

A **cost audit** represents the verification of **cost** accounts and checking on the adherence to **cost** accounting plan. ... Examination of these records to ensure that they adhere to the **cost** accounting principles, plans, procedures and objective. To report to the government on optimum utilisation of national resources.

A **tax audit** is an examination of your **tax** return by the IRS to verify that your income and deductions are accurate. A **tax audit** is when the IRS decides to examine your **tax** return a little more closely and verify that your income and deductions are accurate.

**Management Audit** is an assessment of methods and policies of an organization's **management** in the administration and the use of resources, tactical and strategic planning, and employee and organizational improvement.

## **Origin of Auditing**

The origin of auditing may be traced back to the 18th century when the practice of large-scale production was developed as a result of Industrial Revolution. It is found that some systems of checks and counter checks were applied for maintaining accounts of public institutions, as early as the days of the ancient Egyptians, the Greek and the Romans.

The growth of Accounting profession in India is of a quite recent origin. It was an outcome of the Indian companies Act, 1913 which prescribed for the first time the qualifications of an auditor. Due to rapid growth in the size of business firms, it has become necessary that the accounts must be checked and audited by an independent person, known as auditor especially in case of joint-stock companies where the shareholders are drawn from far off places. That is why it becomes necessary to assure them that their investment is safe and that the directors and the managing directors etc. handling capital and accounts, have presented true and correct accounts.

## **Definition of Audit**

The word “audit” is derived from the Latin word “audire” which means “to hear”. In olden times, whenever the owners of, a business suspected fraud they appointed certain persons to check the accounts. Such persons sent for the accountants and “heard” whatever they had to say in connection with the accounts. Since then there have been lot of changes in the scope and definition of audit. The following are some of the definitions of audit given by some writers:

According to *Spicer and Pegler*, “An audit may be said to be such an examination of the books, accounts and vouchers of a business as will enable the auditor to satisfy himself that the balance sheet is properly drawn-up, so as to give a true and fair view of the state of the affairs of the business, and whether the profit and Loss Accounts gives a true and fair view of profit or loss for the financial period, according to the best of his information and the explanations given to him and as shown by the books and if not, in what respect he is not satisfied”

R.B. Bose has defined as audit as “the verification of the accuracy and correctness of the books of account by independent person qualified for the job and not in any way connected with the preparation of such accounts.” M.L. Shandily has defined auditing as “inspecting, comparing, checking, reviewing, vouching ascertaining scrutinising, examining and verifying the books of account of a business concern with a view to have a correct and true idea of its financial state of affairs”.

Audit may be defined as :

1. an intelligent and a critical examination of the books of account of a business which,
2. is done by an independent person or body of persons qualified for the job,
3. With the help of vouchers, documents, information and explanations received from the authorities, so that,
4. the auditor may satisfy himself with the authenticity of financial accounts prepared for a fixed term and ultimately report that,
  - (i) the Balance Sheet exhibits a true and fair view of the state of affairs of the concern,
  - (ii) the Profit and Loss Account reveals the true and fair view of the profit or loss for the financial period, and
  - (iii) the accounts have been prepared in conformity with the law. In short, an audit implies an investigation and a report.

## **Difference between Accountancy and Auditing**

The difference between Accountancy and Auditing is as follows :

1. Accountancy is mainly concerned with the preparation of summary and analysis of the records prepared by the book-keeper for this, an accountant has to prepare trial balance and then annual accounts. On the other hand, Auditing means the verification of book entries and accounts to find out their accuracy. So the auditor's work is to find out whether the final accounts exhibit a true and fair view of the state of affairs of the concern or not and to report his findings to the share holders.
2. An accountant is an employee of the business while an auditor is an independent outsider.
3. As an employee of business, an accountant draws his monthly salary regularly from the business itself while an auditor is paid a remuneration agreed upon between him and his client.
4. An accountant is not expected to have a knowledge of auditing but for an auditor, it is very essential to possess a thorough knowledge of accountancy.
5. An auditor can be changed from year to year but an accountant is not, as he is usually a permanent employee of the business.

## **Book-Keeping, Accountancy and Auditing**

Book-Keeping, Accountancy and Auditing are the three aspects of the term 'Accountancy' itself in its widest sense.

Book-keeping is the art of recording the daily transactions in a set of financial books. It is concerned with systematic recording of transaction in the books of original entry and their posting into ledger. A person with the knowledge of rules of journalizing and posting can very easily do the job. In some countries like Africa & England, this work is done by machines.

## **Accountancy**

Accountancy begins where book-keeping ends." It means that an accountant comes into the picture only when the book keeper has done his job. The functions of accountant can be classified as under :

- (i) Checking the work of book-keeper.
- (ii) Preparation of trial balance,
- (iii) Preparation of Trading and Profit and loss Account.
- (iv) Preparation of balance sheet,
- (v) Passing entries for rectification of errors and making adjustments.

An accountant is supposed to be an expert in the accounting procedures as he has to examine analytically the final accounts. But it is not necessary for him to pass the chartered Accountant's examination. He it's not supposed to submit his report after the completion of work.

## **Auditing**

It is said, "where accountancy ends, auditing begins." It is rightly said. An auditor has to verify the entries passed by the accountant and the final accounts prepared by him. Thus, auditing is the checking of the accounts of a business with the help of vouchers, documents and the information given to him and the explanations submitted to him. An auditor has to satisfy himself after due verification and complete. Checking of accounts as to whether the transactions entered into the books are accurate.

An auditor is required to submit his report to the effect whether or not the balance sheet is a true and fair representation of the existing state of affairs of a business concern.

Thus, an auditor should have the proper knowledge of accounting principles. That is why he should be a chartered Accountant. He has to express his impartial opinion in his report which he can not give unless he satisfies himself completely with the proper recording of transactions.

Thus, auditing is based on accountancy and not accountancy on auditing. An auditor must be well familiar with the principles and practical aspects of accountancy but it is not necessary for an accountant to be an expert in the audit work.

### **Audit and Investigations**

There is a lot of difference between auditing and investigation which is as follows :

1. Audit is conducted to find out whether the balance sheet is properly drawn up and exhibits a true and fair view of the state of affairs of the business while investigation means a searching enquiry with certain object in view, e.g.; to find out the profit earning capacity, or the financial position of a concern or a fraud and the extent thereof.
2. Investigation covers several years, say, 3,5, and 7 years to find out the average earning capacity, financial position, etc. of a concern while audit usually relates to one year.
3. Investigation may be carried out on behalf of outsiders who either want to purchase the business, to become partners, to advance loans or to purchase the shares of a firm. Audit is always conducted on behalf of proprietors only. However investigation may also be carried out on behalf of proprietors in case fraud is suspected.
4. Audited accounts are further investigated for some special purpose in view while investigated accounts are not audited in the ordinary course.
5. Audit is legally compulsory, specially in case of companies, but investigation is voluntary and depends upon the necessity of some purpose in view.

### **Objects of an Audit**

The main object of audit is to verify the accounts and to report whether the Balance Sheet and the Profit and Loss Account have been drawn up properly according to the companies Act and whether they exhibits a true and fair view of the state of affairs of the concern. For this, an auditor has to discover errors and frauds.

As such the subsidiary objects of audit are :

- (i) Detection and Prevention of errors,
- (ii) Detection and Prevention of frauds.

The difference between an error and fraud is that error generally arises out of the innocence or carelessness on the part of those responsible for the preparation of accounts, while fraud involves some intention to gain out of manipulating records.

### **Types of Errors**

A. *Clerical Errors* : Clerical errors are those which result on account of wrong posting that is posting an item to a wrong account, totalling and balancing. Such errors may again be subdivided into:

- (i) *Errors of Omission* : An error of omission takes place when a transaction is completely or partially not recorded in books of account. For example, goods purchased from Narendra Kumar were not recorded anywhere in account books. This error will not affect the agreement of Trial Balance. But if posting is not done in one of the accounts, this will affect the agreement of Trial Balance.

(ii) *Errors of Commission* : Errors of commission take place when some transaction in incorrectly recorded in books of account. Following are the examples of such errors :

(i) Error in the books of Original Entry.

(ii) Debiting or crediting one account instead of the other.

These two errors do not affect the agreement of Trial Balance,

(iii) Wrong balancing of an account.

(iv) Error in writing amount in an account. For example, debiting Prem Chand's Account with Rs. 107- instead of Rs. 100/-.

(v) Casting of the same amount to two accounts.

(vi) Posting of an amount on the wrong side.

(vii) Posting in one account and omitting of posting in the other account.

(viii) Error in carrying forward the total of a subsidiary book or an account from one page to the other.

These errors affect the agreement of Trial Balance.

B. *Errors of principle* : Errors of Principle take place when a transaction is recorded without having regard to the fundamental principles of book-keeping and accountancy. For example a capital expenditure, say expenses incurred in constructing a godown, may be treated as a revenue expenditure or vice versa. Sometimes adjustments are not taken into consideration while preparing Final Accounts. These are errors of principle. These errors, however, do not affect the agreement of the Trial Balance.

