



**KLE SOCIETY'S
COMMERCE DEGREE COLLEGE
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Principles & Practice of Auditing

For B.Com V Semester
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1.1 Introduction:

Auditing is an independent examination of financial information of any entity, whether profit-oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to express an opinion thereon.

According to the **ICAI**, auditing primarily aims to ensure that the financial statements present a **true and fair view** of the state of affairs of an entity. The process involves critical scrutiny of books of accounts, vouchers, and other relevant documents to ensure accuracy, reliability, and compliance with applicable laws and standards.

Auditing plays a crucial role in strengthening the trust of stakeholders—such as shareholders, creditors, and regulators—by enhancing the credibility of financial reports. It helps in detecting and preventing errors and frauds, and promotes good governance and transparency in financial reporting.

The study of auditing includes understanding its basic principles, types, techniques, legal framework, and the duties and responsibilities of an auditor. The **ICAI curriculum** emphasizes ethical conduct, independence, and professional scepticism as foundational pillars of auditing practice.

History of Auditing:

Origin of Auditing (Ancient Times): Root word: The word "Audit" is derived from the Latin word 'Audire', which means "to hear." In ancient times, accountants used to **read out the accounts** to higher authorities, who would "hear" them and approve.

Early forms of auditing were practiced in: **Egypt (around 3000 B.C.)**: Accountants maintained records for grain and wealth. **Greece and Rome**: Auditors were appointed to check the finances of public offices. **India**: During the time of **Kautilya (Chanakya)** in the Mauryan Empire, a system of auditing was mentioned in **Arthashastra**.

Auditing in the Middle Ages (Medieval Period): During the **medieval period**, especially in **England**, the growth of trade and feudal estates led to the **need for verifying accounts** maintained by stewards and estate managers. Auditors were appointed by kings and noblemen to detect **frauds or mismanagement**.

Development in the 19th Century (Modern Auditing): The **Industrial Revolution** in Britain during the 18th and 19th centuries led to Large-scale manufacturing, Formation of **joint-stock companies** and Increase in **public investment** this led to the **need for auditing** to protect shareholders. Audit was focused mainly on **detection of frauds and errors**. And Auditing began to **formalize** as a profession.

Evolution in the 20th Century: In the **early 20th century**, the scope of auditing **expanded** beyond fraud detection to include **Verification of financial statements, Assessment of internal controls**

Expression of audit opinion Auditing standards were developed across countries to bring **uniformity and professionalism**.

History of Auditing in India

Ancient India: As mentioned, the concept of financial control and verification existed in Kautilya's Arthashastra. Revenue collection and treasury accounts were inspected by royal auditors.

British India: The Indian Companies Act of 1857 and subsequent versions required certain companies to have their accounts audited. Auditing gradually became mandatory for companies.

Post-Independence: In 1949, the Institute of Chartered Accountants of India (ICAI) was established under the Chartered Accountants Act, 1949. ICAI became the regulatory body to Conduct CA exams, Prescribe Standards on Auditing (SAs) and Promote ethical practices and audit discipline

Modern Era: With the growth of corporate governance and regulatory compliance, the role of the auditor has become more analytical and judgment-based, focusing on Risk assessment, internal control evaluation and Fraud detection and reporting

1.2 Meaning and Definition and Objectives:

Meaning

Auditing is a **systematic and independent examination** of financial records and statements of an entity to ensure that they reflect a **true and fair view** of its financial performance and position, and are prepared in accordance with the applicable financial reporting framework (e.g., Indian Accounting Standards, Companies Act, etc.).

Auditing means a systematic review of financial statements by an independent professional to ensure they are accurate, fair, and comply with applicable rules.

Definition

According to Montgomery (Famous American Auditor)

"Auditing is a systematic examination of the books and records of a business or other organization, in order to ascertain or verify and to report upon the facts regarding its financial operations and the results thereof."

According to ICAI Definition (Official)

"Auditing is the independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to express an opinion thereon."

Objectives: These objectives are categorized into two broad levels:

1. Primary Objective (Main Objective)

- ❖ **To enable the auditor to express an opinion:** on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. The main purpose of an audit is to give an **independent and unbiased opinion** on the **truth and fairness** of the financial statements. It means checking whether the financial statement are free from **material misstatements** (errors or frauds). Comply with the **accounting standards** and laws (like Ind AS, Companies Act). The auditor does **not prepare** the financial statements but verifies the ones prepared by management.

2. Secondary Objectives (Subsidiary Objectives)

(While the main objective is opinion expression, several **supporting objectives** help in achieving that)

- ❖ **Obtain Reasonable Assurance:** To obtain **reasonable assurance** that the financial statements as a whole are free from **material misstatements**, whether due to fraud or error. "Reasonable assurance" means **high, but not absolute, level of assurance**. Auditor uses **sampling, analytical procedures, tests of controls**, etc.
- ❖ **Report on the Financial Statements:** Auditor must **express a clear written opinion** through an **audit report**. If unable to express a full opinion, they must provide a **qualified, adverse, or disclaimer** opinion, depending on the situation. This enhances the **credibility** of financial statements.
- ❖ **Ensure Compliance with Standards on Auditing (SAs):** The auditor should **follow all applicable Standards on Auditing** issued by ICAI. Ensures consistency, professionalism, and legal protection.
- ❖ **Evaluate the Risk of Material Misstatement:** Auditor identifies areas where misstatements are more likely (inherent risk). Plans audit procedures accordingly to **minimize audit risk**.
- ❖ **Maintain Professional Skepticism and Judgment**
 - **Professional Skepticism:** Always question and critically assess evidence.
 - **Professional Judgment:** Apply experience and ethics to form balanced opinions. Essential to avoid being misled or manipulated by management.
- ❖ **Communicate Audit Findings Clearly:** Auditor should clearly communicate Material weaknesses in internal control Misstatements detected Uncertainties or going concern issues any limitations on scope

1.3 Types of Audit: (as per ICAI Study Material)

Auditing can be classified into various types depending upon **statutory requirements, function or nature, period of audit, and specific purposes**. Each category serves different objectives and provides assurance on different aspects of an organization's financial and operational performance.

1. Based on Statutory Requirement

This classification is based on whether an audit is **mandated by law** or any **specific regulation**. Such audits are compulsory for certain entities and are performed according to statutory provisions.

(a) Statutory Audit: A statutory audit is a **legal requirement** under the **Companies Act, 2013** for all registered companies.

The main objective is to **verify the true and fair view** of the company's financial statements.

The auditor's duties, qualifications, powers, and responsibilities are defined by law.

It ensures that the company's financial statements comply with **accounting standards, laws, and regulations**.

(b) Tax Audit (Sec 44AB): A tax audit is conducted under **Section 44AB of the Income Tax Act, 1961**.

It ensures that the books of accounts of taxpayers are **properly maintained** and that **income and deductions** are accurately reported for tax purposes.

The report is submitted in **Form 3CA/3CB and 3CD** by a Chartered Accountant.

It helps in preventing tax evasion and ensuring compliance with tax laws.

(c) Cost Audit: A cost audit is mandated under the **Companies Act, 2013 (Section 148)** for specific industries such as manufacturing, cement, steel, pharmaceuticals. It involves the verification of **cost accounting records** to ensure accuracy in cost computation and control over production expenses.

The auditor submits a **cost audit report** to the company and the Central Government.

(d) Secretarial Audit: Secretarial audit is conducted under **Section 204 of the Companies Act, 2013**. It verifies whether the company has complied with **corporate laws, SEBI guidelines, FEMA, and other applicable regulations**.

This audit is mandatory for listed companies and other prescribed classes of companies.

It ensures good governance and transparency in management practices.

(e) Bank Audit: Bank audit is conducted as per the guidelines of the **Reserve Bank of India (RBI)**.

It includes statutory audit, concurrent audit, internal audit, and stock audit of banks.

The objective is to ensure accuracy of financial statements, compliance with RBI norms, and safeguarding of public deposits.

(f) Co-operative Society Audit: This audit is conducted under the **Co-operative Societies Act** of the respective state. It ensures that the society's accounts are **true, fair, and properly maintained**.

The auditor checks compliance with society laws, member transactions, and use of funds.

(g) Insurance Audit: Insurance audits are performed under the **Insurance Act, 1938** and the **IRDAI regulations**. The auditor ensures **accuracy of premium income, claims settlement, policy liabilities**, and adherence to regulatory requirements.

2. Based on Function or Nature of Work

This classification is based on the **purpose and scope** of the audit. It focuses on operational efficiency, internal control, management effectiveness, and performance improvement.

Types of Audit (as per ICAI)

1. Based on Statutory Requirement

- Statutory Audit
- Tax Audit (Sec 44AB)
- Cost Audit
- Secretarial Audit
- Bank Audit
- Co-operative Society Audit
- Insurance Audit

2. Based on Function/Nature

- Internal Audit
- Management Audit
- Operational Audit
- Performance Audit
- Environmental Audit
- Social Audit
- Forensic Audit

3. Based on Time or Period

- Interim Audit
- Final Audit
- Continuous Audit
- Concurrent Audit

4. Special Types of Audit

- Information System / IT Audit
- Proprietary Audit
- Due Diligence Audit
- Compliance Audit

(a) Internal Audit: An internal audit is conducted by the organization's internal audit department. It ensures the effectiveness of internal control systems, risk management, and operational efficiency. Internal auditors report to management and provide recommendations for improvement.

(b) Management Audit: This audit examines the efficiency and effectiveness of management decisions. It evaluates planning, organizing, and controlling functions of management. The aim is to improve decision-making, increase profitability, and achieve organizational goals.

(c) Operational Audit: Operational audit focuses on the efficiency of operations and the use of resources. It is performance-oriented and helps identify wastage, inefficiency, and non-compliance in processes.

(d) Performance Audit: Performance audit is conducted to assess whether the resources are utilized economically, efficiently, and effectively (3Es). It is widely used in public sector undertakings and government departments.

(e) Environmental Audit: This audit evaluates the impact of an organization's activities on the environment. It ensures compliance with environmental laws, pollution control norms, and sustainable development practices.

(f) Social Audit: A social audit measures the company's contribution to society and social welfare. It reviews activities such as CSR projects, employee welfare, community development, and environmental protection.

(g) Forensic Audit: A forensic audit is conducted to detect and investigate frauds, financial irregularities, and embezzlements. It is often used in **litigation cases** and involves the collection of evidence for legal proceedings.

3. Based on Time or Period

This classification depends on the **timing and frequency** of the audit conducted during an accounting year.

(a) Interim Audit: An interim audit is conducted **between the accounting year**, before the final audit. It helps management in **preparing interim financial statements** and declaring interim dividends.

(b) Final Audit: A final audit is conducted **after the end of the accounting year**. It involves a **complete and comprehensive examination** of the books of accounts. It ensures the preparation of **final accounts** and the auditor's **final report**.

(c) Continuous Audit: Continuous audit involves **regular or frequent verification** of accounts throughout the year. It is useful for **large organizations and banks** where transactions are voluminous. It helps in **timely detection of frauds and errors**.

(d) Concurrent Audit: A concurrent audit is a **real-time audit** conducted simultaneously with transactions. It is mainly used in **banks and financial institutions** to ensure continuous review of operations.

4. Special Types of Audit

Some audits are designed for specific purposes or under special circumstances to meet the particular needs of management or stakeholders.

(a) Information System / IT Audit: An IT audit examines the security, integrity, and efficiency of an organization's information systems. It evaluates data processing, cyber security, and internal IT controls. The goal is to ensure data accuracy, confidentiality, and system reliability.

(b) Proprietary Audit: A proprietary audit is concerned with examining whether public funds are used properly and for the intended purpose. It is mainly conducted in government and public sector undertakings. It ensures efficiency, economy, and accountability in spending public money.

(c) Due Diligence Audit: This audit is performed before mergers, acquisitions, or investments. It verifies financial, legal, and operational aspects of the target company. It helps investors or buyers make informed decisions before entering into contracts.

(d) Compliance Audit: Compliance audit ensures that the entity is following laws, rules, regulations, and internal policies. It is essential for maintaining corporate governance and legal compliance.

1.10 Audit Engagement and Audit Documentation (As per SA 210 & SA 230)

A. Audit Engagement (SA 210 – Agreeing the Terms of Audit Engagements) Audit Engagement refers to the agreement between the auditor and the client to perform an audit of financial statements under the applicable financial reporting framework. It establishes a clear understanding of the responsibilities of both auditor and client, and ensures mutual agreement on scope, objectives, and limitations of the audit.

SA 210 – "Agreeing the Terms of Audit Engagements" provides guidance on how an auditor should agree on the terms of the audit with the management and, where appropriate, those charged with governance, before commencing the work.

Main Objectives of Audit Engagement

- Establishing Clarity on Audit Scope and Responsibilities:** The auditor must ensure that the client understands that the audit will be conducted in accordance with the applicable financial reporting framework and the SAs. This includes explaining that the auditor's role is to express an opinion on the financial statements, not to prepare them. Avoids role confusion and ensures management does not expect services outside the audit scope without proper agreement.
- Confirming Management's Acknowledgement of Responsibilities:** Management must acknowledge that it is responsible for:
 - Preparation and fair presentation of the financial statements.
 - Internal controls necessary to ensure accuracy and reliability.
 - Providing access to all relevant information and persons during the audit.

This recognition forms the foundation for the audit, as the auditor relies on management's cooperation and information. ICAI Emphasis Without this acknowledgement, the auditor should not accept the engagement.

- Avoiding Misunderstanding and Disputes:** Without a written agreement, there may be differences in expectation about the audit's objectives, extent of work, or reporting format. The engagement letter acts as a legal safeguard against such disputes by documenting agreed terms. Example: If management expects a forensic audit but the auditor conducts only a statutory audit, conflicts will arise unless scope is clarified.
- Formalizing Agreement through Engagement Letter:** The engagement letter is a binding document that contains all agreed terms.

Key Elements:

- ✓ Objective of the audit
- ✓ Responsibilities of auditor and management
- ✓ Identification of applicable financial reporting framework
- ✓ Reference to SAs
- ✓ Expected form and content of reports

The auditor should send an engagement letter before starting work to confirm the terms in writing.

- Complying with Professional Requirements:** SAs and ICAI Code of Ethics require auditors to have a documented agreement before starting work. This ensures compliance with quality control requirements (SA 220) and helps in peer review or regulatory inspections. Benefit: Protects the auditor in case of legal or disciplinary proceedings.
- Reviewing Preconditions for an Audit:** The auditor must assess whether preconditions are present before accepting the engagement.

Preconditions include:

- ✓ Acceptable financial reporting framework
- ✓ Management's agreement to responsibilities
- ✓ Ability to obtain sufficient appropriate audit evidence

If preconditions are not met, the auditor should decline the engagement

- Setting the Basis for Auditor's Opinion:** The ultimate goal of the audit engagement is to express an independent opinion on the financial statements. Agreeing on terms ensures that the audit will be based on recognized auditing standards, giving credibility to the opinion.

