Act is not an order to rectify a mistake apparent from the record and hence it is not sustainable. Question No.1 is, therefore, answered in the affirmative i.e., in favour of the assessee and against the revenue.

"…Section 34 is not in the nature of merely an enabling provision. In the absence of particulars of depreciation as required by section 34, there is no mandate on the Income-tax Officer under section 29 to compute the income by allowing depreciation under section 32…"

7. It is clear from the above decision of the Supreme Court that no depreciation can be allowed in a particular assessment year if the assessee does not want to claim it in that year. In the instant case, the assessee did not claim any depreciation in the year under consideration. He did not even furnish the particulars required for allowance of depreciation under section 34 of the Act. In such a situation, the Income-tax Officer could not and should not have allowed the same.

8. In view of the above, we are of the clear opinion that on the facts and in the circumstances of the present case, the Tribunal was right in holding that the Income-tax Officer was not justified in allowing depreciation in respect of the truck which had not been claimed by the assessee.

9. In the premises, question No. 2 is answered in the negative, i.e., in favour of the assessee and against the revenue. Question No.3 is answered in the affirmative, i.e., in favour of the assessee and against the revenue.

The reference is disposed of accordingly with no order as to costs.

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