C. *Compensating Errors* :- Compensating errors arise when an error is counter balanced or compensated by any other error so that the adverse effect of one on debit (or credit) side is neutralized by that of another on credit (or debit) side. For example Rani's account was to be debited with Rs. 10, but it was debited with Rs. 100 similarly Shyam's account was debited with Rs. 10 instead of Rs. 100. Both these errors compensate each other's deficiency and will not affect the agreement of the Trial Balance.

*Detection of Errors* :- Although it is not the duty of the auditor to trace and locate errors in the books which he is required to check and audit as this is the work of an accountant but in many cases the auditor is frequently asked to discover the errors, specially so, when the accountant is unable to locate such errors. While locating errors, the auditor should take note of following devices :-

1. Check the totals of the trial balance.

2. Compare the names of the accounts in the ledger with the names of the accounts as have been recorded in the trial balance.

3. Total the list of debtors and creditors and compare them with the trial balance.

4. If the books are maintained on the self-balancing system, see that the total of different accounts agrees with the total of these accounts with the balance of accounts as recorded in the trial balance.

5. Compare the items of the trial balance with the items of the trial balance of the previous year to see if any item have been omitted.

6. Whatever the difference is in the trial balance, see if there is any item of this amount. This is done to avoid the putting of the debit balance on the credit side of the trial balance or vice versa.

7. It is possible that the totals of some subsidiary books, e.g. Cash book, Sales book etc. might not have been transferred to the trial balance. Recheck the totals of these books.

### **Detection and Prevention of Fraud**

Fraud means false representation or entry made intentionally or without being in its truth with a view to defraud somebody. Detection of fraud is considered to be one of the important duties of an auditor.

#### **Fraud may be of three types**

1. *Misappropriation of Cash* : It is easier to misappropriate cash, therefore the auditor will have to pay particular attention towards cash transaction. Cash may be misappropriated by,

- (a) Omitting to enter any cash which has been received; or
- (b) Entering less account than what has been actually received; or
- (c) making fictitious entries on the payment side of the cash book; or
- (d) entering more amount on the payment side of the Cash Book than what has been actually paid.

In order to discover fraud under (a) and (b) above, the auditor should check the debit side of the cash book with rough cash book, salesmen's reports, counterfoils of the receipt books, agent's returns and other original records while the fraud under (c) and (d) can be discovered by reference to the vouchers, wage sheets, salary book invoices, etc.

2. *Misappropriation of Goods* :- This type of fraud is very difficult to detect especially when the goods are less bulky and are of higher value. Proper methods of keeping accounts in regard to purchases and sales, stock, taking, periodical checking of stocks, comparing the percentage of gross profit to sales of two periods, necessity for collusion will help to avoid misappropriation of goods.

3. *Fraudulent Manipulation of Accounts* : This type of fraud is more difficult to discover as it is usually committed by directors or managers or other responsible officials. That is why the auditor should be very careful in detecting such frauds. He should carry out the routine checking and vouching most carefully and make searching, tactful and intelligent enquiries. Such a fraud is committed with the following two objects :-

- (a) Showing more profits than what actually they are so as to increase the commission payable on the basis of profits, borrow money by showing a better position, to attract more subscribers for the sale of the shares of the company etc. or
- (b) Showing less profits than what actually they are so as to purchase shares in the market at a lower price ; or to reduce or avoid the payment of income tax or to mislead a prospective buyer of the business etc.

The accounts may be manipulated in a number of ways which are as follows:

- 1. by not providing any depreciation or less depreciation or more depreciation; or
- 2. by under valuation or over-valuation of assets and liabilities; or
- 3. by showing fictitious sales or purchases or returns in order to show more profits or less profits whatever the case may be ; or
- 4. by showing revenue expenditure to capital account or vice versa.
- 5. by the utilization of secret reserves during a period when the concern has made less or no profit without disclosing that fact to the shareholders etc.

### **Auditor's duty with regard to detection and prevention of frauds and errors.**

The legal perception of auditor's duty with regard to detection and prevention of frauds and errors has undergone various changes. Initially, it was based on the decision given in Kingston Cotton Mills Co. [1896] case. The learned Judge Lopes summed up auditor's duty by stating, "Auditor is a watchdog, not a blood hound. This statement implies.

1. In case of a limited company, an auditor is appointed by the shareholders. Thus, he is expected to play the role of a watchdog on their behalf and should look after their interests.

2. Unlike a bloodhound the duty of the auditor is verification and not detection. If he finds out something suspicious during the course of audit, he should enquire the matter in detail and inform the shareholders about it. But if he does not discover any such suspicious matter, he is fully justified in trusting and relying on representations made by the employees of the company.

In brief, in case of errors and frauds, the auditor has a duty of reasonable care only.

In recent years, auditor's duty has been extended in some cases, besides shareholders, to third parties. But the condition is that his negligence is proved. This is in recognition of public pressure on auditors to take more responsibility for detection of fraud in pursuance of their role of lending credibility to financial statements. The judgement in 'Headly Byrne and Co. Ltd. V. Heller and partners Ltd. Co. (1963)' recognised for the first time the liability of professionals including company auditors towards third parties.

### **Advantages of Auditing**

It is of great importance to get accounts audited in a proprietary concern to see that business is running efficiently, in a partnership firm to ensure healthy relations among partners and especially to

decide questions like valuation of goodwill at the time of entry, retirement and death of a partner and

in joint stock company in which shareholders invest their money and presume their capital intact if

accounts of such a company are audited by some qualified auditor. Audit is made compulsory also

under the Companies Act.

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The advantages of audit can be grouped into the following categories :

#### **A. for Business itself :**

1. The accounts of a business and its financial position can be examined by an independent and qualified auditor.

2. Quick discovery of errors and frauds—Errors and frauds are located very easily and at early stage. Therefore, chances of their repetition are reduced to the minimum.

3. Moral check on the Employees—Through auditing, the staff maintaining accounts become more alert and careful in keeping future accounts up-to-date.

4. Loans and credit can easily be obtained from banks and other money lenders on the basis of properly audited accounts.

5. The business itself enjoys better reputation due to audited accounts.

6. In case of Advice to the management—regular audit, the auditor can come into close touch with the working of the business & thus, can give suggestions the management to improve it in case he is asked to do so.

7. Audit is useful in case of a business managed by some agent or representative of its owner.

8. Uniformity in accounts if the accounts have been prepared on a uniform basis, accounts of one year can be compared with other years and if there is any discrepancy, the cause may be enquired into.

### **B. For the owners of Business**

1. If the business is owned by a sale trader, he can rely well on the audited and on his accounts clerks who are responsible for maintaining accounts.
2. In case of partnership firm, its partners can utilize the audited accounts to settle their disputes in regard to adjustment of capital and valuation of goodwill at the time of admission, retirement and death of a partner.
3. In case of a joint stock company. Shareholders living at distant places can rely on audited accounts and can be sure of their investment being safe with the company.
4. In case of a trust, its trustees can easily make their position clear before others by getting the accounts audited by an outside auditor.

### **C. For others**

1. Filing of Income Tax Return—Income Tax authorities generally accept the profit & loss account that has been prepared by a qualified auditor and they do not go into details of accounts.
2. Settlement of Insurance claim—In case of fire, flood and the like unexpected happenings, the insurer company may settle the claim for loss or damages on the basis of audited accounts of the previous year.
3. Sales Tax payments—The audited books of accounts may generally be accepted by the sales tax authorities.
4. Payment of wealth-tax, expenditure-tax etc.—The taxation authorities can also rely on audited accounts for the purpose of imposing wealth tax, expenditure-tax etc.
5. Actions against Bankruptcy and insolvency—The audited accounts of a business can be produced in support of a legal case before the court. It forms a basis to determine action in bankruptcy and insolvency cases.
6. Future trends of the business—The future trends of the business can be assessed with certainty from the audited books of accounts.

### **Limitations of Auditing**

Truly speaking an audit should have no limitation of its own. It is designed to protect the interest of all parties who are interested in the affairs of the business. If there is any short coming arising there from, it may be due to its narrow scope of application in its related field of operations and un-extended designation of the concept. The audit has following limitations.

1. Lack of complete picture—The audit may not give complete picture. If the accounts are prepared with the intention to defraud others, auditor may not be able to detect them.
2. Problem of Dependence—Sometimes the auditor has to depend on explanations, clarification and information from staff and the client. He may or may not get correct or complete information.
3. Existence of error in the audited accounts—Due to time and cost constraints, the auditor can not examine all the transactions. He uses sampling to check the transactions. As a result, there may be errors & frauds in the audited accounts even after the checking by the auditor.