Audit Engagement Process as per SA 210 (Agreeing the Terms of Audit Engagements)

1. **Preconditions for an Audit:** Before accepting an audit engagement, the auditor must ensure that certain conditions are satisfied:
 - **Acceptable Financial Reporting Framework:** The entity must prepare its financial statements using an acceptable framework such as:
 - ✓ Indian Accounting Standards (Ind AS)
 - ✓ Accounting Standards (AS)
 - ✓ International Financial Reporting Standards (IFRS)
 This ensures consistency and comparability.
 - **Agreement on Management's Responsibilities:** Management must acknowledge and agree that they are responsible for:
 - a) **Preparation of Financial Statements** – in accordance with the chosen reporting framework.
 - b) **Internal Control** – designing, implementing, and maintaining systems to prevent fraud and error.
 - c) **Access to Information** – providing unrestricted access to records, documents, and other necessary information.
 - d) **Additional Information** – supplying explanations and details as requested by the auditor.
 - e) **Unrestricted Access to Personnel** – allowing discussions with staff and management during the audit.
 - **Willingness to Cooperate:** The client should be cooperative and willing to provide support for the audit process. And Unwillingness or restrictions may be grounds for declining the engagement.

2. **Agreement on Terms of the Engagement:** Once the preconditions are met, the auditor and client must agree on **clear terms** before starting the audit.

Audit Engagement Letter: The terms are generally confirmed in writing through an **Audit Engagement Letter**, which serves as a contract.

It should include:

- ✓ **Objective and Scope of the Audit** – Purpose and extent of audit procedures.
- ✓ **Responsibilities of the Auditor** – Conducting the audit in accordance with SAs, obtaining sufficient audit evidence, and issuing a report.
- ✓ **Responsibilities of Management** – As stated in preconditions.
- ✓ **Identification of Applicable Financial Reporting Framework** – e.g., Ind AS.
- ✓ **Form and Content of Reports** – Nature of opinion, expected modifications (if any).
- ✓ **Access to Records and Personnel** – Rights of the auditor to obtain necessary data.
- ✓ **Confidentiality Clause** – Maintaining confidentiality of client information.
- ✓ **Fees and Billing Arrangements** – Terms of payment and expenses.
- ✓ **Other Agreed Services** – Tax audits, advisory services, etc.
- ✓ **Limitations on the Audit** – If any, clearly mentioned.

3. **Recurring Audits:** For continuing clients, SA 210 provides that the engagement letter **need not be issued annually** unless:

- ✓ **Change in Senior Management** – New leadership may require reconfirmation of terms.
- ✓ **Significant Changes in Engagement Terms** – New laws, regulations, or accounting standards.
- ✓ **Major Changes in Business Size/Nature** – Mergers, acquisitions, or diversification.
- ✓ **Change in Ownership** – Shareholding structure changes.
- ✓ **Doubt About Understanding of Terms** – Misunderstandings in prior audits.

4. **Changes in Terms of Engagement:** If the client requests a change in the audit terms (e.g., converting an audit to a review):

- ✓ The auditor may accept **only if the change is justified** and not done to avoid certain audit procedures.
- ✓ If the change is unreasonable, the auditor should refuse or withdraw.
- ✓ New terms should be documented and signed.

5. Limitations on Scope before Acceptance: If the client imposes restrictions before engagement that will likely prevent the auditor from forming an opinion. The auditor should **not accept** the engagement unless required by law. If required by law, the auditor must inform the client that the report may be disclaimer of opinion.

6. Documentation: The auditor must document:

- ✓ Preconditions for the audit.
- ✓ Agreed terms of the engagement.
- ✓ Engagement letter (signed by both parties).
- ✓ Changes in terms and reasons for change.

B. Audit Documentation (SA 230 – Audit Documentation)

Meaning and Definition:

Audit Documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions reached by the auditor.

According to SA 230, it is the "**record of the auditor's work**" that serves as proof that the audit was conducted in accordance with Standards on Auditing (SAs) and applicable laws/regulations. It includes working papers, schedules, analyses, memoranda, summaries, and correspondence relating to the audit.

Objectives of Audit Documentation: The objectives as per SA 230 are:

- **Evidence of Basis for Auditor's Report** – To demonstrate that the audit opinion is based on sufficient appropriate audit evidence.
- **Evidence of Audit Compliance** – To show that the audit was planned and performed in accordance with SAs and legal requirements.
- **Facilitating Supervision & Review** – To enable proper direction, supervision, and review of work performed, especially in multi-level audit teams.
- **Future Reference** – Serves as a reference point for future audits of the same client.
- **Support for Accountability** – In case of disputes, complaints, or legal proceedings, documentation acts as proof of due diligence.

Nature and Form of Audit Documentation: Audit documentation can be **manual, electronic, or other media**. The form depends on:

- ✓ Nature of engagement
- ✓ Size and complexity of the entity
- ✓ Nature of audit procedures performed
- ✓ Identified risks
- ✓ Extent of judgment exercised
- ✓ Use of IT in the audit process

Examples: Audit programs, Checklists, Written records of discussions, Memos of significant matters, Letters of confirmation, Audit evidence (invoices, contracts, bank statements)

Requirements of SA 230

(A) Timely Preparation: Documentation should be prepared **on a timely basis** to enhance quality and accuracy. Delayed documentation may result in omission of important details.

(B) Content of Documentation: Each audit file must clearly record:

- ✓ **Nature of Audit Work** – What procedures were performed.
- ✓ **Timing** – When the work was performed.
- ✓ **Extent** – How much work was done.
- ✓ **Results** – Findings and conclusions from procedures.
- ✓ **Name and Date** – Who performed the work and who reviewed it.

(C) Linkage to Audit Plan: Documentation should clearly link to the overall audit strategy and plan, showing coverage of significant risk areas.

(D) Significant Matters: Auditors must record:

- ✓ Issues requiring significant professional judgment.
- ✓ Discussions with management and those charged with governance.
- ✓ Reasons for conclusions reached.
- ✓ Alternative treatments considered.

Assembly of Final Audit File: Auditor must complete the assembly of the final audit file **within 60 days** after the date of the auditor's report. After assembly, no **deletion** of documentation is permitted. Additions or amendments must be documented with Reason for change and Date and person making the change.

Retention of Audit Documentation: Retention period: **Minimum 7 years** from the date of auditor's report (as per ICAI guidelines). In case of litigation or regulatory requirements, retention may be longer.

Confidentiality of Audit Documentation: The auditor must maintain confidentiality of working papers and not disclose them without client consent, except when required by law or professional duty. Working papers remain the **property of the auditor**. Maintain **physical and digital security**.

Module No.2:

Risk Assessment and Internal Control

⊕ Introduction -Audit risk and Assessment of risk

Audit Risk – Meaning

Audit risk is a fundamental concept in auditing which refers to the risk that the auditor may express an inappropriate audit opinion on financial statements that are materially misstated. In simple words, it is the possibility that even after conducting an audit, the auditor may fail to detect material misstatements and may give an unqualified (clean) opinion when the statements actually contain errors or fraud. The Institute of Chartered Accountants of India (ICAI), in line with International Standards on Auditing, emphasizes that audit risk cannot be eliminated completely but can be reduced to an acceptably low level through proper planning, execution, and professional judgment.

Components of Audit Risk Audit risk is generally considered as a function of three components:

1. Inherent Risk (IR): The risk that a material misstatement could occur in the financial statements due to the nature of business, industry, or transactions before considering any internal controls.

Causes / Examples:

- ✓ Complex transactions (e.g., derivatives, foreign exchange contracts).
- ✓ Involvement of management judgment and estimates (e.g., provision for doubtful debts).
- ✓ High volume of routine transactions.
- ✓ Industry factors (e.g., rapidly changing technology, regulatory pressures).

Inherent risk is usually higher in businesses that are complex, volatile, or heavily regulated.

2. Control Risk (CR): The risk that a material misstatement will not be prevented, detected, or corrected by the entity's system of internal controls.

Causes / Examples:

- ✓ Weak internal controls or absence of segregation of duties.
- ✓ Lack of effective internal audit.
- ✓ Management override of controls.
- ✓ Human errors or negligence in implementing controls.

Even if inherent risk is high, good internal controls can reduce the chance of misstatement. Conversely, poor controls increase the overall audit risk.

3. Detection Risk (DR): The risk that the auditor's procedures fail to detect material misstatements that exist in the financial statements.

Causes / Examples:

- ✓ Inappropriate audit procedures.
- ✓ Misapplication of audit techniques.
- ✓ Use of wrong sampling methods.
- ✓ Lack of professional skepticism.

Detection risk is under the auditor's control and can be reduced by designing effective audit procedures, applying professional judgment, and ensuring sufficient audit evidence is collected.

Audit Risk Model The relationship is expressed as:

$$AR = IR \times CR \times DR$$

Where:

AR = Audit Risk

IR = Inherent Risk

CR = Control Risk

DR = Detection Risk

Assessment of Audit Risk

Audit Risk (AR) is the chance the auditor gives a wrong opinion on financial statements (FS) that are materially misstated. We manage AR by understanding and calibrating its parts:

$$AR = IR \times CR \times DR$$

Inherent Risk (IR): Susceptibility of an assertion to misstatement before considering controls. Drivers: complexity, judgment, volatility, susceptibility to theft.

Control Risk (CR): Risk that the entity's internal controls won't prevent, or detect and correct, a misstatement.

Detection Risk (DR): Risk that the auditor's procedures won't detect an existing misstatement.

Because RMM = IR × CR, we assess risk at:

Financial statement (FS) level (pervasive risks affecting many assertions—e.g., going concern, control environment, ITGC failures), and Assertion level (for classes of transactions, account balances, disclosures): Existence/Occurrence, Completeness, Accuracy/Valuation/Allocation, Cut-off, Classification, Rights & Obligations, and Presentation & Disclosure.

Objectives of risk assessment (SA 315)

1. Identify & assess RMM at FS and assertion levels to pinpoint where and why misstatements may arise.
2. Understand the entity & its environment, incl. internal control—to evaluate design/implementation (D&I) of relevant controls and decide whether to rely on them.
3. Provide a basis for responses (SA 330): translate risks into tailored audit procedures (substantive and, where relevant, tests of controls).
4. Maintain professional scepticism; consider fraud (SA 240): presume risks related to management override; consider revenue recognition fraud unless rebutted; remain alert to bias.
5. Scalability: Apply work proportionate to entity complexity—document your rationale either way.
6. Update continuously: Reassess risks as evidence emerges (rolling risk assessment).
7. Documentation cues (SA 230): Record identified risks, related controls, your rationale for “significant risk” designation, and linkage to planned procedures.

Procedures used to assess risk (how to gather inputs)

- **Inquiries:** Management (CFO, COO), process owners, internal audit, IT, legal, those charged with governance (TCWG). Ask about fraud, pressures, unusual transactions, changes in processes/IT.
- **Analytical procedures (SA 520) at planning:** Ratios, trends, reasonableness (e.g., revenue vs headcount, margins vs industry, DSO/DIO/ DPO). Flag unexpected relationships for further work.
- **Observation & inspection:** Site visits; watch how transactions flow; inspect org charts, policies, process manuals, board/Audit Committee minutes, key contracts/leases/loan covenants.
- **Walk-troughs & flowcharts:** Trace a single transaction end-to-end from initiation to GL to verify points where misstatement could occur and where controls address them.
- **IT understanding (SA 315 & 402):** Landscape, in-scope applications, GITCs (access, change management, operations, backups), automated controls, interfaces, spreadsheets/end-user computing, service organisations (SOC 1).
- **External context:** Regulatory changes, macro trends, supply disruptions, FX/interest rates, competitor actions—helps challenge management narratives.
- **Output:** A risk register/matrix mapping risk → assertion(s) → relevant controls → planned response.

Components internal control

1. Control environment: Integrity/ethics, governance, competence, accountability. Weak tone at the top → FS-level risk; expect more substantive work and unpredictability.
2. Entity risk assessment process: How management identifies and responds to business/financial reporting risks; absence suggests blind spots.
3. Information system & communication: How transactions are initiated, recorded, processed, reported; master data governance; IT dependencies; key reports used in controls (test their completeness/accuracy).

4. Control activities: Approvals, reconciliations, segregation of duties, automated validations, exception reports. Identify key controls per significant assertion.
5. Monitoring: Ongoing/periodic evaluations, internal audit, remediation tracking; ineffective monitoring increases CR.

Internal Control-Meaning and objective

A. Meaning of Internal Control

According to the Institute of Chartered Accountants of India (ICAI),

"Internal Control refers to the process designed and implemented by those charged with governance, management and other personnel to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance."

In simple terms, Internal Control is a system of policies, procedures, and practices adopted by an organization to safeguard assets, ensure reliability of financial reporting, promote operational efficiency, and ensure adherence to laws and regulations.

Key Features of Internal Control

- ✓ Process, not an event: It is continuous and embedded into operations.
- ✓ Designed by management: Responsibility lies with management and TCWG.
- ✓ Covers all levels: Applies to top management, middle management, and employees.
- ✓ Reasonable assurance, not absolute: Because of inherent limitations (collusion, human error, cost-benefit).
- ✓ Linked with risk management: Identifies risks and builds safeguards.

B.1 Objectives of Internal Control (aligned with COSO framework):

(A) Operational Objectives

- ✓ Efficiency and effectiveness of operations.
- ✓ Ensuring optimum use of resources – men, material, money, and machines.
- ✓ Prevention of wastage, fraud, and mismanagement.

Example: Budgetary controls, standard costing, performance reviews.

(B) Reporting Objectives

- ✓ Reliability of financial reporting.
- ✓ Ensuring accounting records are complete, accurate, and reliable.
- ✓ Preparation of true and fair financial statements in accordance with applicable accounting standards and regulatory framework.

Example: Reconciliation of accounts, authorization procedures, segregation of duties.

(C) Compliance Objectives

- ✓ Compliance with applicable laws and regulations.
- ✓ Safeguarding the organization from penalties, fines, or reputational damage.

Example: Compliance with Companies Act, Income Tax, GST, Labour Laws, SEBI guidelines, RBI directives etc.

B.2 Specific Objectives of Internal Control (as emphasized by ICAI in Auditing Standards)

1. **Safeguarding of Assets:** Prevent unauthorized use/disposal. Ensure assets are recorded and periodically verified. Example: Physical verification of inventory, asset tagging.
2. **Accuracy and Completeness of Accounting Records:** Transactions should be recorded correctly, in the right amount, period, and account. Example: Sequential numbering of vouchers, reconciliation of bank accounts.
3. **Prevention and Detection of Frauds and Errors:** Prevent opportunities for fraud through segregation of duties, authorization, and supervision. Example: Different persons handling custody of cash, recording, and reconciliation.

4. **Timely Preparation of Reliable Financial Information:** Information provided to management and stakeholders must be accurate and timely for decision-making. Example: MIS reports, monthly trial balance, variance analysis.
5. **Compliance with Policies, Plans, Procedures, Laws and Regulations:** Ensures operations are carried out according to management's policies and within legal framework. Example: Credit policy adherence, statutory dues remittance.

C. Importance of Internal Control (from ICAI's perspective)

- ✓ Provides a basis for auditor's reliance while planning audit (SA 315).
- ✓ Helps management achieve business objectives.
- ✓ Builds confidence of stakeholders, investors, regulators.
- ✓ Supports corporate governance and risk management framework.