4. Exercise of judgement—The nature, timing and extent of audit procedures to be performed is a matter of professional judgement of the auditor. The same audit work can be done by two different auditors with difference in sincerity & personal judgement.
5. Diversified situations—Auditing is considered to be a mechanical work. Auditors may not be in a position to frame audit programme which can be followed in all situations.
6. Lack of Expertise—In some situations, an auditor has to take opinion of experts on certain matters on which he may not have expert's knowledge. The auditor has to depend upon such reports which may not be always correct.
7. Limitations of internal control—The auditor can only report on the truth and fairness of the financial statements. But other problems relating the management and control may not be possible to be covered by the auditor. Examples of such problems or limitations of internal control are cast-ineffectiveness, manipulations by management, etc.
8. Influence of management on the auditor—This is also come of the limitations of the audit that the auditor is influenced by the doings of those in management. The reason is that he is appointed by the share holders and directors who pay him remuneration or fee.

### **Classification of Audit**

Audit may be classified into two categories mainly ; - (a) according to organizational structure of a business; and (b) from practical point of view.

#### **According to Organizational Structure of a Business**

##### **1. Statutory Audit**

In case of many undertakings, audit is made compulsory under statute because these undertakings are established by statute. The audit of their accounts is termed as statutory audit. The following are the examples of such an audit:

(i) *Company Audit*:- The audit of joint stock companies compulsory under the companies act. For the first time the Indian Companies Act, 1913, made it legally compulsory for joint-stock companies in India to get their accounts audited by an independent professional accountant, but now, the companies Act, 1956 and subsequent amendments have made tremendous changes in the rights,duties, powers etc., of an auditor.

(ii) *Audit of Trusts* :- Trust are usually created for the benefit of the weak and helpless persons like widows, minors etc., who are not in a position to have access to and understand the accounts of such trusts. Therefore the trustees are made responsible to look after the property and to maintain accounts. But in a large number of cases, the trustees either do not maintain accounts at all or if they are forced to do so, such accounts are very often misleading. To avoid such a situation specific provisions are sometimes made in the trust deed for the appointment of auditors to check the accounts of the trusts. In some of the state in India, Public Trust Acts, (for example, the Bombay Public Trust Act, 1950 etc.) have been enacted which provide for compulsory audit of the accounts of trust by qualified auditors.

(iii) *Audit of other institutions* :- There are other corporate bodies such as electricity and gas companies which has been formed under their respective statutes. There is another set of public bodies in the name of public corporations, for example, Reserve Bank of India, Industrial Financial Corporation, etc.; Which work according to the various Acts passed for the purpose. All these institutions fully recognise the significance of a professional audit which is compulsory for them.

The powers, duties and liabilities of auditors are also well defined and fixed by statutes.

## **2. Private Audit**

The institutions which are private in character also get their accounts audited by some qualified auditors. As such an audit is not required by statute, it is known as private audit. There may be three types of such institutions which are as follows :

(i) *Audit of the accounts of Sole Trader* :- The appointment of an auditor in case of a proprietary concern rests absolutely on the proprietor. His rights, duties and nature of work will depend upon the terms given in the agreement. Such an auditor must get clear instruction in writing by his client as to what he has to do and how he has to proceed so that he can be held responsible for any charge of negligence and by producing the agreement, he can protect himself against such a charge.

(ii) *Audit of the Accounts of partnership Firms* :- In case of a partnership firm, the auditor is appointed by agreement between the partners. His rights, duties and liabilities are also defined by mutual agreement and can be subjected to modification.

(iii) *Audit of the accounts of other individuals and institutions* :- There are other individuals, e.g., rent collectors, estate managers, etc., who have large income and huge expenditure. The qualified auditors are appointed by these individuals in order to verify various accounts prepared by the accountants.

## **3. Government Audit**

The Government maintains a separate department in the name of accounts and audit department which performs the audit of its different departments and offices. This department is headed by the Comptroller and Auditor General of India who is assisted by different officials at various levels.

The duties and liabilities of such auditors are not defined by statute. They are not public auditors and hence can not be appointed auditors for public concerns. They are meant for Government departments and as such, they work according to departmental rules and instructions.

## **4. Internal Audit**

By virtue of the organizational pattern, some business institutions appoint auditors who are made responsible to have a constant and regular review of their accounts. Such auditors are of a permanent nature and are known as internal auditors. Such auditors, besides checking the accounts are required to report also as to how the system of accounting can be improved and the system of internal check be made economical and efficient. They can not be appointed as public auditors or external auditors and hence are not required to submit their reports in the manner in which external auditors do.

In short internal audit is the examination of books of account which is conducted by the salaried officials of a business known as internal auditors throughout the year. The scope of internal audit is a bit different.

It is more closely related to managerial functions than to accounting duties.

### **From Practical Point of View :**

All those forms in which audit is often conducted practically by business houses are as follows :-

1. Continuous Audit or Detailed Audit.
2. Periodical audit or Final Audit or complete Audit.
3. Interim Audit.
4. Occasional Audit.

5. Partial Audit.
6. Balance Sheet Audit.
7. Cash Audit.
8. Cost Audit.

1. **Continuous Audit or Detailed Audit :-** According to Spicer and Pegler "A continuous Audit is one where the auditor's staff is occupied continuously on the accounts the whole year round, or where the auditor attends at intervals, fixed or otherwise, during the currency of the financial year, and performs an interim audit; such audits are adopted where the work involved is considerable, have many points in their favour, although they are subject to certain disadvantages."

Thus, a continuous audit involves the conducting of audit of accounts throughout the year at regular intervals, fixed or otherwise, of say, one month or months. The accounts in such a case are subjected to audit as and when they are prepared. Such an audit is necessary only for big business houses.

Continuous Audit is applicable in case of following business concerns:

- (i) where final accounts are prepared just after the close of the financial year, as in the case of a bank.
- (ii) where the transactions are many in number and thus it becomes necessary to get them audited at regular intervals.
- (iii) where the system of internal check in operation is not satisfactory.
- (iv) where the statements of accounts are prepared after every month or quarter to be presented to the management.
- (v) where sales effected are very large.

**Advantage of Continuous Audit :**

1. Easy and quick discovery of Errors and frauds: Errors and frauds can be discovered easily and quickly as the auditor checks the accounts at regular intervals and in details.
2. Helps the auditor in making valuable suggestions: since the auditor remains more in touch with the business, he is in a position to know the technical details of it and hence can be of great help to his clients by making valuable suggestions.
3. Quick presentations of accounts: As the checking work is already performed during the year, the final audited accounts can be presented to the share-holders soon after the close of the financial year at the annual general meeting.
4. Keeps the client's staff regular: As the auditor visits the clients at regular intervals, the clerk will be very regular in keeping the accounts up-to-date.
5. Moral check on the clients staff: If the auditor pays surprise visits, it will have a considerable moral check on the clerks preparing the accounts.
6. Efficient Audit: As the auditor has more time at his disposal, he can check the accounts with greater attention and in detail and his work will be more efficient.
7. Preparation of Interim Accounts : If the directors of a company wish to declare an interim dividend. Continuous audit will help in the preparation of the interim accounts without much delay,
8. Audit staff can be kept busy: The audit staff may be sent to other clients after having finished the work for one client and thus can be kept busy throughout the year.

**Disadvantages :**

1. Alteration of figures: Figures in the books of account which have already been checked by the auditor at his previous visit, may be altered by a dishonest clerk to defraud the accounts.

2. Dislocation of client's work: As the auditor visits frequently, it may dislocate the work of his client and cause inconvenience to the latter.
3. Expensive: It is an expensive system of audit as such an audit is carried on throughout the financial year at regular intervals.
4. Queries may remain outstanding : As there may be a long interval between the two visits, the audit clerk may lose the link between the past and present work and the queries which he wanted to-make may remain outstanding.
5. Mechanical work: Under such an audit, the work of the auditors becomes mechanical and his frequent visits may also cause boredom to him.

*Precautions to guard against its disadvantages :*

1. The auditor should issue clear instructions to the effect that the audited figures should not be changed without bringing it to his notice. If some alteration is necessary it should be done by passing rectification entries in the journal.
2. He should try to check the accounts of similar nature in one and continuous sitting as far as possible and if not possible he should check the transaction up to a particular date. He should also note important totals and balances up to that date in his diary and compare them at his next visit,
3. The auditor should prepare an exhaustive programme to prevent any loop-holes.
4. The explanations of important questions which he finds unsatisfactory should be noted in his note-book and efforts should be made to get the matters settled.
5. He should go through the past work and alterations, if any, before he begins his work.
6. The checking of impersonal accounts should be undertaken at the time of final audit because the fraud in personal accounts can easily be made by passing false entries in the impersonal accounts,
7. Special ticks should be used by the auditor while checking altered figures,
8. He should pay surprise visits so that the clerks of the client may not know the exact date of the visit of the auditor.

**2. Periodical or Final or Complete Audit:-** That system under which the auditor takes up his work of checking the books of account and other related documents, only at the end of the accounting period when the transactions for the whole period are completely recorded, balanced and a Trading profit and Loss Account and the Balance Sheet have been prepared, is known as periodical or final audit, He would complete his audit work in one continuous session or without any interval, In other words the auditor visits his client only once a year and goes on checking the accounts and other related documents until the audit work for the whole of the period is completed.

**Advantages :**

1. The Work of audit does not present any inconvenience and dislocation in the work of the concern as the auditor comes only once a year.
2. It is less expensive and more useful for small business concerns than continuous audit.
3. In periodical audit the work of the auditor can be finished quickly and within a reasonable time.
4. The audit work does not become mechanical for the auditor.
5. Undue collusion is not established between the auditor and the clerks.

**Disadvantages :**

1. In periodical audit, detailed checking of accounts is not possible.

2. There is a greater chance of errors and frauds in accounts as the auditor visits his client only once a year and not at regular intervals.
3. If such an audit is undertaken in large concerns it takes more time to complete the audit and hence presentation of auditor's report to the shareholders is delayed. But shareholders are usually very anxious for the dividends which cannot be declared until the final accounts have been prepared and audited. Therefore, such an audit is not practicable for big concerns.

**3. Interim Audit :-** Interim audit is one which is conducted in between the two annual audits for some interim purpose, say, to enable a company to declare an interim dividend. This kind of audit involves a complete checking of the accounts prepared by a company for a part of the year to the date set of interim accounts, say, quarterly or half-yearly accounts.

**Advantages :**

1. This audit is helpful when the publication of interim figures becomes necessary.
2. With interim audit, the final audit can be completed easily and within short period of time.
3. Errors and frauds can be more quickly found and detected during the course of the year.
4. Since the interim audit is performed during the course of a year, it helps in exercising moral check on the staff of the client.

**Disadvantages :**

1. There is greater possibility of altering figures in the accounts which have already been audited.
2. Interim audit involves additional work as the audit staff will have to prepare notes after finishing the interim audit.

*Distinction between Continuous Audit and Interim Audit :*

1. In case of continuous audit, the auditor undertakes the audit work for the whole financial year at intervals according to client's own need and convenience, while in interim audit, the audit work is done only up to a definite date.
2. Under continuous audit, verification of Assets and Liabilities is done at the close of the financial year, but under interim audit, this work is done at the time of audit.
3. When continuous audit is done, the trial balance is not to be prepared necessarily at intervals, but in case of interim audit, the trial balance has to be prepared.
4. The auditor has to give the report at the close of financial year when continuous audit is done, but in case of interim audit, such a report is to be submitted at the time of audit.

**4. Occasional Audit:-** An audit which is conducted occasionally, that is, once a while whenever the need arises and the client desires it to be undertaken. For instance, the audit is not compulsory in case of sole proprietorship and partnership business but whenever the need arises, the owners can get the accounts audited.

**5. Partial audit:-** Under partial audit, an auditor is asked to check some of the records and books for a part or whole of the period. For example, auditor may be instructed to audit only the payment side of the cash book because he himself receives cash and cheques on behalf of his business. Such an audit is not permitted in case of private or public limited companies.

**6. Balance Sheet Audit :-** Under such an audit, the auditor checks capital, reserves, assets and liabilities, etc., given in the Balance Sheet. Those items of Trading and Profits and Loss Account are also checked which have a bearing on the Balance Sheet items. For example, the purchase of goods on credit will increase the liabilities to creditors, increase the stock and will be shown in

the Trading Account as an increase in purchases and closing stock. So this item will have to be verified. This type of audit can be successful in those business concerns where efficient system of internal check and control is in operation. Such an audit is popular in U.S.A.

## **INTERNAL AUDIT**

Internal audit is the review of operations and records undertaken within a business by specially assigned staff on a continuous basis. Internal audit has been defined as “the independent appraisal of activity within an organization for the review of accounting, financial and other business practices as a protective and constructive arm of management. It is a type of control which functions by measuring and evaluating the effectiveness of other types of controls.” Therefore it is clear that internal audit not only includes the verifications of accounting matters but also financial and other matters.

### **Objects of Internal Audit**

1. To verify the correctness of the financial accounting and statistical records presented to the management.
2. To comment on the effectiveness of the internal control system and the internal check system in force and to suggest means to improve them.
3. To facilitate the early detection and prevention of frauds.
4. To ensure that the standard accounting practices to be followed by the organization are strictly followed.
5. To confirm that the liabilities have been incurred by the organization in respect of its legitimate activities.
6. To examine the protection provided to assets and the uses to which they are put.
7. To undertake special investigation for the management.
8. To identify the authorities responsible for purchasing assets and other item as well as disposal of assets.

### **Distinction Between Internal Check and Internal Audit**

1. Internal check is an arrangement of as duties allocated in such a way that the work of one clerk is automatically checked by another while internal audit is an independent review of operations and records undertaken by the staff specially appointed for the purpose.
2. In Internal audit, a separate salaried staff of internal auditors is entrusted with the audit work but in internal check, there is no separate staff appointed especially for this purpose. Different clerks are assigned with various tasks with which they proceed and carry on checking at the same time.
3. In Internal audit, the work of a clerk is checked by an internal auditor after the former has finished the work while in case of internal check, the work of one clerk is automatically and independently checked by another simultaneously.
4. In internal audit, errors and frauds which have already been committed can be discovered but the system of internal check is so devised that the possibilities of errors and frauds are reduced to the minimum.

## **Audit Programme**

According to Professor Meigs, “An Audit Programme is a detailed plan of the auditing work to be performed, specifying the procedures to be followed in verification of each item in the financial statements and giving the estimated time required.”

### **Advantages**

1. It provides assistants with a set of clear instructions about their duties.
2. It enables the auditor to keep constantly in touch with the work done and the general progress of the audit.
3. It serves as an evidence in case of a charge of negligence against the auditor in the performance of his duties.
4. The chance of work being over-looked is considerably reduced. In case an audit assistant goes on leave, the portion of work done by him can easily be located and the unfinished work can be resumed by another without any difficulty.
5. In case any fraud or error has remained undetected, the responsibility for negligence can be fixed on the clerk performing that work as his initials are put on the audit programme.
6. A uniformity of work can be obtained, as the same programme will be followed at subsequent audits.
7. It serves as a guide to the duty for a new clerk.
8. It facilitates the final review before the report is signed.
9. It provides for systematic audits routine and therefore eliminates inefficiency.
10. It is useful basis for planning the programme for the subsequent years.

### **Limitations**

1. The work may become too mechanical and the clerks do not get enough opportunities to show their intelligence and initiative as they have to follow a predetermined programme.
2. It is not proper to frame a rigid programme for cash type of business because each business may have different problems and procedures.
3. An audit programme, which may be detailed and well drawn up may not cover everything that might come up during the course of audit.
4. The programme may be subjected to amendment due to changes in work or procedures. Actually the audit programme for each new audit should be an improvement over previous one.
5. It would be unnecessary to prepare a programme for small business concerns.
6. Inefficient and careless auditors or audit clerks may try to conceal their weaknesses on the basis of audit programme.

These limitations can be minimised by treating audit programme as a guidance only and making it flexible so that audit clerks may use their initiative and intelligence during the audit, make suggestions for improving it from time to time keeping in view the experience and changes in the business.

Test checking is a substitute for detailed checking. It involves only a partial checking. The auditor normally does not check completely all the records made into the books of accounts but, through a process of sampling, selects a few items and if they are found correct, he presumes that the remaining entries would also be correct likewise.

Routine checking is the regular monitoring of business accounts, books and ledgers to determine how the business is functioning and to detect any errors that may have occurred, either accidentally or fraudulently.

Audit notebook

**Audit Note Book** is a register maintained by the **audit** staff to record important points observed, errors, doubtful queries, explanations and clarifications to be received from the clients. It also contains definite information regarding the day-to-day work performed by the **audit** clerks.

A **bank audit** is a routine procedure designed to review the services of financial institutions to ensure they are in compliance with laws and industry standards. An accounting specialist known as a **bank auditor** carries out the review. **Bank** or credit union **audits** can be internal **audits** or external **audits**.

An **insurance audit** is the carrier's way of determining how much risk they actually insured over the past year. The **company** could've undergone a drastic change over that whole year your policy was in effect. Several factors determine the premium carriers charge for general liability (GL) and workers comp **insurance**

#### Preliminary Audit of Educational Institutions

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

It is to be confirmed whether the letter of his appointment (the Auditor's) is in order.

The Auditor should obtain a list of books, documents, register and other records as maintained by the educational institutions.

He should examine the audit report of last year and should note down the observation and qualification, if any.

He should note down the important provisions regarding to accounts and audit from the Trust Deed, Charter of Regulations.

He should examine the Minutes of Meetings of the Board of Trustee or the Governing Body for important decisions regarding the sale or purchase of fixed assets, investments or delegation of finance power.