5. Inherent Limitations of Internal Control (as ICAI notes)

- ✓ Human error due to negligence, fatigue, or misunderstanding.
- ✓ Collusion among employees may override controls.
- ✓ Management override of established controls.
- ✓ Cost–benefit consideration: Controls should not be more expensive than the benefit derived.
- ✓ Unusual transactions may bypass normal control procedures.

Fundamental Principles of Internal Control [As per auditing principles (ICAI)]

1. Segregation of Duties (Division of Work): No single individual should be responsible for authorizing, executing, recording, and reviewing a transaction. Functions like authorization, recording, and custody of assets should be separated. Prevents frauds and errors because collusion becomes difficult and no single employee has complete control.

Example: One employee approves purchases, another records them, and a third handles payments.

2. Proper Authorization of Transactions: All financial and operational transactions should be carried out only with appropriate approval. Authorization should be given by personnel with suitable authority depending on the value and type of transaction. Prevents unauthorized use of resources and ensures compliance with company policies.

Example: Credit sales above a fixed limit must be approved by the sales manager.

3. Adequate Documentation and Records: Every transaction must be supported by documentary evidence (invoice, voucher, bill, receipt). Provides an audit trail, accountability, and accuracy in records. Documents should be:

- ✓ Pre-numbered to avoid omission or duplication.
- ✓ Properly classified and filed for easy retrieval.

Example: Purchase orders should be numbered sequentially and filed systematically.

4. Physical Safeguarding of Assets: Assets must be properly secured against theft, misuse, or unauthorized access. Prevents misappropriation of assets and ensures assets are available for business use.

Examples:

- ✓ Cash locked in safes, access given to authorized personnel only.
- ✓ Inventory stored in guarded warehouses.
- ✓ Fixed assets tagged and recorded.

5. Independent Internal Checks: Work performed by one employee should be automatically checked by another. Detects errors quickly and reduces chances of intentional fraud.

Example: Cashier receives cash, while accountant records the receipt, and another person reconciles it with bank deposits.

6. Rotation of Duties: Employees should be periodically rotated from one job to another. Prevents collusion, reduces chances of fraud, and increases employee skills.

Example: Staff handling bank reconciliation may be rotated after a few months.

7. Periodic Reviews and Monitoring (Supervision) L: Managers and supervisors should review work regularly. Surprise checks, management reviews, and internal audits strengthen the system. Detects inefficiencies, enforces discipline, and ensures compliance with procedures.

8. Arithmetic and Accounting Controls: Regular checking of calculations, reconciliations, and cross-verification of accounts. Ensures accuracy of accounting records and reduces clerical errors.

Example: Trial balances, control accounts vs. subsidiary ledgers. And Bank reconciliations.

9. Standardized Policies and Procedures: Clear rules, policies, and standard operating procedures (SOPs) should be documented and communicated to employees. Ensures uniformity, consistency, and adherence to management policies.

Example: Written guidelines for approving expenses or granting credit.

10. Competent and Trustworthy Personnel: Internal control depends on the honesty, skill, and competence of employees. Even the best system fails without reliable and competent people.

Example: Staff handling cash must be trustworthy and adequately trained.

11. Use of Technology and IT Controls: In modern business, internal controls must include IT controls. Prevents unauthorized access, ensures data accuracy, and reduces human error.

Examples:

- ✓ Password protection for accounting systems.
- ✓ Access rights given on a “need-to-know” basis.
- ✓ Automated validation checks in ERP systems.

12. Cost–Benefit Principle: Controls should not cost more than the benefit derived. Ensures efficiency and practicality in designing control systems.

Example: For small petty cash payments, simple authorization may be sufficient rather than complex approvals.

13. Internal Audit and Independent Verification: Independent reviews by internal auditors or external auditors strengthen control. Provides objective evaluation and helps improve internal control systems.

Example: Verification of stock, fixed assets, or accounts by audit teams.

Internal check- Meaning, objectives

Meaning of Internal Check

According to ICAI,

“Internal check is an arrangement of duties allocated in such a manner among the staff members of an organization that the work of one person is automatically checked by another person, with the objective of preventing and detecting errors and frauds at the earliest possible opportunity.”

In simple words:

- ✓ Internal Check is not a separate system, but a subdivision of internal control.
- ✓ It ensures that no single individual has full control over a transaction from initiation to completion.
- ✓ Responsibility is divided systematically so that one person’s work acts as a check on another’s work.

Key Features of Internal Check

- Part of internal control system – specifically focused on allocation of duties.
- Division of work – responsibility shared among staff to prevent monopoly.
- Automatic checking – no extra effort needed, since one person’s work naturally verifies another’s.
- Prevention and detection – designed to avoid errors/frauds and detect them early.

- Continuous process – operates day-to-day, not periodically.

Objectives of Internal Check

A. Prevention and Detection of Errors and Frauds: To prevent the occurrence of mistakes, misappropriations, and manipulations.

Example: Cashier collects money, but accounting and reconciliation are done by a separate clerk.

B. Accuracy and Reliability of Accounts: To ensure that transactions are properly authorized, recorded, and classified. Helps maintain reliable books of accounts.

Example: Sequential numbering of invoices checked by a supervisor.

C. Division of Work and Responsibility: To divide work among employees in such a way that no one individual handles a transaction completely. Ensures segregation of duties (authorization, custody, and recording).

Example: One staff member prepares purchase order, another checks goods received, a third makes the payment.

D. Moral Check on Staff: Since employees know their work will be reviewed/checked by others, they are discouraged from committing fraud or negligence. Promotes honesty and discipline.

E. Facilitates Early Detection: Errors and frauds, if any, are detected quickly since work is continuously cross-verified.

Example: Bank reconciliation detects mis-postings of cash collections.

F. Promotes Efficiency: Clearly defines roles and responsibilities. Reduces duplication of work and increases productivity.

Example: In sales, order processing, dispatch, and billing are handled by different departments.

G. Saves Auditor's Time: A strong internal check reduces the extent of detailed checking by the auditor. Auditor can rely on the system and use more test-checking instead of 100% verification.

H. Ensures Compliance with Procedures: Internal check ensures that organizational policies and procedures are strictly followed.

Example: Authorization of expenses by departmental heads before payment.

I. Builds Confidence in Stakeholders: Reliable accounts and financial reporting increase confidence among management, investors, creditors, and regulators.

Advantages of Internal Check (as per ICAI)

A. Prevents and Detects Errors/Frauds: Since duties are divided and one person's work is automatically checked by another, mistakes or frauds are quickly spotted.

Example: The cashier collects cash, but recording and reconciliation are done by a different staff member. Thus, manipulation becomes difficult, ensuring accuracy.

B. Increases Efficiency of Operations: Work is divided among staff systematically, which reduces duplication and confusion. Each employee specializes in a particular function, increasing speed and efficiency. Example: In sales, order-taking, dispatch, and billing are carried out by different employees, streamlining the process.

C. Strengthens Reliability of Accounts: Since transactions are cross-verified continuously, the chances of errors in financial statements are reduced. This ensures true and fair view of accounts.

Example: Sequential numbering of invoices, verified by another person, ensures completeness of records.

D. Provides Moral Pressure on Staff: Employees know their work will be checked by others, which discourages them from committing fraud or negligence. It builds a culture of honesty, discipline, and accountability in the organization.

E. Saves Auditor's Time and Cost: If internal check is strong and reliable, the auditor can reduce detailed checking and rely more on test checks. This saves both time and cost in the audit process.

Example: Instead of verifying all cash transactions, the auditor can test-check selected samples.

Limitations of Internal Check

- A. **Possibility of Collusion:** If two or more employees collude, they can bypass the system of checks. Example: Cashier and accountant working together may hide misappropriation of cash. Hence, collusion reduces the effectiveness of the system.
- B. **Management Override:** Senior management can override procedures and controls, which may lead to errors or frauds going undetected. Example: Manager approving fake expenses despite proper checks.
- C. **Costly for Small Organizations:** Internal check requires adequate staff to divide responsibilities effectively. Small businesses cannot afford such staff strength, making it impractical.
- D. **Monotony and Carelessness:** Employees may become careless while checking routine work done by others. Over time, this leads to inefficiency and reduced effectiveness of the system.
- E. **Not Foolproof – Only Reasonable Assurance:** Internal check reduces errors and frauds but cannot eliminate them completely. It provides only reasonable assurance, not absolute guarantee, of accuracy.

Fundamental Principles of Internal check.

1. Proper Division of Work (Segregation of Duties): No single person should handle a transaction from start to finish. Duties must be divided among employees so that one person's work acts as a check on another's.

Example: One person prepares vouchers, another authorizes them, and a third maintains records.

2. Rotation of Duties: Employees should be rotated periodically from one job to another. This prevents familiarity with a particular job, which might otherwise lead to fraud or manipulation.

Example: Cashier role may be rotated with accounts assistant periodically.

3. Responsibility should be fixed: Each employee must know clearly what they are responsible for. This helps fix accountability and detect errors/frauds easily.

Example: If a cashier is responsible for bank deposits, errors in deposit slips can be traced directly to him.

4. Automatic Checking (Cross Verification): System should be designed so that work done by one employee is automatically checked by another.

Example: Invoices prepared by sales clerk are checked by accounts clerk before dispatch.

5. No Single Person should Control a Transaction: From initiation to completion, a transaction should pass through multiple hands.

Example: In wage payments, HR prepares wage sheet, accounts department verifies, and cashier makes payment.

6. Adequate Supervision: Senior staff should continuously supervise the work of subordinates. Supervision ensures discipline, accuracy, and moral pressure.

Example: Storekeeper's stock register may be reviewed by store supervisor regularly.

7. Use of Proper Authorization: Transactions must be supported by proper authorization at appropriate levels. Example: Purchases above ₹50,000 may require manager's approval.

Authorization prevents unauthorized actions and fraudulent payments.

8. Use of Sound Accounting Systems and Documents: Accounting records should be maintained properly with pre-numbered documents (vouchers, cheques, invoices). This prevents alteration or misuse of documents.

Example: Pre-numbered cheque books reduce risk of missing cheques.

9. Periodic Comparison and Reconciliation: Records should be reconciled with physical assets and third-party confirmations periodically.

Example: Cash book vs. bank statement; stock register vs. physical inventory.

10. Rotation and Compulsory Leave: Employees should be asked to take compulsory leave at intervals. This helps in detecting frauds which an employee may hide continuously.
Example: If a cashier goes on leave, fraud (if any) can be detected by substitute staff.

11. Simplicity and Clarity in the System: Procedures of internal check should not be overly complex. They should be simple, clear, and easily understood by all employees.
Overly complex systems may create loopholes instead of preventing fraud.

12. Cost-Benefit Balance: The system should be economical, i.e., benefits of internal check must outweigh its cost. Example: In small firms, very complex internal checks may not be feasible.

13. Independent Internal Audit / Monitoring: Internal check should be supported by internal audit or monitoring to verify its effectiveness. Continuous evaluation strengthens the system.

Internal check with regards to wage payment

Internal check is a part of the internal control system where work is divided in such a way that the work of one employee is automatically checked by another, thereby reducing chances of errors and fraud. When applied to wage payment, internal check with regard to wages means a system of procedures and division of duties in an organization to ensure that:

- ✓ **Only genuine employees are paid** – preventing payment to “ghost employees.”
- ✓ **Correct wages are calculated** – ensuring proper computation of basic pay, overtime, allowances, and deductions.
- ✓ **Wages are paid to the right person** – through proper identification and acknowledgement.
- ✓ **No fraud, errors, or irregularities occur** – as responsibilities are divided and cross-checked.

In simple words, it is a systematic arrangement of wage-related work (preparation, authorization, recording, and payment) in such a way that frauds like bogus employees, overpayments, or unauthorized changes in wage sheets are automatically prevented or detected.

Objectives of Internal Check in Wage Payment

- **Ensure genuineness of employees** – only real workers who are on the rolls of the company are paid wages.
- **Prevent fictitious/dummy names** – eliminate chances of ghost workers being included in the payroll.
- **Accuracy in calculation** – proper recording of hours worked, overtime, and correct application of wage rates.
- **Correct deductions** – ensure statutory deductions like PF, ESI, Professional Tax, Income Tax are properly deducted and remitted.
- **Prevention of fraud** – reduce scope for manipulation, collusion, or misappropriation in wage payment.
- **Fairness and transparency** – build trust among workers by ensuring timely and correct payments.
- **Audit convenience** – reduce the auditor’s workload by providing reliable records for verification.

Stages of Wage Payment and Internal Check Procedures

1. Time-Keeping / Attendance Recording: Attendance should be recorded **independently** by a **Time Office** or HR department.

Methods:

- Mechanical time-recording machine / biometric scanner / punch cards.
- Attendance registers signed and counter-checked by supervisor.
- Gatekeeper ensures only employees with valid ID enter the premises.
- Overtime should be supported by an overtime slip authorized by production manager.
- Internal check principle: The person maintaining attendance should not prepare wage sheets.

2. Preparation of Wage Sheet (Payroll Preparation):

Wages are calculated in a separate Wage/Payroll Department.

Wage sheet must include:

- ✓ Name and employee number.
- ✓ Days/hours worked.
- ✓ Wage rate per hour/day.
- ✓ Overtime hours & rates.
- ✓ Allowances and bonuses.
- ✓ Deductions (PF, ESI, tax, advances, fines).
- ✓ Net wages payable.

Sheets must be serially numbered and cross-checked with attendance records. Any changes in wage rates should be supported by formal authorization from HR/management.

Segregation of duties: The payroll clerk should not be involved in wage disbursement.

3. Authorization and Approval of Wage Sheet:

Completed wage sheets are checked and signed by an independent senior officer (e.g., Accounts Manager or HR Head).

- ✓ Cross-verification with personnel records ensures only legitimate workers are included.
- ✓ Overtime and incentive payments must be supported by valid authorization.
- ✓ This step ensures no unauthorized changes in payroll.

4. Preparation of Pay Slips

- Each employee is issued a pay slip showing: Pay slips create transparency and allow employees to verify correctness.
 - ✓ Gross wages
 - ✓ All deductions
 - ✓ Net wages payable

5. Payment of Wages

Preferred method: Wages paid via bank transfer or cheque. Surprise checks should be conducted by senior officers during payment.

If cash payment is made:

- ✓ Cash is withdrawn from the bank based on the approved wage sheet.
- ✓ Cash distribution should be done by cashier in presence of HR/independent officer.
- ✓ Payment is made to employees individually, against their signature/thumb impression on wage sheet/pay slip.
- ✓ Any unpaid wages (for absent workers) should be recorded in a Unpaid Wages Register and redeposited into bank.

6. Segregation of Duties (Key Internal Check Principle)

- Time-keeping → Handled by Time Office/HR.
- Payroll preparation → Accounts/Wages department.
- Authorization → Manager/Senior Officer.
- Cash withdrawal/payment → Cashier.
- Supervision → Independent officer/HR Manager.

This ensures no single employee can manipulate the entire process.

7. Reconciliation and Review

- ❖ ***Wage sheets reconciled with:***
- ✓ Attendance records,
- ✓ Personnel department records,
- ✓ Cost accounts,
- ✓ Bank payment vouchers.