In case of colleges and university, the Grants Commission provides Grants to them subject to certain conditions. The Auditor should study all the conditions concerning grants.

The Auditor should examine the Code of State regarding grant-in-aid.

He should be aware of all the provisions and rules of related laws concerning books of account and audit.

#### Audit of Cooperative Societies

The Registrar shall audit or cause to be audited by some person authorized by him by general or special order in writing in this behalf the accounts of every registered society once at least in every year. 2) The audit under sub-section (1) shall include an examination of overdue debts, if any, and a valuation of the assets and liabilities of the society. 3) The Registrar, the Collector or any person authorized by general or special order in writing in this behalf by the Registrar shall at all times have access to all the books, accounts, papers and securities of a society, and every officer of the society shall furnish such information in regard to the transactions and working of

the society as the person making such inspection may require. "Registrar" means a person appointed to perform the duties of a Registrar of Co-operative Societies under this Act.

**Efficiency Audit** is the **audit** which ensures that every rupee invested yields optimum results. The main objective of **Efficiency Audit** is to ensure that: (i) There is most optimum utilization of investment, and. (ii) That investment is canalized in most profitable lines.

A **social audit** is a way of measuring, understanding, reporting and ultimately improving an organization's **social** and ethical performance. A **social audit** helps to narrow gaps between vision/goal and reality, between efficiency and effectiveness.

## **Internal Check And Internal Control**

### **Internal Check**

Internal check is a method of organising the accounts system of a business concern or a factory where the duties of different clerks are arranged in such a way that the work of one person is automatically checked by another and thus the possibility of fraud, or error or irregularity is minimized unless there is collusion between the clerks. For example, the receipt of cash is entered by the cashier on the debit side of the cash book; this entry is carried to the ledger by another clerk; the statement of account relating to this transaction is sent to the customer by a third clerk and so on. Thus the same transaction has passed through three different hands and the work of one is checked automatically by the other. It is a kind of division of labour. This minimises the possibilities of frauds and errors unless all the three join hands in defrauding their employer.

According to the special committee on Terminology, American Institute of Accountants, 1949 “Internal check-a system under which the accounting methods and details of an establishment are so laid out that the accounts procedures are not under the absolute and independent control of any person - that, on the contrary, the work of one employee is complementary of that of another, and that a continuous audit of the business is made by the employees.”

The essential elements of an internal check are :

- (a) Instituting of checks on day-to-day transactions.
- (b) These checks operate continuously as a part of routine system.
- (c) Work of each person is made complementary to the work of another.

### **Internal control**

Internal control has been defined as being “not only internal check and internal audit but the whole system of controls, financial and otherwise, established by the management in order to carry on the business of the company in an orderly manner, safeguard its assets and secure as far as possible the accuracy and reliability of its records.”

Therefore internal control is a broad term with a wide coverage. Its scope extends beyond those matters which relate directly to the functions of accounting and financial records. In its modern sense, internal control includes two types of controls:

(a) *Accounting Controls* : These comprise primarily the plan of organization and the procedures and records that are concerned with and directly related to the safeguarding of assets and reliability of financial records. These include budgeting control, standard costing, control accounts, bank reconciliation, self balancing ledgers and internal auditing etc.

(b) *Administrative Controls* : These comprise the plan of organization that are concerned mainly with operational efficiency. They may include controls, such as time and motion studies, quality controls through inspection, performance reports and statistical analysis.

From the point of view of the auditor, the distinction between these two controls, is very significant. An auditor has to make a careful review of the accounting controls in order to ensure the accuracy and adequacy of financial statements. He is not expected to review the administrative controls because they have only a remote relationship with financial records.

However he may evaluate only those administrative controls that have a bearing on the reliability of financial statements.

### **Characteristics of Good Internal Control System**

1. There should be a well developed plan of organization with delegation of proper responsibilities at various levels of operational hierarchy.
2. These should be a scientifically developed system of record procedures with a view to maintain reasonable control over assets, liabilities, revenues and expenses.
3. A system of healthy practices and traditions is also necessary for the performance of duties and activities of various departments of the organization.
4. The personnel engaged in the business should be of high quality and character with a deep understanding of their responsibilities and a proper background of training and ability. This is necessary because controls are exercised by personnel engaged in the business.
5. There should be managerial supervision and reviews of the company's financial operation and positions at regular and frequent intervals by means of interim accounts and reports and operating summaries etc.

### **Divisions of Internal control**

Depending upon the nature of business and the environment in which it works, the main divisions of an overall internal control system are:

1. *General Financial Control* : This control includes a proper efficient system of accounting, adequate supervision, recording and duplicating systems, good efficient staff and the maintenance of healthy relationships amongst the staff.
2. *Cash Control*: The system includes certain important aspects of control for receipts, payments and balances held. A proper system of internal check must operate at all stages. There may be specially deputed officials including the internal audit staff to exercise checks at regular and irregular intervals. Effort should be made to avoid misappropriation of cash.
3. *Employee Remuneration* : The system must cover all sections of employee remuneration and maintenance of records for remuneration, their preparation and methods of payment should be brought under tight control. So pacific instructions must be issued to the staff concerned.
4. *Trading Transactions* : These refer to the purchases, sales etc. So in respect of these transactions, effective procedure should laid down for acquisitions, handling and accounting of goods purchased or sold.
5. *Fixed Assets* : Capital expenditure on fixed assets should be kept under strict check and supervision. The authority right from sanctioning of capital expenditure to its use should be clearly defined so that any type of misappropriation by officials of the organization can be reduced to the minimum.
6. *Stock maintenance* : Stocks of raw materials, work-in-progress and finished goods should be properly maintained and accounted for. Regular stock taking procedures are quite helpful as means of independent, checks and reconciliation of records.
7. *Investments* : The procedures of control in regard to investments cover such measures as authorisation, recording and maintaining record of investments held and safeguarding the documents of title.

### **Internal control and the Auditor**

An auditor is mainly concerned with the evaluation of the internal control system in force so that he may be able to know :

- (i) whether mistakes, errors and frauds are likely to be located in the ordinary course of business.
- (ii) Whether an effective internal auditing department exist or not.
- (iii) How far and how adequately the management is discharging its function in so far as correct

recording of transaction is concerned.

- (iv) How extensive examination he should carry out in different areas of accounting.
- (v) How far administrative control has a bearing on his work.
- (vi) What should be the appropriate audit programme in existing circumstances.
- (vii) To what extent reliability can be placed on the reports, records and the certificates of the management.
- (viii) Whether some suggestion can be given to improve the existing control system.

Therefore we can conclude by saying that internal control is a broad term which includes internal check, internal audit, and other forms of control.

### **Vouching**

The act of examining documentary evidence in order to ascertain the accuracy and authenticity of entries in the books of account is called "Vouching". In other words vouching means a careful examination of all original evidences that is invoices, statements, receipts, correspondence, minutes, contracts etc. With a view to ascertain the accuracy of the entries in the books of accounts and also to find out, as far as possible that no entries have been omitted in the books of accounts. According to Dicksee. "Vouching consists of comparing entries in books of account with documentary evidence in support thereof.

According to R. B. Bose, "By vouching is meant the verification of the authority and authenticity of transactions as recorded in the books of account".

From these definitions it is clear that vouching means testing the truth of entries appearing in the primary books of account, vouching includes routine checking of carry forwards, extentions, posting into the ledgers, casts, sub-casts and other calculations in the books of original entry. Vouching may be lengthy process in a big organisation unless there is efficient internal control system iiv existence.

The vouching is an important tool in the hands of auditor provided he handles this work with intelligence, observation and commonsense. Vouching is a sort of preliminary work which forms an important part of audit work. Since accounts of a business begin with the passing of entries, hence it becomes a basis for further scrutiny to be made at a later stage. The auditor, after satisfying himself with regard to the authority and authenticity of transactions, can only then say specifically that the books of account are correct and the Balance sheet and Profit and Loss Account exhibit the true and fair state of the financial affairs of business.

This is why vouching is said to be the backbone of auditing.

But all this depends upon the efficiency of the auditor. He, besides checking the arithmetical accuracy of the books or comparing the entries with the available documentary evidence, should also go to the source of a transaction. He should also see that the transaction has been properly authorised. Frauds can be detected only by proper vouching conducted in an intelligent and searching manner. The importance of proper vouching was emphasised in the case of "Armitage Vs. Brewer and Knott". In this case auditors were found guilty of negligence because of their failure to detect defalcations committed by manipulating wage records and petty cash book.

### **Objects of Vouching**

1. To see that all transactions connected with the business have been recorded in the books of account.
2. To establish that no transaction which is not connected with the business has been recorded.
3. To verify that all recorded entries are genuine.

### Verification of assets & liabilities

Various assets and liabilities are verified by the auditor with the help of various documentary evidences and other information.

## **Appointment Qualifications**

The accounts of the Company are to be audited annually by a qualified auditor. Hence the question is, who is a qualified auditor. The answer to this question can be sought in Section 226 of the Companies Act, which states, “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 Accountants Act 1949”. A firm whereof all the partners practising as a Chartered Accountants in India, may also be appointed by its firm’s name as an auditor of a company and the partner of the firm may act in the name of the firm.

A person holding a certificate under the Restricted Auditors Certificate (Part B States) Rules 1956, is also qualified to act as an auditor of a company.

The Central Government has powers to make rules providing for the grant, renewal, suspension or cancellation of such certificates to persons. It also has got powers to prescribe conditions and restrictions for such purposes. But it has to notify to this effect in the official gazette (Section 216(2) (b)).

Thus to be a qualified, auditor should have passed the examination of the Institute of Chartered Accountants of India and be a member of the Institute of the Chartered Accountants : or he should hold a certificate of practice under the Restricted Auditors Certificate (Part B States) Rules 1956. If he does not possess either of the qualifications, he is not qualified to act as an auditor of a company.

## **Disqualifications**

From the above it is clear that the following can not act as an auditor of a Company :

[Section 226 (3)]. & (4)

(i) a body corporate ;

(ii) an officer or an employee of the company. (Officer here means a director, managing director, manager or secretary);

(iii) a person who is a partner or who is in the employment or an officer or employee of the company;

(iv) a person who owes the company more than Rs. 1,000/- or who has given a guarantee of provided any security in connection with the indebtedness of any third person to the company amounting to more than Rs. 1,000/-.

(v) a person who is disqualified for appointment as an auditor of the company’s subsidiary or holding

company or a subsidiary of a holding company.

(vi) A person holding any security after a period of one year from the date of commencement of the companies (Amendment) Act, 2000.

Thus it is quite clear that the persons governed by the above stated clauses of Sec. 226(3) are disqualified from being appointed as an Auditor of a Company.

## **Company auditor : Appointment and Removal**

(i) a body corporate (because of its characteristic feature of limited liability); or

(ii) an officer or employee of the company under audit; or

- (iii) a person who is a partner, or who is in the employment of an officer or employee of the company; or
- (iv) a person who is indebted to the company for an amount exceeding one thousand rupees, or who has given any guarantee for an amount exceeding one thousand rupees; or
- (v) a person holding security, i.e. an instrument which carries voting rights of that company; and
- (vi) under section 226 (4), a person who has been disqualified for appointment as an auditor of a company on above-mentioned grounds, shall also not be eligible for appointment with any other body corporate which may be that company's subsidiary or that company's holding company or that company's fellow subsidiary.

#### **Appointment of auditors - Section 224**

Under section 224 of the Act detailed provisions regarding appointment of statutory auditors have been laid down. This section [except sub-sections 224 (A) and 224 (1B)] is applicable to *all kinds of* companies. The Act has vested the power to appoint auditors with directors, shareholders, the Central Government and the Comptroller and Auditor General of India.

#### **Appointment by directors**

- \* First Auditors (i) The board of directors shall appoint the first auditor(s) of a company within one month of the date of registration of the company by a valid resolution.
- (ii) The auditor so appointed shall hold office till the conclusion of first annual general meeting.
- \* Casual Vacancy - The directors have been empowered to fill any casual vacancy in the office of the auditor, except one, which is caused by prior resignation of an auditor. Any auditor appointed in a casual vacancy shall hold office until the conclusion of next annual general meeting.

#### **Appointment by shareholders**

- \* First Auditors - In case the directors fail to appoint first auditor(s), the shareholders shall appoint the auditor at a general meeting by passing a resolution.

#### **\* Subsequent Auditors**

##### **(i) By ordinary resolution**

As per provisions of section 224 (1), subsequent auditors are to be appointed at each annual general meeting by the shareholders by passing a resolution. The auditor so appointed shall hold the office from the conclusion of that meeting until the conclusion of the next annual general meeting.

##### **(ii) By special resolution**

1. 'Body corporate' connotes a wider expression than company and is used under the Companies Act to denote a company incorporated in India, a foreign company, a public financial institution, a nationalised bank and also a corporation formed under any special Indian or foreign law except as expressly excluded by the definition.

In case of certain companies, the auditor is to be appointed only with the approval of the company

by a special resolution. Section 224A lays down that in case of a company, in which not less than twenty-five per cent of the subscribed share capital is held, whether singly or in any combination, by :

- (a) a public financial institution or a Government company or Central Government or any State Government; or
- (b) any financial or other institution established by any provincial or State Act in which a State Government holds not less than 51% of the subscribed share capital; or
- (c) a nationalised bank or a general insurance company.

the auditor is to be appointed or re-appointed by a special resolution only.

(iii) In case of appointment of subsequent auditors the company must inform the auditor within seven days of appointment;

(iv) The auditor within seven days of receipt of information from the company, must inform the Registrar in writing whether he has accepted or rejected it.

\* **Casual Vacancy**—If a casual vacancy in the office of auditor arises by his resignation, such vacancy should only be filled by the company in a general meeting. In case a casual vacancy arises because of any other reason except resignation, the shareholders can appoint the auditor only if directors fail to fill the vacancy.

### **Appointment by the Central Government**

(i) If a company, at an annual general meeting, fails to appoint or re-appoint an auditor(s), the Central Government may appoint a person to fill the vacancy under powers conferred upon it by section 224(3). The expression. 'fails to appoint or re-appoint' also includes refusal to accept the appointment by the auditor.

(ii) The said company has to give notice of the above fact to the Government and, if a company fails to give such notice within seven days of the annual general meeting, the company and every officer of the company who is in default shall be punishable with fine, which may extend up to five thousand rupees.

(iii) The appointment by the Central Government is made from the panel of names suggested by the applicant company.

(iv) It may be noted that if appointment of a person as an auditor is void *ab initio*, it should not be treated as a casual vacancy, rather this would give rise to powers of the Central Government under section 224(3).

### **Appointment by the Comptroller and Auditor General**

In case of Government companies, the Comptroller and Auditor General appoints or re-appoints the auditor(s).

### **Compulsory re-appointment**

Ordinarily, an auditor appointed by whatsoever authority, is to be compulsorily re-appointed by passing a resolution at the annual general meeting. However, the retiring auditor shall not be reappointed

in the following cases :

1. Subscribed share capital includes equity as well as preference share capital.

(i) if he is not qualified for re-appointment; or

(ii) if he has given the company notice in writing about his unwillingness to be re-appointed; or

(iii) if a resolution has been passed at the meeting—

(a) appointing somebody other than him; or

(b) providing expressly that he shall not be re-appointed; or

(iv) if a notice has been given of any resolution proposing the appointment of some other person in place of the retiring auditor (even if such a resolution could not be proceeded with due to death, incapacity or disqualification of that person proposed as auditor); or

(v) if auditor is unable to comply with the ceiling on number of audits under section 224(1B).

Even for re-appointment of a retiring auditor, passing of a resolution is essential. There cannot be any automatic re-appointment.

### **Ceiling on number of Audits**

A person of a firm can act as an auditor of a limited number of companies. No company or its Board of directors shall appoint or reappoint any person (who is in full time employment elsewhere), or a firm as its auditor, if such a person or a firm is, at the date of such appointment or reappointment holding appointments as auditor of the specified number of companies. However the 'specified number' will not include audit of private companies.

### **Special Resolution and the appointment of an Auditor**

The Companies Amendment Act 1974, by its Section 224-A, requires passing of a special resolution for the appointment or re-appointment of an auditor(s) at the each annual general meeting, in case of companies where less than 25% of the subscribed capital is held whether singly or in any combination by.....

- (a) a public financial institution or a Government Company or a Central Government or any State government; or
  - (b) any financial or other institution established by any Provincial or State Act in which the State Government holds not less than 51% of the subscribed share capital or;
  - (c) a nationalized bank or an insurance company carrying on general insurance business.
- Failure to pass a special resolution in the annual General Meeting by the Company, gives a right to the Central Government to appoint a person(s) to be the auditor of the company.

### **Removal of an auditor - Section 224 (7) and Section 225**

The removal of an auditor can be discussed under the following heads :

1. Removal before the expiry of the term—section 224 (7) of the Act includes provisions relating to removal of an auditor of a company before the expiry of term. These are :

(a) Removal of first auditor :- The company (and not the board of directors) in a general meeting can remove the first auditor appointed by the directors before the expiry of the term. In this case the prior approval of the central Government is not needed for removal of first auditor.

(b) Removal of subsequent auditor :- Any subsequent auditor can be removed from office before the expiry of his term, by the shareholders at a general meeting only after obtaining the prior approval of the central government.

The only purpose of obtaining the prior approval of shareholders through general meeting and the central government is to prevent directors of the company to remove an auditor without adequate and justified reasons.