- ❖ *Periodic review by internal auditor or management.*
- ❖ *Surprise physical verification of workforce.*

Advantages of Internal Check in Wage Payment

1. *Authenticity* – ensures wages are paid only to genuine workers.
2. *Error & fraud prevention* – prevents fictitious workers, inflated wages, or double payments.
3. *Accurate accounting* – proper allocation of wages in cost and financial accounts.
4. *Statutory compliance* – deductions are made in accordance with laws.
5. *Moral pressure on staff* – segregation of duties discourages malpractice.
6. *Audit convenience* – auditor can place reasonable reliance on records, saving time and cost.
7. *Improved employee trust* – transparency in wage slips increases worker satisfaction.

Limitations of Internal Check in Wage Payment

1. *Collusion among employees can bypass checks.*
2. *Management override may allow unauthorized payments.*
3. *Costly for small firms* – biometric/time office systems require resources.
4. *Repetitive nature of work may lead to carelessness.*
5. *Only reasonable assurance* – not a complete guarantee against fraud.

Internal check with regards to cash sales

Meaning / concept

Internal check in cash sales is a system of procedures and division of duties so arranged that each stage of a cash-sales transaction is automatically checked by another person or by an independent control. The objective is to ensure that all cash sales are correctly recorded, cash received is safely handled and promptly banked, and that errors, omissions or frauds (for example “ghost sales”, skimming or manipulation of receipts/returns) are prevented or discovered at an early stage.

Objectives

1. Ensure all cash sales are recorded promptly and completely.
2. Ensure cash received is genuinely received from customers and is safeguarded until banked.
3. Prevent or detect misappropriation (skimming), short-leverelling, or false refunds.
4. Ensure correct calculation of sale value, discounts and taxes.
5. Provide an audit trail (pre-numbered receipts, Z-tapes, deposit slips) to facilitate reconciliation.
6. Enable management to verify daily sales totals, margin and cash flow for control and decision making.

Fundamental elements of an effective internal check system for cash sales (step-by-step)

1. **Issuance of pre-numbered receipts / invoices:** Every cash sale must generate a pre-numbered serial receipt or invoice. Duplicate/counterfoil remains with seller and original given to customer. Missing numbers should be investigated.
2. **Point-of-Sale (POS) or cash register recording:** Cash sales should be recorded immediately in a cash register or POS system that produces a daily Z-report (total sales, cash/ card splits). Manual registers must use stout pre-numbered receipts.
3. **Segregation of duties:** Sales personnel may effect a sale and issue a receipt, but **should not** be responsible for recording the receipt in the accounting cash book or preparing bank deposits. The cashier / till operator receives cash and issues receipt; a different person (accountant/cashier supervisor) posts the daily total to the cash book. The person preparing bank deposit should be independent of those maintaining cash records.
4. **Daily cash reconciliation and banking:** At close of business the cashier prepares a cash summary (Z-tape or receipts total). A supervisor or independent official countersigns the summary. Cash is counted in presence of another officer and remitted intact to the cashier who prepares bank deposit. All cash should be banked daily; a copy of deposit slip retained and matched to the cash summary.
5. **Control over change/float and petty cash:** A fixed cash float (for change) is established and periodically reconciled. Replenishments require vouchers and supervisor approval.

6. **Recording & accounting:** The daily cash totals are recorded into the **cash book** by the accounting department (not the cashier) and posted to sales ledger and VAT/GST accounts. Reconcile posted amounts with POS/Z-tapes and bank deposit.
7. **Handling of discounts, refunds and returns:** Refunds or discounts require **written authorisation** from a manager. Refunds should be processed only against original counterfoil and a refund voucher; cash refunds should be rare and require countersignature. Returns must generate credit notes, be recorded, and deducted from sales totals.
8. **Controls over cancellations / voids / manual adjustments:** Voids or manual journal adjustments to daily sales must require higher-level approval and be supported by documentation explaining reason.
9. **Physical safeguards & monitoring:** Cash drawer locked; access limited. CCTV on counters/ tills. Regular surprise cash counts. Supervisor's daily review of variances.
10. **IT controls (where POS/ERP used):** POS must have user authentication, role-based access, protected Z-tape generation, prevention of alteration of closed Z-reports, logging of voids and overrides, and periodic backup. Reconciliations between POS data and accounting system must be automatic or performed daily.

Documents & records typically used

- ✓ Pre-numbered cash receipts / invoice counterfoils.
- ✓ POS Z-tapes / cash register tapes.
- ✓ Daily cash summary sheets (signed by cashier & supervisor).
- ✓ Bank deposit slips and counterfoils.
- ✓ Cash book / daily posting sheet.
- ✓ Refund vouchers, credit notes and authorization forms.
- ✓ Sales journal and VAT/GST summary.
- ✓ Reconciliation working papers and variance reports.

Common frauds/weaknesses and preventive controls

1. **Skimming** (taking cash before recording): Prevent with pre-numbered receipts issued at point of sale and match receipts to cash totals; supervise and perform surprise counts; use CCTV.
2. **Short-leveelling** (under-recording sales): Prevent by reconciling POS totals with bank deposits and inventory movement, and using analytical review of cash vs expected sales.
3. **Fake refunds / false returns:** Require manager authorization, require original receipt/counterfoil, independent verification of returned goods.
4. **Collusion between salesperson & cashier:** Segregation of duties, compulsory leave, independent reconciliations, CCTV, rotation of duties.
5. **Unauthorized price/discount overrides:** Limit override rights, require supervisor sign-off, review override reports.

Advantages of a good internal check in cash sales

- ✓ Minimises theft and leakage of cash.
- ✓ Ensures accurate, timely recording of revenue & taxes.
- ✓ Improves reliability of daily cash flows used by management.
- ✓ Reduces auditor time and increases possibility of placing control reliance.

Limitations / practical problems

- ✓ Small retailers may find complete segregation impractical; compensating controls (supervision, surprise checks) are needed.
- ✓ Collusion and management override can defeat controls.
- ✓ Dependence on technology introduces IT risk if GITCs are weak.
- ✓ High volume, low value transactions (e.g., kiosks) inherently increase detection difficulty.

Quick Comparison (for exam answers):

Aspect	Wage Payment	Cash Sales
Main risk	Ghost workers, inflated wages	Cash theft, suppression of sales
Key check	Timekeeping & payroll segregation	Pre-numbered cash memos & cash register
Control focus	Authenticity of workers	Completeness of recording
Unclaimed balance	Unpaid wages register	Daily deposit to bank
Audit benefit	Reliability of payroll accounts	Reliability of sales and cash records

Internal check with regards to cash purchases.

Meaning / Concept

Cash purchases are transactions where goods or services are bought and immediately paid for in cash. Since cash is highly susceptible to misuse, a proper internal check system is required to prevent fraud, bogus purchases, overpayment, or misappropriation.

Internal check in cash purchases refers to a system of division of duties and checks built into the purchasing and payment process, ensuring that no single person has complete control over the entire transaction (from ordering goods to making payment).

Objectives of Internal Check in Cash Purchases

- ✓ Ensure that only genuine purchases are made for business needs.
- ✓ Ensure that purchases are made at fair prices and on competitive terms.
- ✓ Prevent frauds such as fictitious purchases (ghost suppliers) or inflated bills.
- ✓ Ensure that cash paid is properly authorized and accounted for.
- ✓ Maintain proper records for inventory and accounting purposes.
- ✓ Avoid duplication of orders or excess/unnecessary purchases.
- ✓ Provide management with reliable data on purchase costs and cash outflow.

Fundamental Elements of Internal Check for Cash Purchases

1. **Authorization of Purchases:** All purchases must be made only after proper authorization by a responsible officer. A purchase requisition slip should be prepared by the department requiring goods.
2. **Selection of Supplier & Order Placement:** Orders must be placed only with approved suppliers. Comparative quotations should be obtained wherever possible to avoid favouritism. Purchase orders should be pre-numbered and copies sent to the purchase department, accounts department, and stores.
3. **Receipt of Goods:** A separate stores department should receive the goods. On receipt, the goods must be checked with the purchase order (quantity, quality, and specification). A Goods Inward Note (GIN) should be prepared and signed by the storekeeper.
4. **Verification of Invoice:** Supplier's invoice should be checked with the purchase order and Goods Inward Note. The accounts department verifies calculations, rates, taxes, and discounts.
5. **Payment Process**
 - Cash payment should only be made against verified invoices.
 - Payment must be authorized by a senior officer who was not involved in purchase or receipt of goods.
 - A proper cash voucher must be prepared, supported by purchase documents.
 - Payment should be acknowledged by supplier's official receipt.
6. **Recording in Books:** All cash purchases should be recorded in the Cash Book immediately. Purchases should also be entered in the Purchase Day Book (or directly in cash book with narration). Proper accounting ensures linkage with inventory records.
7. **Segregation of Duties:** Person raising purchase requisition should not be the one approving payment. Storekeeper receiving goods should not handle cash. Cashier should not record purchase transactions in books.
8. **Periodic Review & Controls:** Surprise checks by management on cash purchase vouchers. Analytical review of cash purchases (volume, price comparisons, abnormal fluctuations). Monthly reconciliation of goods purchased with inventory and accounts.

Documents Used

- Purchase requisition slip
- Comparative statements/quotations
- Purchase order (pre-numbered)
- Goods Inward Note (GIN)
- Supplier's invoice
- Payment voucher / cash voucher
- Official receipt from supplier
- Cash Book / Purchase Book

Common Frauds & Errors Prevented by Internal Check

- Bogus suppliers raising fake bills and taking away cash.
- Inflated invoices or duplicate payments.
- Collusion between purchase staff and suppliers to overcharge.
- Unrecorded purchases leading to misappropriation of goods.
- Suppression of discounts or returns to pocket cash.

Advantages of Strong Internal Check on Cash Purchases

- ✓ Safeguards against misuse of cash.
- ✓ Ensures economy, efficiency, and fairness in purchases.
- ✓ Increases reliability of purchase and expense data.
- ✓ Minimises auditor's detailed checking work (when system is effective).

Limitations

- ✓ Collusion between employees and suppliers can defeat controls.
- ✓ Over-dependence on manual vouchers may lead to manipulation.
- ✓ Management override is always possible.
- ✓ Difficult to exercise control where petty cash purchases are very frequent and of low value.

Quick Comparison – Internal Check: Wage Payment vs Cash Purchase

Aspect	Wage Payment	Cash Purchase
Objective	To ensure only genuine employees are paid correct wages and to prevent fraud like ghost workers or overpayment.	To ensure all purchases are genuine, properly authorised, and paid at fair prices without misuse of cash.
Key Documents	Attendance register, time sheets, wage sheets, pay slips, acquittance roll.	Purchase requisition, purchase order, goods inward note, supplier's invoice, payment voucher, supplier receipt.
Segregation of Duties	Time-keeping (attendance) done separately from wage calculation; cashier pays wages, not the person who prepares wage sheet.	Purchase dept. orders goods, stores dept. receives them, accounts dept. verifies invoices, cashier makes payment.
Authorization	Wage sheet checked and authorised by responsible officer before payment.	Purchase requisition & orders approved by management; payment authorised by senior officer.
Payment Process	Wages distributed by cashier in presence of supervisor; signature/thumb impression taken from employees.	Cash paid only against verified invoice and supporting documents through vouchers and receipts.
Control Objective	Prevents fraud like fictitious/duplicate workers, inflated wages, and misappropriation of cash.	Prevents fraud like bogus suppliers, inflated bills, duplicate or excess payments, and misappropriation of goods.
Auditor's Focus	Check wage sheets, reconcile with attendance, verify signatures, test-check wage distribution.	Verify matching of purchase order, goods inward note, and invoice; check cash vouchers and receipts; trace to books.

Quick Comparison – Internal Check: Cash Purchases vs Cash Sales

Aspect	Cash Purchases	Cash Sales
Objective	To ensure goods are purchased genuinely, at fair prices, with proper authorisation and without misuse of cash.	To ensure all cash received from sales is properly recorded, deposited, and safeguarded against theft or fraud.
Key Documents	Purchase requisition, purchase order, goods inward note, supplier invoice, cash voucher, supplier's receipt.	Cash memo, sales invoice, daily cash register, till roll, deposit slip, cash summary sheet.
Segregation of Duties	Purchase dept. places orders, stores dept. receives goods, accounts verifies bills, cashier makes payment.	Sales clerk issues bill, cashier collects cash, accounts dept. records entries, another officer deposits into bank.
Authorization	Payment made only after approval of purchase order and verification of goods received.	Sales prices authorised by management; discounts only with approval; daily cash sales summary verified by supervisor.
Payment / Collection	Cash paid only against verified invoice and authorised voucher; proper receipt obtained.	Cash collected by cashier against cash memo; daily reconciliation of cash with sales recorded.
Control Objective	Prevents fraud like bogus suppliers, inflated invoices, duplicate or excess payments.	Prevents fraud like suppression of sales, misappropriation of cash, unauthorised discounts.
Auditor's Focus	Verify voucher–invoice–GRN–PO matching, check receipts, trace to cash book.	Verify daily cash sales summary, reconcile with cash book and bank deposit slips, test-check sales invoices.

Module No.3

Verification and Valuation of Assets and Liabilities

Meaning and objectives of verification and valuation

Verification:

Verification means proving the correctness of assets and liabilities as shown in the Balance Sheet. It is one of the main duties of an auditor. Verification ensures that the assets and liabilities actually exist, belong to the organization, are correctly valued, and are free from any undisclosed charge.

Definition: According to Spicer and Pegler:

“The verification of assets implies an inquiry into the value, ownership and title, existence and possession, and the presence of any charge on the assets.”

Objectives of Verification of Assets and Liabilities

1. Valuation of assets and liabilities: The auditor must ensure that assets and liabilities are shown at their **correct values** as per accounting standards, law, and sound accounting principles.

Example: Fixed assets must be shown at cost less depreciation; stock at cost or market price whichever is lower.

2. Finding out the ownership and title of assets: Verification confirms that the organization owns the assets legally and has proper rights over them.

Example: Checking title deeds of land and building, registration papers of vehicles, and agreements of leased assets.

3. Detection of errors and frauds: Verification helps the auditor detect misstatements, over-valuation, under-valuation, fictitious assets, or concealed liabilities.

Example: If stock is intentionally inflated, verification through stock register and physical check helps in detecting fraud.

4. Certification of arithmetical accuracy: Verification ensures that the balances appearing in books are arithmetically correct and supported by documents.

Example: The total of sundry debtors in the schedule should match with the figure in the Balance Sheet.

5. To check whether assets are free from charge or lien: The auditor has to verify whether assets are free from any encumbrance, pledge, or mortgage, or whether they are charged to banks/creditors.

Example: Machinery given as security for a loan must be disclosed in financial statements.

6. To ensure true and fair view of financial position: The ultimate aim of verification is to help the auditor certify whether the Balance Sheet presents a true and fair view of the state of affairs of the company. Correct verification gives credibility to financial statements and builds trust among shareholders, creditors, and stakeholders.

Valuation: Meaning

Valuation is the process of ascertaining the correct monetary value of assets and liabilities, so that they are presented at a fair value in the Balance Sheet.

Valuation is the process of determining the monetary worth of an asset, a liability or an entire business at a particular date. It uses methods (cost, market, income, discounted cash flows, replacement cost, fair value, etc.) and involves judgement — some parts are objective (market price) and some subjective (future cash-flow estimates, assumptions). Valuation is used for preparing financial statements, purchase/sale, mergers & acquisitions, taxation, insurance, loan collateral, impairment testing, and shareholder reporting.

Definition of Valuation: According to Spicer and Pegler:

“Valuation is the process of ascertaining the value of assets and liabilities at a particular date.”

Objectives of Valuation

- To know the actual financial position of the company:** Correctly valued assets and liabilities give a true and fair view of net worth and solvency ratios (e.g., current ratio, debt-equity).
Example: If fixed assets are undervalued, the capital base and shareholders' funds appear smaller than reality.
- To know about the goodwill of the concern:** Goodwill is an intangible arising on purchase of a business (purchase consideration – fair value of net assets). Valuation methods: average profit method, super-profit method, or DCF of future excess earnings.
Example: When a company is acquired, valuers compute goodwill to decide consideration.
- To know the difference in the value of assets at time of purchase & at the date of Balance Sheet:** Assets change value because of depreciation, appreciation, impairment, obsolescence or market movement. Valuation shows how much of original cost remains economically useful.
Example: Plant bought at ₹10 lakh may be worth ₹6 lakh as on balance-sheet date after depreciation and impairment.
- To know the original cost of the assets:** Knowing original/historical cost is necessary for computation of depreciation, capital gains and tracking asset history. Valuation contrasts historical cost with current or realizable value.
- To know the mode of investment of the capital of the company:** Valuation shows asset composition (cash, inventory, fixed assets, and investments), helping stakeholders see how capital is deployed and assess liquidity, risk and returns.

Differences between Valuation and Verification

Aspect	Valuation	Verification
Primary purpose	To determine the monetary amount to be shown in the financial statements (what the amount should be).	To obtain evidence that recorded amounts are correct, exist, belong to the entity and are complete (whether the amount recorded is supported).
Focus	Amount (how much) — often forward-looking (future cash flows) or market-based.	Existence, ownership, completeness and accuracy of recorded items.
Basis	Uses valuation techniques/models (market prices, DCF, replacement cost, realizable value).	Uses documentary and physical evidence (invoices, confirmations, physical inspection).
Subjectivity	Generally more subjective — depends on assumptions, estimates and professional judgement.	More objective — based on verifiable evidence; though interpretation can involve judgement.
Who performs	Management prepares valuations; sometimes external valuation experts are engaged.	Auditors or verifying officers perform verification procedures (management also does self-checks).
When done	At reporting dates, during transactions like acquisition, impairment testing, M&A, periodic revaluation.	During audit cycles, stock counts, period end checks, and as part of internal controls.
Techniques/tools	Valuation models, comparative market data, DCF calculations, actuarial models.	Inspection, confirmation, recalculation, analytical review, vouching, reconciliation.
Accounting impact	Directly determines the figures that appear in FS (asset values, goodwill, impairment losses).	Provides audit evidence to support or challenge the amounts and disclosures in the FS.
Example	Estimating fair value of an investment or goodwill.	Physically counting inventory and matching to ledger balance.

 Position of an auditor as regards the valuation of assets

1. Responsibility of Management: The responsibility for the valuation of assets lies entirely with the management of the entity. It is the duty of management to ensure that all assets are valued in accordance with the applicable financial reporting framework, such as Accounting Standards (AS) or Indian Accounting Standards (Ind AS), and that the financial statements reflect a true and fair view.

2. Auditor is Not a Valuer: The auditor is not expected to carry out the valuation of assets personally. The auditor's role is limited to verifying and evaluating whether the valuation made by management is appropriate, reasonable, and in compliance with the applicable accounting principles and standards. The auditor acts as an examiner, not as a valuer.

3. Requirement of Audit Evidence (SA 500): According to Standard on Auditing (SA) 500, the auditor must obtain sufficient and appropriate audit evidence to support the values of assets reported in the financial statements. This includes reviewing documents such as valuation reports, purchase agreements, market data, and other supporting evidence that validates the management's valuation.

4. Evaluation of Estimates (SA 540): When valuations involve significant estimates or judgments, the auditor must apply the requirements of SA 540, which deals with auditing accounting estimates. Under this standard, the auditor is required to examine the assumptions made by management, assess the valuation methodology used, check the data applied in the estimate, and evaluate whether these are consistent and free from management bias.

5. Use of Expert's Work (SA 620): In cases where the valuation involves technical or specialized knowledge, such as in the valuation of real estate, machinery, or complex financial instruments, the auditor may rely on the work of an expert in accordance with SA 620. The auditor must assess the competence, capabilities, and objectivity of the expert and determine whether the expert's work provides sufficient and appropriate audit evidence.

6. Professional Scepticism: Throughout the audit process, the auditor must maintain professional scepticism, especially when dealing with subjective valuations or areas with a high risk of material misstatement. The auditor should be alert to any signs of overstatement or understatement of asset values and must challenge the assumptions made by management if they appear unrealistic or unsupported.

7. Disclosure Requirements: The auditor must also ensure that there is adequate disclosure in the financial statements regarding the **basis of valuation**, the **methods and assumptions used**, and the **degree of uncertainty** involved in the estimation process. Transparency in disclosures is critical to enable users of financial statements to understand how valuations have been derived.

8. Impact on Audit Report (SA 705/SA 701): If the auditor identifies any **material misstatements** in asset valuation that management refuses to correct, the auditor is required to **modify the audit opinion** in accordance with **SA 705**. In cases where there is significant uncertainty surrounding the valuation but no misstatement, the auditor may include an **Emphasis of Matter** paragraph or report it as a **Key Audit Matter** as per **SA 701**.

9. Compliance with Accounting Standards: The auditor must also assess whether the valuation of assets complies with relevant accounting standards, such as **AS 10** for Property, Plant and Equipment, **AS 2** for Inventories, or **Ind AS 113** for Fair Value Measurement, depending on the nature of the asset and the applicable framework.

Verification and Valuation of Land and Building

A. Verification of Land and Building: Verification means checking the existence, ownership, possession, and title of land and building recorded in the books. Auditor's duties in this regard are:

1. Examine Title Deeds: Auditor should inspect original title deeds (sale deed, conveyance deed, lease deed, gift deed, etc.). If deeds are with bankers/financial institutions (as security), auditor should obtain confirmation directly from them.

2. Verify Possession: Confirm that land/building is actually in the possession of the entity. For leasehold properties, check lease agreement, lease period, and renewal clauses.

3. Board Resolution/Approval: Verify whether purchase/sale of land/building is duly authorised by the Board of Directors (in case of companies).

4. Charges and Liens: Check whether property is free from encumbrances (e.g., mortgage, charge, lien). If charged, auditor should ensure proper registration with Registrar of Companies under Companies Act

5. Physical Verification: Though auditor is not expected to visit physically, he may rely on management's report on physical verification of assets. In case of suspicion, personal verification may be undertaken.

6. Capitalization: Ensure that the cost of land and building is capitalised correctly (purchase price, stamp duty, registration fees, legal expenses, architect's fees, etc.).

7. Revaluation or Impairment: Check whether revaluation/impairment has been properly carried out and disclosed as per AS 10 (PPE) / Ind AS 16 & Ind AS 36.

B. Valuation of Land and Building: Valuation refers to ascertaining the monetary worth of land and buildings. Different bases of valuation are followed depending on accounting principles and circumstances.

1. Land

- ✓ Land has an unlimited useful life; hence, no depreciation is charged.
- ✓ Normally valued at historical cost (purchase price + incidental expenses).
- ✓ If revalued, it should be at fair market value as certified by an approved valuer.
- ✓ If impairment is identified, land should be written down to recoverable amount.

2. Building: Building has a finite useful life; hence, subject to depreciation. Valuation methods include:

(i) Historical Cost Method

- Building shown at original cost + incidental expenses.
- Depreciation charged systematically over useful life.
- Widely accepted as per AS/IndAS.

(ii) Revaluation Method

1. Revaluation at current replacement cost or fair market value.
2. Surplus on revaluation is credited to Revaluation Reserve (part of equity).
3. Must be carried out by an independent valuer.

(iii) Realizable Value / Net Selling Price

- Building valued at price it would fetch if sold, less costs of disposal.
- Used in case of liquidation or when company plans to sell the asset.

(iv) Replacement Cost Method

- Valued at cost of replacing the asset with a new one of similar capacity, less depreciation.
- Used in insurance claims or special cases.

(v) Impairment Value: As per Ind AS 36 / AS 28, if carrying amount > recoverable amount (higher of value in use and fair value less costs of disposal), impairment loss is recognised.

Auditor's Duties in Valuation of Land & Building

- ✓ Ensure valuation basis (historical cost, fair value, impairment) is in line with accounting standards.
- ✓ Verify calculations of depreciation as per Schedule II of Companies Act, 2013 or Ind AS 16.
- ✓ In case of revaluation, check valuer's report, competence, and disclosure in notes.
- ✓ Ensure disclosure of: Gross block, accumulated depreciation, net block. Revaluation details. Impairment losses, if any.
- ✓ Obtain written representation from management on appropriateness of valuation.

- ✓ Ensure compliance with Schedule III of Companies Act, 2013 regarding presentation in Balance Sheet.

Verification and Valuation of Plant and Machinery

Plant and Machinery constitute an essential part of the fixed assets of a manufacturing or industrial organization. They play a vital role in the production process, and their correct verification and valuation are crucial to ensure that the financial statements reflect a true and fair view of the company's financial position.

According to SA 500 (Audit Evidence) and SA 501 (Audit Evidence—Specific Considerations for Selected Items) issued by ICAI, the auditor must obtain sufficient and appropriate audit evidence regarding the existence, ownership, and valuation of plant and machinery.

A. Verification of Plant and Machinery

Verification refers to the process of ensuring the existence, ownership, and proper recording of the asset in the books of accounts. The auditor's duty is to confirm that the plant and machinery physically exist, belong to the entity, and are shown at correct values in the financial statements.

- Examination of Title and Ownership:** The auditor should examine purchase invoices, supplier's bills, and ownership documents to verify that the plant and machinery belong to the business. In case of leased machinery, the lease agreement should be checked to confirm the terms of ownership and usage.
- Physical Verification:** The auditor should ensure that the plant and machinery physically exist by inspecting them personally or by reviewing a physical verification report prepared by management. If the machinery is located at different branches or factories, the auditor may rely on branch auditors or third-party confirmations.
- Verification of Fixed Asset Register:** The auditor should examine the fixed asset register to confirm that each item of plant and machinery is properly recorded with relevant details such as date of purchase, cost, location, identification number, and depreciation.
- Verification of Additions and Disposals:** The auditor should verify any additions made during the year by examining suppliers' invoices, payment vouchers, and installation reports. Similarly, for disposals, the auditor should check the sale deed or scrap sale records and ensure that profit or loss on sale is properly recorded.
- Verification of Installation and Commissioning Costs:** In many cases, installation, carriage, testing, and commissioning expenses form part of the cost of machinery. The auditor should ensure that such costs are capitalized as per **AS 10 (Property, Plant and Equipment)** and not treated as revenue expenses.
- Verification of Repairs and Maintenance:** The auditor should distinguish between capital and revenue expenditure. Major overhauling that increases the efficiency or life of machinery should be capitalized, while normal repairs and maintenance should be charged to the revenue account.
- Verification of Machinery Under Construction:** If some machinery is still under installation, it should be shown under "Capital Work-in-Progress." The auditor should verify supporting documents like work orders, contractors' bills, and engineers' certificates.
- Verification of Hypothecation or Charge:** If the machinery is hypothecated or pledged as security for loans, the auditor should verify the loan agreements and ensure that appropriate disclosure is made in the financial statements as required under the **Companies Act, 2013**.
- Verification of Insurance:** The auditor should verify whether the machinery is adequately insured against fire, theft, or other risks. Insurance policies and premium receipts should be examined.

B. Valuation of Plant and Machinery

Valuation is the process of determining the correct value of plant and machinery to be included in the balance sheet. The auditor must ensure that valuation is in accordance with AS 10 (Revised) and the accounting policies consistently followed by the company.

- Cost Method:** Under this method, machinery is valued at its historical cost less accumulated depreciation. The cost includes the purchase price, transportation, installation, and other directly

attributable costs necessary to bring the asset to working condition.

Example: Machinery purchased for ₹10,00,000, installation expenses ₹50,000, and depreciation ₹2,00,000.

Value of machinery = ₹10,00,000 + ₹50,000 – ₹2,00,000 = ₹8,50,000.

2. **Revaluation Method:** When a company revalues its plant and machinery to reflect the current market value, the auditor should verify the valuation report of an independent valuer. Any increase in value should be credited to the **Revaluation Reserve** account.

Example: Book value of machinery ₹5,00,000.

Revalued amount ₹8,00,000.

Increase of ₹3,00,000 to be credited to Revaluation Reserve.

3. **Replacement Cost Method:** In this method, the value of machinery is based on the cost required to replace it with a similar new asset, less depreciation. It is often used for insurance or reconstruction purposes.

Example: Replacement cost ₹12,00,000, accumulated depreciation ₹3,00,000.

Value = ₹9,00,000.

4. **Impairment Test (AS 28 / Ind AS 36):** If there are indicators that the machinery's carrying amount exceeds its recoverable amount, impairment loss must be recognized.

Example: Carrying amount = ₹10,00,000. Recoverable amount = ₹7,50,000.

Impairment loss = ₹2,50,000 to be charged to the Profit and Loss Account.

5. **Net Realisable Value (Liquidation Value):** When the company plans to sell or dispose of the machinery, it should be valued at the estimated selling price minus expenses of sale.

Example: Estimated sale price ₹6,00,000, cost of disposal ₹50,000. Value = ₹5,50,000.

Auditor's Duties Regarding Plant and Machinery

- **Verification of Ownership and Existence:** The auditor must confirm that the machinery exists physically and belongs to the business.
- **Verification of Correct Valuation:** The auditor should ensure that machinery is valued in accordance with accounting standards and that depreciation is properly charged.
- **Verification of Additions and Disposals:** Ensure all additions and disposals are supported by proper documentation and recorded accurately.
- **Verification of Depreciation:** Confirm that depreciation is charged using appropriate methods such as Straight Line Method (SLM) or Written Down Value (WDV) and is consistently applied.
- **Verification of Disclosure:** The auditor should ensure that proper disclosure is made in the balance sheet under the head "Property, Plant, and Equipment," showing cost, additions, deletions, depreciation, and net book value.
- **Verification of Revaluation:** If revaluation has been done, the auditor must verify that it is based on a professional valuer's report and that the surplus or deficit is properly accounted for.

Verification and Valuation of Goodwill

Goodwill is an intangible fixed asset that represents the reputation, customer loyalty, and business connections that a firm develops over time. It arises when a business is able to earn superior profits compared to other firms in the same industry due to factors such as a good name, favourable location, efficient management, or quality service.

From the auditor's point of view, goodwill requires careful verification and valuation because it does not have a physical existence, and its value can fluctuate depending on business conditions and profitability.

According to Accounting Standard (AS) 26 – Intangible Assets issued by ICAI, goodwill should be recognized only when it is purchased and not self-generated.

- A. **Verification of Goodwill:** Verification of goodwill means ensuring that the goodwill appearing in the books of account is real, properly valued, and correctly disclosed in the financial statements.