### **2. Removal after the Expiry of the term**

The auditor can be removed after the expiry of his term of office, as per the procedures laid down in section 225. According to the section, for removal of a retiring or appointing another auditor in his place, the following procedures must be observed.

1. **Special notice** : A special notice of intention to move such resolution must be given to the company by shareholders (holding ten percent voting rights), who wish to nominate some other person for appointment, at least fourteen (14) days before the annual general meeting.

2. **Notice to be sent to retiring auditor** : On receipt of such a notice, the company must send a copy thereof to the retiring auditor.
3. **Right of retiring auditor make a representation** : The retiring auditor has a right to make a written representation (not exceeding a reasonable length) to the company. He may also ask the company to notify such representatives to the shareholders of the company.
4. **Right to get representation circulated** : The company, on receipt of representations, shall mention the fact of representations being made in the notice of the meeting and send a copy thereof to every member of the company to whom the notice of one meeting is sent. However, if the representations are not sent because of the default of the company or late receipt, these may be read out during the meeting.
5. **Ground for exemption** : If the central government, on the application by the company or any other aggrieved person, is satisfied that the auditors securing needless publicity or degamatory publicity, it can exempt the company from sending the copy of representations to the members or reading them out at the general meeting.
6. **Right to attend meeting** : The auditor to be removed has right to attend the general meeting where his removal is to be discussed. He has also a right to speak at such meeting.
7. **Passing of resolution** : The general meeting may, by passing a resolution remove the auditor.

#### **Remuneration of an Auditor**

The appointing authority fixes the remuneration of an auditor. Thus it is clear that where the auditor is appointed by the Board, it is to fix the remuneration; if he is appointed by the Share Holders in the General Meeting, the remuneration is to be fixed in the Annual General Meeting ; if he is appointed by the Central Government, the remuneration is to be fixed by it. The General Meeting can also lay down the manner of fixing the remuneration.

The retiring auditor, when reappointed in the General Meeting, shall get the remuneration, which he was already getting, in the absence of any resolution passed for refixing his remuneration.

When an auditor is required to do some extra work, he is entitled to claim extra-remuneration for such work. Such extra-remuneration payable to him is to be shown in the Profit and Loss Account of the Company also. (Schedule VI Part II Clause B). Any sum paid by the Company in respect of the auditor(s) expenses shall be deemed to be included in his remuneration.

#### **RIGHTS AND POWERS OF AN AUDITOR**

An auditor gets the following rights and powers from the companies Act, to enable him to discharge his duties as an Auditor in a faithful manner.....

##### 1. *Right to inspect books of accounts* (S, 227(1))

The auditor has a right to see the books and the vouchers of the Company, at all times, The books here mean the account books as well as the Statutory, statistical and costing books, Vouchers mean documentary evidence of any nature concerning the books and accounts under Audit, He has a right of free and complete access at all times of even the books and vouchers of the Branch. This has been decided in the Cuff vs. London and County Land Building Co. Ltd. (1912) case.

##### 2. *Right to ask for information and clarifications.* (S. 227 (1) ),

The auditor has a right to call information and explanations from the directors and officers of the Company. This information and explanation should be necessary for discharging his duties as an auditor while auditing the books of account of the Company.

##### 3. *Right to get notice of the general meeting and attend it.* (S. 231).

The auditor has a right to receive notice of the general meeting and attend it. It is not necessary that the accounts of the Company are to be discussed in these meetings. He can attend every meeting of the shareholders.

4. *Right to make a statement in the meeting.*

The auditor has a right to make statement in the shareholder's meeting relating to the accounts of the company only. But he is not bound to make any statement, unless the Chairman of the meeting asks him to do so. In such a case also, he should answer questions relating to accounts only.

5. *Right to be indemnified.* (Section 633).

The auditor has a right to be indemnified out of the assets of the company for all legitimate expenses incurred by him in defending a law suit filed against him for any Civil or Criminal proceedings, provided he has been acquitted in these cases by the court.

6. *Right to visit the Branches.*

The auditor has a right to visit each and every branch of the company, in connection with the audit of these branches or of the Company, provided these branches do not have a separate auditor and further, these branches have not been granted exemption by the Central Government for being audited.

7. *Right to take legal and technical advice.*

The auditor has a right to take legal, expert or technical advice in connection with the performance of his work. But he should give his own opinion in the audit report and not that of the experts. Such a decision has been given in *Re : London and General Bank* (1895).

8. *Right to ask for remuneration.*

The auditor has a right to ask for the remuneration, after completing the audit work of the company. In case of his dismissal after his appointment too, he is entitled to his fees.

9. *Right to sign the audit report* (S. 229).

The auditor has a right to sign the audit report. But where the auditor is a firm, a partner of such firm has a right to sign the audit report, provided he is a practising Chartered Accountant in India. Such partner is also entitled to sign or authenticate any other document of the Company required by law to be signed or authenticated by the auditor.

10. *Right to correction of wrong statements.*

The auditor has a right to correct any wrong statement made by the directors in the general meeting. But this statement must relate to the accounts of the company which he has audited.

## **DUTIES OF AN AUDITOR**

Duties of an auditor can be stated under two heads : A. Duties under the Companies Act; and B. Duties as per the Legal Decisions. Let us see these duties under these heads separately.

### **A. Duties under the Companies Act**

The auditor has the following duties under the Companies Act:

1. *To make special enquiries and investigations in connection with the following matters* (Sec. 227 (IA) ).

(i) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interest of the company of its members;

- (ii) whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company;
- (iii) 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 consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company ;
- (iv) whether loans and advances made by the company have been shown as deposits ; (v) whether personal expenses have been charged to revenue accounts ;
- (vi) 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 the account books and the balance sheet is correct, regular and not misleading.

*2. To make report to the shareholders. (Section 227 (2, 3 & 4) ).*

The auditor of the company is duty bound to make report to the members of the company on the accounts examined by him and on every balance sheet, every profit and loss account laid before the company in the general meeting during his tenure of office. The auditor has to make a report to the members and not to the directors, though his appointment may have been made by the directors. The duty of the auditor is over as soon as he submits the report to the Secretary of the company. It is none of his concern to know whether the same has reached to the hands of the members of the company.

The Audit Report must expressly state the following besides other necessary things ;

- (a) whether in his opinion and to the best of his information and according to the explanations given to him the accounts give the information required by the Act and in the manner so required.
- (b) Whether the balance sheet gives true and fair view of the company's affairs as at the end of the financial year and the profit and loss account gives a true and fair view of the profit and loss of its financial year;
- (c) whether he has obtained all the information and explanations required by him for the purposes of his audit;
- (d) whether, in his opinion, proper books of account as required by law have been kept by the company, and proper returns for the purposes of his audit have been received from the branches not visited by him;
- (e) whether the company's balance-sheet and profit and loss account dealt with by the report are in agreement with the books of account and returns.

*3. Duty to state the reasons for the answers in negative.*

In case of the answers to any of the points stated above are in negative, the auditor is required to explain the reason for the answer in his report.

*4. Duty to include in the report the matters as directed by the Central government.*

Section 227 (4A) empowers the Central Government to require by order, that the auditor's report will include a statement on such matters as may be specified therein. Before making any such order the Central Government may consult the Institute of Chartered Accountants of India in regard to the classes of description or companies and other ancillary matters proposed to be specified therein.

*5. Duty to sign the audit report. (Section 229).*

It is the duty of the auditor to sign the audit report before sending it to the secretary of the company.

6. *Duty to give a report upon the Prospectus* (Section 56 (1) ).

The auditor is required to give his report upon the Prospectus issued by an existing company. He should also give his report on the assets, liabilities and Profit and Loss of such company.

7. *Duty to certify the Statutory Report.* (Section 165 (4) ).

The auditor has to certify the correctness of the Statutory Report with regard to the following:

(a) the number of shares which have been allotted by the company whether for cash or for consideration other than cash;

(b) the total amount of cash received by the company in respect of all the shares allotted, distinguished as aforesaid;

(c) an abstract of the receipt of the company and the payments made.

8. *Duty to declare the solvency of the Directors,* (Section 488 (2) (b)),

The auditor has to declare that solvency of the directors in case of the Voluntary Liquidation of the company,

9. *Duty to give a report upon the Profit and Loss Account and the Balance Sheet enclosed with the Declaration of Solvency.* (Section 488 (2) (b)).

The auditor has to give his report upon the profit and loss account and the balance sheet which is enclosed with the Declaration of solvency made by the Directors of the company, in the case of Voluntary Liquidation of the Company,

10. *Duty to assist the Investigators* (Section 240 (v) (b)).

In case the affairs of the company are to be investigated, the auditor should assist the Investigators in every possible manner. He should produce his working papers relating to audit when asked for by the Investigators.

11. *Duty to assist the Advocate General.*

If the Advocate General is making any enquiry against the directors, the auditor is duty bound to help him in his work.

### **B. Duties According to the Legal Decisions**

Certain matters have been taken to the court of law from time to time and the courts have in their decisions fixed certain duties upon the auditors. These duties in short are enumerated here.