1. **Purchased Goodwill:** Purchased goodwill arises when a business acquires another business for a price higher than the net value of its identifiable assets and liabilities. The auditor should verify the purchase agreement and ensure that the goodwill amount is supported by reliable documentation such as a sale

deed or contract.

Example: If a business is purchased for ₹10,00,000 and the net assets taken over are worth ₹8,00,000, then goodwill = ₹2,00,000.

The auditor must ensure that such goodwill is recorded properly and amortized as per accounting standards.

2. **Self-Generated Goodwill:** Self-generated goodwill arises through business reputation built over time. According to **AS 26**, self-generated goodwill should not be recognized in the books because it cannot be measured reliably. The auditor should ensure that no self-generated goodwill is recorded in the balance sheet.
3. **Examination of Documents:** The auditor should examine the purchase deed, agreement of merger or amalgamation, and any valuation report to verify the correctness of goodwill. In case of reconstitution of a partnership firm, the auditor should check the partnership deed to verify goodwill adjustments among partners.
4. **Verification of Disclosure:** The auditor should ensure that goodwill is shown under the head “**Non-Current Assets – Intangible Assets**” in the balance sheet and that appropriate disclosure of its amortization and impairment is made.
5. **Verification of Amortization and Impairment:** Goodwill should be systematically amortized over its useful life, generally not exceeding ten years. If the value of goodwill has been impaired, an **impairment loss** should be recognized as per **AS 28 (Impairment of Assets)**. The auditor must verify the calculation of amortization and impairment to ensure compliance with accounting standards.

B. Valuation of Goodwill:

Valuation of goodwill is the process of determining its **monetary worth**. Since goodwill is intangible and subjective, its value is based on the ability of a business to earn future profits.

As per ICAI, goodwill may be valued using one of the following recognized methods:

1. Average Profit Method

Under this method, goodwill is calculated based on the average maintainable profits of the business multiplied by the agreed number of years of purchase.

Formula:

$$\text{Goodwill} = \text{Average Profit} \times \text{Number of Years' Purchase}$$

Steps:

1. Calculate the profits of the past few years.
2. Eliminate any abnormal gains or losses.
3. Find the average profit.
4. Multiply by the number of years' purchase (generally 2 to 5 years).

Example: Profits of the last three years = ₹80,000, ₹1,00,000, ₹1,20,000

$$\text{Average Profit} = (80,000 + 1,00,000 + 1,20,000) / 3 = ₹1,00,000$$

$$\text{Goodwill} = ₹1,00,000 \times 3 = ₹3,00,000$$

The auditor should verify that the profits used are genuine and adjusted for non-recurring items.

2. Weighted Average Profit Method:

This method gives more importance to recent profits assuming they better reflect the current earning capacity of the business.

Formula: Goodwill = Weighted Average Profit × Number of Years' Purchase

Example:

Year Profit (₹) Weight Product (₹)

2022	80,000	1	80,000
2023	1,00,000	2	2,00,000
2024	1,20,000	3	3,60,000

$$\text{Total Products} = ₹6,40,000, \quad \text{Total Weights} = 6$$

$$\text{Weighted Average Profit} = 6,40,000 / 6 = ₹1,06,667 \quad \text{Goodwill} = ₹1,06,667 \times 3 = ₹3,20,001$$

The auditor should check that weights are assigned logically and consistently.

3. Super Profit Method

Under this method, goodwill is based on super profit, which is the excess of actual profit over normal profit.

Formula: $\text{Goodwill} = \text{Super Profit} \times \text{Number of Years' Purchase}$

Where, Super Profit = Actual Average Profit – Normal Profit

Normal Profit = Capital Employed \times Normal Rate of Return / 100

Example:

Capital Employed = ₹10,00,000

Normal Rate of Return = 10%

Normal Profit = $10,00,000 \times 10\% = ₹1,00,000$

Average Profit = ₹1,40,000

Super Profit = ₹1,40,000 – ₹1,00,000 = ₹40,000

Goodwill = ₹40,000 \times 4 = ₹1,60,000

The auditor should ensure that capital employed and normal rate of return are computed accurately.

4. Capitalization Method

This method determines goodwill based on the total value of the business derived from capitalizing its average profits or super profits.

(a) Capitalization of Average Profit Method

Goodwill = Capitalized Value – Net Tangible Assets

Where, Capitalized Value = (Average Profit \times 100) / Normal Rate of Return

Example:

Average Profit = ₹1,20,000

Normal Rate = 12%

Capitalized Value = $(1,20,000 \times 100) / 12 = ₹10,00,000$

Net Tangible Assets = ₹8,00,000

Goodwill = ₹10,00,000 – ₹8,00,000 = ₹2,00,000

(b) Capitalization of Super Profit Method

Goodwill = (Super Profit \times 100) / Normal Rate of Return

Example:

Super Profit = ₹40,000

Normal Rate = 10%

Goodwill = $(40,000 \times 100) / 10 = ₹4,00,000$

The auditor should verify that the calculations are made correctly and the assumptions are reasonable.

Auditor's Duties Regarding Goodwill

- **Verification of Existence and Ownership:** The auditor must ensure that goodwill recorded in the books represents purchased goodwill and that supporting documents such as purchase deeds are available.
- **Verification of Correct Valuation:** The auditor should verify the method used for valuation and ensure that it is appropriate, consistent, and in line with ICAI guidelines.
- **Verification of Amortization and Impairment:** The auditor must ensure that goodwill is amortized systematically over its useful life and that any impairment is recognized immediately.
- **Verification of Disclosure:** Goodwill should be properly disclosed under “Intangible Assets” with notes indicating its cost, amortization, and carrying amount.
- **Verification of Revaluation or Write-off:** If goodwill has been revalued or written off, the auditor should verify the authority for such action and ensure that it is properly accounted for.

Verification and Valuation of Investments

Investments are assets held by a business to earn income through dividends, interest, or appreciation in value. Investments can be either long-term (held for more than a year) or short-term (held for trading or liquidity purposes). The auditor must ensure that investments shown in the financial statements exist, belong to the entity, and are properly valued according to applicable accounting standards (AS 13 or Ind AS 109).

Meaning of Investment: Investment refers to the amount spent by an organization in acquiring shares, debentures, government securities, or other assets with the intention of earning returns or gaining capital appreciation. Investments are generally categorized as:

- **Long-term Investments** – Held for earning income or strategic control (e.g., investment in subsidiaries).
- **Short-term Investments** – Held for a short duration to earn quick returns or for liquidity management.

Objectives of Verification and Valuation of Investments The auditor must ensure the following:

- The investments actually exist and belong to the entity.
- All investments are properly authorized and recorded.
- Investments are valued correctly as per accounting standards.
- Income from investments is properly accounted for.
- Proper disclosures are made in the financial statements.

A. Verification of Investments

(a) Examination of Investment Register: The auditor should verify the *Investment Register* maintained by the entity. It should contain details such as date of purchase, name of investment, face value, purchase price, interest/dividend received, and date of disposal (if any).

(b) Physical Verification: The auditor should physically inspect the investment certificates, bonds, debentures, share certificates, or confirm the same with the custodians (like banks or brokers) if kept in demat form.

(c) Confirmation from Third Parties: For investments held with banks or brokers, direct confirmation should be obtained to ensure existence and ownership.

(d) Verification of Ownership: Ownership of the investment should be verified by checking the registered holder's name on the certificate or statement. If investments are in joint names, the auditor should verify the terms and ensure they belong to the company.

(e) Verification of Purchase and Sale of Investments: The auditor should check the *Board Resolutions* authorizing the transactions and verify the *purchase/sale contracts, brokers' notes, and bank statements*.

(f) Verification of Income from Investments: The auditor should verify dividend warrants, interest coupons, or credited amounts to confirm that income from investments is correctly recorded in the Profit and Loss Account.

(g) Verification of Lien or Charge: If any investment is pledged as security for loans or advances, proper disclosure must be made in the Balance Sheet. The auditor should verify such details from loan agreements.

B. Valuation of Investments:

Valuation of investments should be in accordance with AS 13 (Accounting for Investments) or Ind AS 109 (Financial Instruments) depending on the accounting framework applicable to the entity.

(a) Long-term Investments: Long-term investments are carried at cost. However, if there is a *permanent decline* in value, the investment should be written down to recognize the loss.

Example: If the market value of a share permanently falls below cost due to financial instability of the investee company.

(b) Current or Short-term Investments: Short-term investments should be valued at the *lower of cost and fair value* (market value). The comparison should be made *category-wise*, not individual investment-wise.

(c) Quoted Investments: For quoted investments, valuation is based on *market value* on the Balance Sheet date.

(d) Unquoted Investments: For unquoted investments, valuation should be based on:

- Break-up value of shares (for unlisted companies).
- Net asset value (for mutual funds).
- Cost or estimated realizable value (for others).

(e) Investments in Subsidiaries and Associates: Such investments should be verified to ensure they are shown as *long-term* and valued as per AS 13. The auditor must ensure consolidation requirements are complied with, if applicable.

(f) Government Securities: These should be verified with certificates or statements. Valuation should be done at cost plus accrued interest.

(g) Investments in Mutual Funds: Verify statements of account issued by the fund house. Valuation should be at net asset value (NAV) on the reporting date.

Verification and Valuation of Stock in Trade

Stock-in-trade, also known as *inventory*, represents goods and materials held by a business for the purpose of sale or for use in the production of goods to be sold. It forms a major component of current assets and plays a vital role in determining the profitability and financial position of a business.

The auditor has a responsibility to verify the *existence, ownership, and valuation* of stock-in-trade, ensuring that it is presented correctly in the financial statements as per the relevant accounting standards, primarily AS 2 – Valuation of Inventories (or Ind AS 2 for Ind AS-compliant entities).

Meaning of Stock-in-Trade: Stock-in-trade includes all goods held for sale in the ordinary course of business. It may consist of: Raw materials, Work-in-progress, Finished goods, Consumable stores and spares and Goods purchased for resale

Objectives of Verification and Valuation of Stock-in-Trade:

- ✓ To verify that stock physically exists.
- ✓ To ensure that the stock belongs to the business.
- ✓ To confirm that the stock is valued correctly in accordance with accounting standards.
- ✓ To verify that adequate internal control exists for safeguarding stock.
- ✓ To ensure that proper disclosure is made in the financial statements.

3. Verification of Stock-in-Trade

(a) Examination of Stock Records: The auditor should check the stock register, goods inward and outward registers, purchase and sales invoices, and inventory summary sheets to ensure accuracy and completeness.

(b) Physical Verification of Stock: The auditor should attend the *stock-taking* process conducted by the management on the closing date or at an alternative date. He should ensure that:

- ✓ Proper stock-taking instructions have been issued by management.
- ✓ Physical counting is carried out systematically.
- ✓ Damaged, obsolete, or slow-moving items are identified separately.
- ✓ Test checks are conducted to confirm the correctness of quantities.

(c) Confirmation of Ownership: The auditor must ensure that stock belongs to the client and is not held on behalf of third parties. Stocks held on consignment, hire-purchase, or return basis must be excluded.

(d) Verification of Goods in Transit: Stock that has been purchased but not yet received should be included if ownership has been transferred. Similarly, goods sold but not yet dispatched should be excluded.

(e) Verification of Stock with Third Parties: If stock is held at third-party locations (e.g., godowns, warehouses, or consignees), confirmation should be obtained from such parties.

(f) Verification of Cut-off Procedure: The auditor should verify that proper cut-off procedures are applied at year-end to ensure that purchases and sales are recorded in the correct accounting period.

4. Valuation of Stock-in-Trade

Valuation of stock is done in accordance with AS 2 – Valuation of Inventories which states that “*Inventories should be valued at the lower of cost and net realizable value (NRV).*”

(a) Cost of Inventories: Cost includes all expenditure incurred in bringing the inventory to its present location and condition. It comprises:

- ✓ Cost of purchase (purchase price, duties, freight, etc.)
- ✓ Cost of conversion (direct labour, overheads)
- ✓ Other costs necessary to bring inventory to a saleable condition

(b) Net Realizable Value (NRV): NRV is the estimated selling price in the ordinary course of business less the estimated cost of completion and the cost necessary to make the sale.

(c) Method of Valuation: Common methods used for determining cost include:

- ✓ FIFO (First-In, First-Out): The earliest goods purchased are assumed to be sold first.
- ✓ LIFO (Last-In, First-Out): The latest goods purchased are assumed to be sold first (not allowed under Ind AS).
- ✓ Weighted Average Cost Method: Cost is calculated based on the average cost of items available during the period.
- ✓ Specific Identification Method: Used for specific or unique items such as machinery or jewelry.

(d) Valuation of Different Types of Inventory

- ✓ Raw Materials: Valued at cost or NRV whichever is lower. NRV is considered only when finished goods are expected to be sold below cost.
- ✓ Work-in-Progress: Valued at cost of raw materials, labour, and proportionate overheads.
- ✓ Finished Goods: Valued at cost or NRV whichever is lower.
- ✓ Consumable Stores: Valued at cost unless they have become obsolete.

(e) Exclusions from Cost: As per AS 2, certain costs are not included in inventory valuation, such as:

- ✓ Abnormal waste of materials and labour
- ✓ Administrative overheads not related to production
- ✓ Selling and distribution expenses
- ✓ Interest and other borrowing costs (unless allowed by AS 16)

Auditor's Duties Regarding Valuation of Stock

- Ensure that valuation is made on a consistent basis each year.
- Verify that stock is valued at lower of cost and NRV.
- Confirm that valuation complies with AS 2/Ind AS 2.
- Check arithmetical accuracy of stock valuation statements.
- Examine whether adequate provision has been made for obsolete or damaged stock.
- Ensure that proper disclosure is made in the Balance Sheet under “Current Assets.”

Verification and Valuation of Liabilities-Bills payable, Sundry Creditors

Liabilities represent the financial obligations of a business towards outsiders that are payable in the future. They are classified into current liabilities and non-current liabilities.

Among current liabilities, Bills Payable and Sundry Creditors (Trade Payables) are common and significant items.

The auditor's duty is to verify their existence, completeness, accuracy, and proper valuation.

Verification ensures that all liabilities are correctly recorded and that no unrecorded liabilities are omitted, while valuation ensures that these liabilities are presented at their correct amounts in the financial statements.

Objectives of Verification and Valuation of Liabilities

- ✓ To ensure that all liabilities shown in the balance sheet actually exist.
- ✓ To verify that all liabilities outstanding on the balance sheet date have been recorded (completeness).
- ✓ To confirm that the liabilities belong to the business and not to third parties.
- ✓ To ensure that liabilities are valued correctly and recorded at their payable amounts.
- ✓ To check that adequate provision has been made for all known and expected liabilities.
- ✓ To ensure that liabilities are properly classified and disclosed in the financial statements as per the Companies Act, 2013.

I. Verification and Valuation of Bills Payable

Meaning: Bills Payable are negotiable instruments drawn by creditors (suppliers) on the business for the value of goods or services supplied, and accepted by the business as a promise to pay at a future date. They represent a liability until they are discharged.

Example: If X purchases goods from Y worth ₹50,000 and accepts a bill drawn by Y for 3 months, X's liability is shown as *Bills Payable ₹50,000*.