1. Duty to inform the members and shareholders about the contravention of the provisions of the company Law.

2. Duty to enrol himself with the Institute of Chartered Accountants of India and to obtain a certificate to practice from it.

3. Duty to acquaint himself with the provisions of the company law and also enquire from his predecessor about it in writing,

4. Duty not to canvass for and also approach and press any member of the company for his appointment as an auditor of the company.

5. Duty to enquire about the true and fair state of affairs of the company and submit his proper report.

6. Duty to verify himself cash in hand and not to be negligent in his work.

7. Duty to see the Debenture Trust Deed and verify whether the debentures issued by the company are according to the terms laid down in the trust Deed.

8. Duty to verify the investments himself.

9. Duty to perform his task with ability, care and skill.

10. Duty to verify the inventories and the ledger accounts.

11. Duty to personally inspect all securities and see that they are in the safe custody of the Secretary of the Company.

Various courts have penalised the auditors for non-performance of the above stated duties and therefore, the auditor should take note of these duties also.

### **LIABILITIES OF AN AUDITOR**

Liabilities of an auditor of a company differ from those appointed by a firm, The Companies Act has defined the duties of a company auditor and the liabilities arise on account of these duties.

For the sake of convenience the liabilities are divided under the following headings:

A. Civil Liability;

B. Criminal Liability;

C. Liability towards third parties;

D. Liability for libel;

In all the four cases the auditor can be held liable for one or more causes given hereunder.

(a) Liability for Negligence under the law of Agency;

(b) Liability for Misfeasance under the Statutes—Companies Act and Indian Penal Code.

Let us now discuss these liabilities in some detail.

#### **A. Civil Liability**

**Liability for Negligence:** Under the law of Agency the auditor is liable for negligence and in such a case has to pay damages to the aggrieved party or parties. If the company suffers a loss on account of the acts of the auditor, he has to make good this loss. The auditor shall not be held liable for negligence, if the company does not suffer any loss. He shall also not be held liable for the loss suffered by the company without his negligence. In order to hold him responsible for negligence, the following points are to be proved by the party (ies).....

(a) that he was negligent;

(b) that as a result of his negligence the company has suffered the loss ; and

(c) that the loss was suffered by the person to whom the auditor owed a duty. He cannot be relieved of his liability by an agreement entered in between him and his client.

‘Negligence’ includes the following acts—

(a) Not to see the Articles of Association and not to object payment of dividends out of capital;

(b) Not to get statements of accounts from the creditors and find out the errors and frauds.

(c) Not to verify Cash and Petty Cash;

(d) Not to report to the client about the insufficient provision for bad and doubtful debts, which results in inflating the profits for dividends, thus paying dividends out of capital.

**Liabilities for Misfeasance :** The term ‘misfeasance\* implies a breach of trust or duty. Where the auditor performs his duties negligently and the company suffers a loss on this account, the auditor is held liable for Misfeasance and he has to indemnify the company for such loss. He is also liable for damages u/s 543 of the Companies Act. The court can, on application made by the liquidator of the Company, charge the auditor for misfeasance and ask him to make good the loss. However, the auditor has a right to appeal to the court u/s 633 of the companies Act and he can be excused partly or fully by the court if it is satisfied that he has acted honestly and reasonably. Thus relief can be granted only in the case of Civil liability and not in the case of Criminal liability.

## **B. Criminal Liability**

Criminal liability of the auditor arises under the following Acts:

1. Under the Indian Penal Code ;
2. Under the Companies Act;
3. Under the Income-tax Act;
4. Under the Life Insurance Corporation Act;
5. Under the Banking Companies Act;
6. Under the Chartered Accountants Act.

**1. Under the Indian Penal Code :** He is criminally liable, when he issues or signs a certificate required by law to be given or signed or relating to any fact for which such certificate is admissible as evidence, knowing or believing that such certificate is false in any material point. He shall be punishable in the same manner as if he has given false evidence. (Section 197).

**2. Under the Companies Act:** He is criminally liable for the following acts—

(a) for authorising the issue of a false prospectus. The penalty for this act is a fine upto Rs. 50,000/- or imprisonment upto a period of 2 years, or both. (S. 63)

(b) for fraudulently inducing persons to invest money by purchasing shares or debentures of the company. The punishment is imprisonment for a term extending upto 5 years or a fine extending upto Rs. 1,00,000/- or both. (S. 68).

(c) for making a fraudulent report required under section 227 i.e. if the report is made not in conformity with the requirements of Section 227 or any document of the company is signed or authenticated by him which is also not in conformity with the above section or the report is signed or any other document is signed or authenticated by any person other than the auditor himself and such other person is not authorised to do so. The punishment is a fine upto Rs. 10,000 in both the above cases.

(d) For falsification of books. If it is proved that the auditor has been guilty of destroying, mutilating, altering, falsifying or secreting of any books, papers or securities or is privy to the making of any false or fraudulent entry in any register, book of account or document belonging to the company, he shall be punishable with imprisonment extending to seven years and also be liable to fine. (Section 539).

(e) for delinquency i.e. making a false statement wilfully, in the course of winding up of the company or certifying a false return, report, balance-sheet or giving a false certificate or certifying a false document in the course of winding up of a company. All these acts make him liable for criminal offences and the liquidator can directly prosecute him or refer the matter to the Registrar. (Section 545).

(f) For rendering false statements either in the balance sheet or any other document or destroying or mutilating any voucher or document, the auditor shall be punishable with imprisonment upto a period of two years and also shall be liable to fine.

Criminal offences include the following acts, for which he is punishable with fine or imprisonment or both—

- (a) Wilfully submitting a false report;
- (b) Concealment of frauds in the account books;
- (c) Destroying the vouchers and documents concerning account books;
- (d) damaging the property of the company;
- (e) Abetting in the falsification of the account;

- (f) Certifying wilfully the false accounts;
- (g) Making a false statement knowingly to be false;
- (h) Accepting bribe during the course of discharging his duties as an auditor.

**3. Under the Income tax Act:** The auditor is criminally liable for encouraging or abetting his client to make a false statement or declaration regarding his taxable income. The liability for such offence is imprisonment upto 6 month or fine or both. (Section 278).

**4. Under the Life Insurance Corporation Act:** The auditor is criminally liable for making a false statement wilfully on a material point relating to the return, report, balance sheet or any document. The punishment is imprisonment and fine. (Section 104).

**5. Under the Banking Companies Act:** The auditor is criminally liable, if he makes a false statement knowingly relating to a return, report, balance sheet or any other document or conceals a fact. The punishment is imprisonment upto a period of three years. (Section 46). Auditor is treated like a public servant and shall be punishable like a public servant for criminal breach of trust. (Section 46 A). He is also liable to Public Examination and if found guilty by a court can be declared unqualified for appointment as an auditor for 5 years. (Section 46 A).

**6. Under the Chartered Accountant Act, 1949 :** the auditor is liable for misconduct, which is defined under section 122 of the Act. Cases of professional misconduct are dealt in the various schedules of the Act.

### **C. Liabilities Towards Third Parties**

Auditor is not liable to third party or parties as a general rule. He is liable to his employer only. However, if the third parties are able to prove the following points he shall be liable towards them too—

- (a) that the statement was untrue in fact;
- (b) that the person making it knew that it was untrue or was recklessly or consciously ignorant whether it was true or not;
- (c) that the statement was made with the intention that the third party should act upon it;
- (d) that the third party did act on the faith of the statement in the prospectus.

The controversy whether the auditor is liable to the third party is now set at rest and the auditor is now held liable on account of the following reasons—

- (a) Certifying the improper accounting procedure due to which embezzlement of an employee of the client could not be detected.
- (b) Negligence committed by the employee of the auditor;
- (c) Errors committed in the preparation of final accounts,

#### **1) Liability for Libel**

A libelous or slanderous statement made by an auditor will not hold him liable if he has made such statement bonafide and without any malice. But if he has made such a statement outside the scope of his duties, he shall be held liable.

#### **Liability of an honorary Auditor**

An auditor, whether he is paid or honorary, is liable for his acts and omission. The agreement with his client is very much valid in the eye of the law even though there is no monetary consideration involved.

**Liability of a Joint Auditor**

The Companies Act is silent over the issue. But the statement issued by the Institute of Chartered Accountants of India, on the subject of the liability of Joint Auditors is to be followed in such cases.

The gist of this statement is ; the entire work pertaining to audit is to be divided in between the auditors and they shall be responsible for their part only, where the work cannot be divided in any manner, all joint auditors will be responsible.

**Liability of Local Auditors**

If a company has many branches in the country as well as abroad and appoints local auditors for the branches, the auditor of the Head Office shall not be held responsible for the acts of the local auditors, provided the auditor at the Head Office states clearly in his audit report that he had completely relied upon the statements and figures supplied by the local auditors.