Objectives of Auditor in Relation to Bills Payable

- ✓ To confirm that all bills payable shown in the books represent genuine liabilities.
- ✓ To verify that all outstanding bills payable at the balance sheet date are recorded.
- ✓ To ensure that bills paid or cancelled before the year-end have been excluded.
- ✓ To check that correct amount and due dates are recorded.
- ✓ To ensure proper classification and disclosure under *Current Liabilities*.

A. Audit Procedure for Verification of Bills Payable

- (a) **Examination of Bills Payable Book:** The auditor should check entries in the Bills Payable Book and trace them to the journal and ledger accounts. He should ensure that all bills accepted during the year are properly recorded and that the total agrees with the ledger control account.
- (b) **Examination of Bills and Supporting Documents:** The auditor should inspect the actual bills accepted (if available) or obtain copies from creditors to verify details such as:
 - ✓ Name of drawer and drawee
 - ✓ Amount and date of acceptance
 - ✓ Maturity date
 - ✓ Stamp duty paid
 - ✓ Signature of acceptor
- (c) **Confirmation from Creditors:** The auditor should obtain direct confirmations from creditors holding bills to verify the amount of liability outstanding at the year-end.
- (d) **Verification of Bills Payable Dishonored:** Bills that have been dishonoured should be checked and properly accounted for by debiting the party's account and removing the liability from Bills Payable Account.
- (e) **Verification of Bills Renewed or Retired:** If any bill is renewed or paid before maturity, it should be excluded from the list of outstanding bills payable as on balance sheet date.
- (f) **Reconciliation with Statements of Accounts:** Reconcile the total of the Bills Payable Register with the General Ledger Control Account and the Schedule of Bills Payable Outstanding.

B. Valuation of Bills Payable

Bills payable should be shown at the amount payable on the date of the balance sheet. There is no estimation or revaluation involved, as it is a fixed liability. Any unpresented bills or bills discounted but not yet matured should be disclosed properly as contingent liabilities.

Disclosure in Balance Sheet: Under **Schedule III of the Companies Act, 2013**, Bills Payable are shown under the head "**Current Liabilities – Trade Payables**".

II. Verification and Valuation of Sundry Creditors (Trade Payables)

Meaning: Sundry Creditors, also called Trade Payables, are persons or firms to whom the business owes money for goods or services purchased on credit.

They are shown as a current liability in the balance sheet.

Example: If a business buys raw materials from suppliers on credit, the amount due to suppliers forms part of sundry creditors.

Objectives of Auditor in Relation to Sundry Creditors

- ✓ To ensure that all trade payables existing on the balance sheet date are included.
- ✓ To verify that only genuine creditors are recorded (existence).
- ✓ To ensure that the amounts due are correctly stated (accuracy).
- ✓ To confirm that no unrecorded liabilities are omitted (completeness).
- ✓ To check that adequate provision is made for disputed claims.
- ✓ To ensure correct classification and disclosure as per law.

A. Audit Procedures for Verification of Sundry Creditors

- (a) **Examination of Purchase Records:** Verify purchase invoices, goods inward notes, purchase orders, and supplier statements. Match them with entries in the purchase book and ledger accounts. Check that credit purchases up to the balance sheet date are recorded.
- (b) **Confirmation of Balances:** Obtain direct confirmations from a sample of major creditors to verify the correctness of balances shown. For smaller balances, reliance can be placed on internal records if control is strong.
- (c) **Scrutiny of Creditors' Ledger:** Check the creditors' ledger for abnormal balances such as: Debit balances (which may indicate advance payments or errors). Long outstanding items or old unclaimed balances. Disputed or contingent liabilities.
- (d) **Cut-off Verification:** Ensure that goods received before the year-end are included as purchases and the corresponding liability is recorded. Goods received after the balance sheet date should not be included in current year's liabilities.
- (e) **Verification of Subsequent Payments:** Verify payments made to creditors after the balance sheet date to confirm the existence and accuracy of the liabilities outstanding at year-end.
- (f) **Reconciliation with Supplier Statements:** Obtain supplier statements and reconcile them with the balances in the books of accounts. Differences should be investigated.
- (g) **Verification of Outstanding Expenses and Accrued Liabilities:** Ensure that all outstanding expenses (like wages, rent, interest, etc.) are properly provided for under "Other Current Liabilities."

B. Valuation of Sundry Creditors

- Sundry creditors are to be valued at the amount payable to them as on the balance sheet date.
- Any disputed or doubtful liabilities should be provided separately.
- Foreign currency liabilities should be converted at the closing exchange rate as per accounting standards (AS 11 / Ind AS 21).
- Discounts or rebates expected should not be deducted unless confirmed.

Disclosure in Balance Sheet: As per **Schedule III of the Companies Act, 2013**, Sundry Creditors are shown under: **Current Liabilities → Trade Payables** with further classification as: Dues to Micro and Small Enterprises (MSMEs) Dues to other creditors Proper disclosure must also include information required under the Micro, Small and Medium Enterprises Development Act, 2006 (MSMED Act).

Auditor's Duties Regarding Liabilities

- ✓ Verify that all known and expected liabilities are recorded.
- ✓ Ensure that contingent liabilities are disclosed properly.
- ✓ Check that liabilities of capital nature are not included under current liabilities.
- ✓ Examine whether adequate internal control exists over purchases and payments.
- ✓ Ensure compliance with Schedule III disclosure norms.
- ✓ Verify that liabilities are not understated to inflate profits.

Common Errors and Frauds Detected by the Auditor

- ✓ Omission of liabilities to inflate profits.
- ✓ Double recording of payments to reduce liabilities.
- ✓ Including fictitious creditors to misappropriate funds.
- ✓ Manipulation of cut-off to shift expenses between years.
- ✓ Incorrect classification between current and long-term liabilities.

Verification and Valuation of Liabilities- Contingent liabilities.

A contingent liability is a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the entity's control. In simple words, a contingent liability is a potential liability that may or may not materialize depending upon the outcome of an uncertain event.

Examples of Contingent Liabilities

1. Bills of exchange discounted but not yet matured.
2. Guarantees given on behalf of others.
3. Claims against the company not acknowledged as debt.
4. Disputed taxes, duties, or penalties under litigation.
5. Arrears of cumulative preference dividends (if not declared).
6. Lawsuits or damages under legal proceedings.
7. Liability for calls on partly paid shares of other companies.

Objectives of Verification and Valuation of Contingent Liabilities

- ✓ To ensure that all possible or potential liabilities are identified and disclosed properly.
- ✓ To verify that no known liabilities are left undisclosed.
- ✓ To ensure that the extent and nature of contingent liabilities are clearly stated in the balance sheet or notes to accounts.
- ✓ To confirm that no contingent liability is wrongly treated as actual liability, and vice versa.
- ✓ To assess whether the probability and financial impact have been evaluated properly by management.

Auditor's Duties Regarding Verification of Contingent Liabilities

The auditor's duty is not only to check whether liabilities are recorded but also to ensure that all contingent obligations are disclosed correctly as per law and accounting standards.

The following audit procedures should be followed:

1. Examine the Minutes of Meetings

The auditor should examine the minutes of board meetings and shareholders' meetings to find any resolutions that create potential obligations such as guarantees, undertakings, or commitments.

2. Examine Contracts and Agreements

All contracts, agreements, and correspondence with banks, government authorities, and customers should be reviewed to identify contingent liabilities such as guarantees, pending litigations, or performance obligations.

3. Inspect Legal Papers and Court Cases

The auditor should obtain a list of pending or threatened legal cases from the management and consult with the company's legal advisor to evaluate the possible financial implications.

This helps in determining whether a provision or only disclosure is required.

4. Review Bank Confirmations

Bank confirmations should be reviewed to verify guarantees issued by the bank, letters of credit, or bills discounted but not matured on the company's behalf.

5. Examine Subsequent Events

Events occurring after the balance sheet date but before the audit report date should be examined to determine whether any contingent liability has become an actual liability.

6. Obtain Management Representation

A written representation from management should be obtained confirming that all contingent liabilities have been properly disclosed.

This is a requirement under SA 580 – Written Representations.

7. Review Correspondence with Government Departments

The auditor should review correspondence with tax authorities, customs, and excise departments to check for disputed demands or pending assessments that might lead to contingent liabilities.

8. Verify Disclosures in Financial Statements

The auditor must ensure that contingent liabilities are disclosed separately in the notes to accounts as required by Schedule III of the Companies Act, 2013 and AS 29.

Valuation of Contingent Liabilities: Valuation of contingent liabilities is complex because the amount is uncertain and depends on future events.

The auditor must evaluate the likelihood of the obligation materializing, which can be classified as:

1. Probable: More likely than not to occur – provision should be made.
2. Possible: May or may not occur – disclose as a contingent liability.
3. Remote: Unlikely to occur – no disclosure necessary.

If possible, the estimated financial effect should be stated based on management and legal expert advice.

Disclosure of Contingent Liabilities

As per AS 29 and Schedule III of the Companies Act, 2013, contingent liabilities should not be shown in the main balance sheet figure but should be disclosed by way of a note.

Example of Disclosure:

Contingent Liabilities:

- Claims against the company not acknowledged as debts – ₹5,00,000
- Bills discounted with banks – ₹8,00,000
- Guarantees given on behalf of others – ₹3,50,000

Auditor's Duties as per ICAI and Companies Act, 2013

- ✓ To ensure all contingent liabilities are properly identified and disclosed.
- ✓ To report under Section 143(3)(f) of the Companies Act, 2013, if the company has failed to disclose any material liability.
- ✓ To ensure compliance with Accounting Standard (AS 29) and SA 540 – Audit of Accounting Estimates.
- ✓ To check that contingent liabilities are not understated to overstate profits.
- ✓ To confirm that management's estimates are reasonable and based on sound judgment.
- ✓ To include any significant matter in the Audit Report if management refuses to disclose it.

Illustrative Numerical Example

Example:

XYZ Ltd. has the following potential obligations as on 31st March, 2025:

- Bills discounted with bank: ₹5,00,000
- Legal case pending against the company (possible loss ₹3,00,000)
- Guarantee given to subsidiary company: ₹2,00,000

Treatment: Bills discounted and guarantee → disclose as contingent liabilities.

Legal case (possible loss) → disclose in notes.

If later the legal case becomes probable and amount measurable, then provision = ₹3,00,000 should be made in the books.

Importance of Verification of Contingent Liabilities

1. Helps in accurate presentation of financial position.
2. Prevents misleading disclosure of profits and assets.
3. Protects shareholders and creditors from potential risks.
4. Ensures compliance with accounting and legal standards.
5. Enhances credibility and reliability of financial statements.

Common Errors and Frauds Detected

1. Omission of contingent liabilities to improve financial position.
2. Incorrect classification of actual liability as contingent.
3. Non-disclosure of guarantees given on behalf of directors.
4. Ignoring legal claims under dispute.

ModuleNo.4:

Company Audit and Audit of other Entities

Company Auditor: Appointment

COMPANY AUDITOR: APPOINTMENT AND QUALIFICATIONS

Audit of a company is a statutory requirement under the Companies Act, 2013.

Every company registered under the Act must appoint a qualified auditor to examine its books of accounts and express an independent opinion on the financial statements.

I. APPOINTMENT OF COMPANY AUDITOR (As per Section 139 of the Companies Act, 2013)

1. First Auditor

(a) In the case of a Non-Government Company

- The first auditor of a company (other than a Government company) shall be appointed by the Board of Directors within 30 days from the date of registration of the company.
- If the Board fails to appoint within the prescribed time, then the members (shareholders) shall appoint the first auditor within 90 days at an Extraordinary General Meeting (EGM).
- The first auditor holds office till the conclusion of the first Annual General Meeting (AGM).

Example: If XYZ Pvt. Ltd. was incorporated on 1st April 2024, the Board must appoint the first auditor by 30th April 2024. If it fails, shareholders must appoint the auditor by 30th June 2024.

(b) In the case of a Government Company (Section 139(5))

- The Comptroller and Auditor General of India (C&AG) shall appoint the first auditor of a Government company within 60 days from the date of incorporation.
- If the C&AG fails to do so, the Board of Directors shall appoint the auditor within 30 days.
- If the Board also fails, the members shall appoint the first auditor within 60 days at an Extraordinary General Meeting.

2. Subsequent Auditor

(a) In the case of a Non-Government Company

- The auditor is appointed by the members at the Annual General Meeting (AGM).
- The appointment is made for a term of five (5) consecutive years, subject to ratification by members at every AGM (ratification requirement omitted by the Companies (Amendment) Act, 2017).
- The auditor holds office till the conclusion of the 6th AGM after appointment.

Example: If Mr. A is appointed as auditor in 2024 AGM, his term continues till the conclusion of AGM in 2029.

(b) In the case of a Government Company

- The C&AG appoints the auditor within 180 days from the commencement of the financial year.
- The appointed auditor holds office till the conclusion of the next AGM.

3. Casual Vacancy (Section 139(8)): Casual vacancy means a situation when the office of an auditor becomes vacant before the expiry of his term.

(a) Due to resignation: Filled by the Board of Directors within 30 days, but such appointment must be approved by the members at a general meeting convened within 3 months. And The new auditor holds office till the conclusion of the next AGM.

(b) Due to reasons other than resignation (e.g., death, disqualification): The Board of Directors can directly fill the vacancy within 30 days, without seeking approval from the members.

4. Re-appointment of Auditor: An auditor retiring at an AGM may be re-appointed automatically, unless:

- (a) He is not qualified for reappointment,
- (b) He has given a written notice of unwillingness to be reappointed,
- (c) A special resolution has been passed appointing another auditor, or
- (d) A notice has been received from a member proposing another auditor.

5. Rotation of Auditors (Section 139(2)): To maintain independence and objectivity, certain companies must rotate their auditors after a specified period.

Applicability: Rotation is applicable to

- ✓ All Listed Companies
- ✓ Unlisted Public Companies having paid-up share capital of ₹10 crore or more,
- ✓ Private Companies having paid-up share capital of ₹50 crore or more,
- ✓ Companies having borrowings from financial institutions/banks or public deposits of ₹50 crore or more.

Tenure: **Individual auditor:** Maximum 1 term of 5 years.

Audit firm: Maximum 2 terms of 5 years each (total 10 years).

After completion, the auditor must not be reappointed in the same company for 5 years (cooling period).

6. Removal of Auditor (Section 140)

The auditor may be removed from office before expiry of his term only by passing a special resolution and obtaining prior approval from the Central Government.

The company must give the auditor a reasonable opportunity of being heard before removal

⊕ QUALIFICATIONS OF COMPANY AUDITOR (Section 141 of the Companies Act, 2013)

1. Basic Qualification: Only a Chartered Accountant (CA) holding a valid Certificate of Practice (COP) under the Chartered Accountants Act, 1949, can be appointed as a company auditor.

2. Partnership Firm or LLP as Auditor: A firm of Chartered Accountants or an LLP may be appointed as auditor. Only the partners who are Chartered Accountants are authorized to sign the audit report on behalf of the firm.

3. Joint Auditors: A company may appoint two or more auditors (Joint Auditors) to share the audit work and responsibilities.

DISQUALIFICATIONS OF COMPANY AUDITOR (Section 141(3))

A person is disqualified from being appointed as an auditor if:

1. **Not a Chartered Accountant:** Any person who is not a Chartered Accountant.
2. **Officer or Employee of the Company:** An officer or employee of the company cannot be the auditor.
3. **Partner or Employee of Officer/Employee:** A partner or employee of an officer or employee of the company is disqualified.
4. **Indebtedness to the Company:** If the person or firm is indebted to the company or its subsidiaries/holding company for an amount exceeding ₹5 lakh.
5. **Guarantee or Security:** If the person has given a guarantee or security in connection with the indebtedness of any third person to the company exceeding ₹5 lakh.
6. **Business Relationship:** If the person or firm has a business relationship with the company, its subsidiaries, or holding company (except professional services).
7. **Holding Securities:** If the auditor or his relative holds any security or interest in the company exceeding ₹1 lakh face value.
8. **Limit of Audit Assignments (Section 141(3)(g)):** An auditor cannot audit more than 20 companies at a time.
9. **Conviction by Court:** A person convicted for an offense involving fraud and five years have not elapsed from the date of conviction

POWERS OF COMPANY AUDITOR IN INDIA

An auditor is an independent professional appointed to examine the books of accounts and express an opinion on the true and fair view of the financial statements of a company.

To perform his duties effectively, the auditor must be given adequate powers under the law.

The Companies Act, 2013, mainly under Section 143, specifies the powers of the company auditor.

These powers are necessary to ensure independence, objectivity, and effectiveness of the audit process.

1. Power to Access Books of Accounts and Vouchers (Section 143(1)): The auditor has the right to access at all times the books of accounts, vouchers, and other relevant records of the company, whether kept at the registered office or any other place.

- ✓ The auditor can inspect all records — ledgers, journals, bank statements, invoices, contracts, and supporting documents.
- ✓ This power can be exercised at any time during the audit period, not just at the year-end.
- ✓ It also extends to records of branch offices if the company has any.

Example: If a company maintains its purchase records at a warehouse and sales records at head office, the auditor can visit both places to inspect the documents.

Purpose: This power ensures that the auditor can verify accuracy and completeness of all financial transactions.

2. Power to Obtain Information and Explanations (Section 143(1)): The auditor has the right to require from the company's officers (directors, accountants, company secretary, etc.) any information or explanation necessary for performing the audit.

Explanation:

- ✓ The auditor may ask for clarification on any entry, transaction, adjustment, or policy.
- ✓ Officers of the company are legally bound to provide such information truthfully and promptly.
- ✓ If management refuses to provide details, the auditor may mention it in the audit report.

Example: If the auditor notices large cash advances, he can ask for supporting documents and purpose of those advances. If not explained satisfactorily, he may qualify his report.

Purpose: This ensures transparency and accountability of management during audit.

3. Power to Access Branch Office Accounts (Section 143(8)): When a company has branches, the auditor of the company has the right to access the accounts and records of all branch offices.

- ✓ The main auditor can visit the branch or ask for copies of branch records.
- ✓ If a separate branch auditor is appointed, the main auditor can rely on the branch auditor's report.
- ✓ However, the main auditor remains responsible for forming an overall opinion on the company's financial statements.

Example: If ABC Ltd. has a head office in Mumbai and branches in Delhi and Pune, the company auditor can inspect both branches or obtain certified reports from the branch auditors.

Purpose: To ensure that all parts of the company's operations are properly verified.

4. Power to Visit Branches and Obtain Information: The auditor can physically visit branch offices to check the operations, internal controls, and records.

- ✓ This helps detect errors, frauds, or misstatements occurring at branch level.
- ✓ The auditor can meet branch managers and verify inventory, cash, and local transactions.

Example: If a branch reports large stock losses, the auditor can visit and inspect stock registers and physical inventory.

Purpose: Helps ensure uniformity and accuracy in accounting practices across branches.

5. Power to Inquire into Specific Matters (Section 143(1)(a)–(f)): The Companies Act, 2013 mandates the auditor to make **specific inquiries** on certain matters to detect possible fraud or mismanagement.

The auditor must inquire whether:

- a) Loans and advances made by the company are properly secured and not shown as deposits.
- b) Transactions represented by book entries are not prejudicial to the company.

- c) The company's shares or debentures have been sold below cost.
- d) Loans and advances are shown as deposits to conceal financial position.
- e) Personal expenses are charged to the revenue account.
- f) The company is not being used as a means of evading tax or liability.

Example: If the auditor finds that a director's personal travel expenses are recorded as business expenses, he must report it.

Purpose: To ensure honesty and transparency in management decisions.

6. Power to Sign Audit Report (Section 145): Only the appointed auditor has the authority to sign the audit report and certify the financial statements.

Explanation: If the auditor is a firm, the partner (Chartered Accountant) in charge of the audit signs on behalf of the firm. The signature authenticates that the audit was conducted according to **auditing standards** and the report represents the auditor's opinion.

Purpose: To ensure accountability and authenticity of the auditor's opinion.

7. Power to Report to the Members (Section 143(2)): The auditor must make a report to the members on the accounts examined by him and express whether the financial statements give a true and fair view. The auditor's report must cover both the financial position (Balance Sheet) and financial performance (Profit & Loss Account). The report is addressed to the shareholders, not to the management.

Purpose: Ensures independent communication between auditor and owners (shareholders).

8. Power to Report Fraud (Section 143(12)): If an auditor, during the course of audit, finds or suspects any fraud involving officers or employees, he must report it to the Central Government.

Fraud exceeding ₹1 crore must be directly reported to the Central Government within prescribed time and format (Form ADT-4).

- ✓ Smaller frauds are reported to the Audit Committee or Board.
- ✓ This duty reinforces the auditor's role as a watchdog of corporate integrity.

Example: If fake invoices are found showing inflated expenses, the auditor must evaluate and report the fraud as per Section 143(12).

9. Power to Attend General Meetings (Section 146): The auditor has the right to receive notice of every general meeting and attend it. He also has the right to be heard on any matter concerning the audit. The auditor can clarify points in his report or answer members' questions. Attendance strengthens communication and accountability between the auditor and shareholders.

Purpose: To allow the auditor to defend or explain his findings and maintain transparency.

10. Power to Seek Expert Opinion (SA 620): The auditor may seek the assistance of an expert when technical or specialized knowledge is required (for example, valuation of assets, actuarial computations).

- ✓ The auditor must evaluate the competence, objectivity, and independence of the expert.
- ✓ Even when relying on an expert, the auditor retains overall responsibility for the audit opinion.

Example: An auditor of a construction company may rely on a civil engineer's valuation report for plant and buildings.

11. Power to Communicate with Previous Auditor: Before accepting a new audit assignment, the incoming auditor must **communicate with the previous auditor** to know if there are any professional reasons why he should not accept the audit.

- ✓ This ensures professional ethics and prevents conflicts of interest.
- ✓ Communication can reveal disputes, non-payment of fees, or other issues affecting independence.

12. Power to Demand Reports and Information from Sub-Auditors or Branch Auditors

When the audit work is shared among joint auditors or branch auditors, the main auditor can demand copies of their reports, working papers, and explanations.

Purpose: This ensures that the final audit opinion is based on complete and verified information.

13. Power to Inspect Minutes Books and Legal Documents

The auditor can inspect:

- ✓ Minutes of Board and shareholders' meetings,
- ✓ Legal agreements, contracts, and statutory registers (e.g., register of charges, members, directors).

Example: If the company has borrowed funds, the auditor can verify the loan agreement and charge registration with ROC.

14. Power under Other Laws

- ✓ Under the Income Tax Act, auditor has power to certify tax audit reports.
- ✓ Under GST law, he can certify certain reconciliation statements.
- ✓ Under Banking Regulation Act and Insurance Act, auditors can inspect special records as required by regulators.

■ DUTIES AND LIABILITIES OF A COMPANY AUDITOR

The auditor of a company plays a crucial role in ensuring the accuracy and fairness of the financial statements. His duties are not only professional but also legal and moral in nature. The Companies Act, 2013, and the Institute of Chartered Accountants of India (ICAI) prescribe the framework within which an auditor performs his responsibilities. The duties of an auditor can be broadly classified as Statutory Duties, Professional Duties, Contractual Duties, and Moral Duties.

1. STATUTORY DUTIES (LEGAL DUTIES)

Statutory duties are those imposed on the auditor by law, especially under the Companies Act, 2013. These duties must be performed compulsorily, and failure to do so may lead to legal consequences.

(a) Duty to Report to Shareholders: The auditor must examine the company's books of accounts and financial statements and report to the shareholders whether they show a true and fair view of the financial position and results of the company.

(b) Duty to Enquire under Section 143(1):

The auditor is legally bound to inquire into specific matters such as:

1. Whether loans and advances made by the company are properly secured.
2. Whether transactions represented merely by book entries are not prejudicial to the interests of the company.
3. Whether personal expenses have been charged to revenue accounts.
4. Whether shares allotted for cash have been actually received in cash.
5. Whether the company is maintaining proper books of accounts.

(c) Duty to Report on True and Fair View (Section 143(2)): After the examination, the auditor must express his opinion on whether the financial statements give a true and fair view of the company's financial affairs.

(d) Duty to Sign the Audit Report (Section 145): The auditor must sign the audit report, which signifies his responsibility for the opinion expressed therein.

(e) Duty to Attend the General Meeting (Section 146): The auditor has the right and duty to attend general meetings of the company to clarify doubts raised by shareholders.

(f) Duty to Maintain Confidentiality: The auditor must not disclose any information acquired during the course of the audit, except where required by law.

(g) Duty to Comply with Auditing Standards: Under Section 143(9), the auditor must follow the auditing standards prescribed by the ICAI.

2. Professional Duties (As per ICAI Guidelines)

Professional duties are those that arise from the ethical and technical standards laid down by the Institute of Chartered Accountants of India (ICAI). These ensure that the auditor maintains the dignity and integrity of the profession.

(a) Duty to Exercise Due Care and Diligence: The auditor must perform his work carefully, cautiously, and with reasonable skill expected from a professional accountant.

- (b) **Duty to Maintain Independence:** The auditor must be independent both in fact and appearance, avoiding any relationship that may affect his objectivity or professional judgment.
- (c) **Duty to Obtain Sufficient and Appropriate Audit Evidence:** Before forming an opinion, the auditor must collect adequate audit evidence to support his conclusions.
- (d) **Duty to Maintain Professional Scepticisms:** He should always be alert to possible misstatements, errors, or fraud and must question and verify unusual transactions.
- (e) **Duty to Comply with Ethical Standards:** The auditor must follow the Code of Ethics issued by ICAI, which includes principles like integrity, objectivity, professional competence, confidentiality, and professional behaviour.
- (f) **Duty to Maintain Audit Documentation:** Proper working papers must be maintained to support the audit opinion and for future reference.
- (g) **Duty of Continuous Learning:** Auditors must update their knowledge periodically to keep pace with changes in laws, accounting standards, and auditing practices.

3. Contractual Duties (As per Engagement Letter)

These duties arise from the agreement between the auditor and the client at the time of appointment. They are defined in the engagement letter issued before the audit begins.

- (a) **Duty to Define Scope of Work:** The auditor must clearly understand and document the scope, nature, and extent of work agreed upon in the engagement letter.
- (b) **Duty to Complete Work within Time:** He must complete the audit assignment within the stipulated time as agreed upon with the management.
- (c) **Duty to Maintain Confidentiality of Client Information:** The auditor must not disclose or misuse any confidential information obtained during the audit.
- (d) **Duty to Communicate with Management:** He must communicate significant audit findings, deficiencies, or irregularities to the management or those charged with governance.
- (e) **Duty to Act According to Terms of Engagement:** The auditor must strictly adhere to the terms mentioned in the engagement letter, failing which he can be held liable for breach of contract.

4. Moral Duties (Ethical Responsibilities)

Moral duties are based on ethical values and professional integrity. These duties ensure that the auditor's behaviour upholds public trust in the profession.

- (a) **Duty to be Honest and Fair:** The auditor must always act with honesty and fairness in dealing with clients, employees, and the public.
- (b) **Duty to Avoid Conflict of Interest:** He should not audit a company in which he has a financial interest or personal relationship, as it compromises his independence.
- (c) **Duty to Protect Public Interest:** Since auditors play a key role in financial reporting, they must ensure that their actions serve the public interest, not just the company's management.
- (d) **Duty to Maintain Integrity of Profession:** He must avoid any act that could bring disrepute to the auditing profession.
- (e) **Duty to Report Fraud and Irregularities:** The auditor should report any fraud or serious irregularities detected during the audit to appropriate authorities.

PROFESSIONAL ETHICS OF AN AUDITOR

Professional ethics refer to the set of moral principles, standards, and guidelines that govern the behavior of auditors and ensure that they perform their duties with honesty, integrity, objectivity, and independence. The Institute of Chartered Accountants of India (ICAI) has laid down a comprehensive Code of Ethics to guide auditors in maintaining the dignity of the profession and upholding public confidence.

The professional ethics of an auditor can be classified under various categories such as fundamental principles, ethical requirements under the Chartered Accountants Act, 1949, and professional conduct as per ICAI guidelines.

1. Fundamental Principles of Professional Ethics

These are the core ethical principles that form the foundation of an auditor's conduct in professional and business relationships. They ensure that the auditor acts with integrity and professionalism in all circumstances.

- a) Integrity:** The principle of integrity requires the auditor to be straightforward, honest, and truthful in all professional and business relationships. He must not be associated with reports, communications, or information that are materially false or misleading.
- b) Objectivity:** An auditor should not allow bias, conflict of interest, or undue influence of others to override his professional judgment. Objectivity ensures that the auditor's opinion is fair and based on facts rather than personal feelings or external pressure.
- c) Professional Competence and Due Care:** The auditor must maintain professional knowledge and skill at a level required to ensure that clients receive competent professional service. He should act diligently and in accordance with applicable technical and professional standards.
- d) Confidentiality:** The auditor must respect the confidentiality of information acquired during the course of professional work and should not disclose such information to third parties without proper authority, except where there is a legal or professional duty to disclose.
- e) Professional Behaviour:** The auditor should comply with relevant laws and regulations and must avoid any conduct that discredits the profession. He must behave in a manner that upholds the good reputation of the auditing profession.

2. Professional Ethics under the Chartered Accountants Act, 1949

The Chartered Accountants Act, 1949 specifies the professional misconducts under various schedules which, if committed, may make the auditor liable for disciplinary action by ICAI.

A. First Schedule – Professional Misconduct of Lesser Gravity

- 1. Clause 1 – Soliciting Clients:** A member should not advertise his services or solicit clients through circulars, advertisements, personal communication, or other means.
- 2. Clause 2 – Sharing of Profits:** A member is not allowed to share his fees or profits of professional work with any person other than another member of ICAI.
- 3. Clause 3 – Accepting Commissions or Gratifications:** An auditor should not accept any commission, brokerage, or gratification from a client or any other person in connection with his professional work.
- 4. Clause 4 – Partnership with Non-Members:** A member should not enter into a partnership for professional work with persons who are not members of ICAI.
- 5. Clause 5 – Securing Professional Work by Improper Means:** A member should not obtain professional work through the help of unqualified persons or by using influence or gifts.
- 6. Clause 6 – Signing Reports Without Examination:** A member should not sign audit reports or financial statements without performing adequate examination or without having personally conducted the audit.
- 7. Clause 7 – Failure to Disclose Interest:** An auditor must disclose any financial or managerial interest he holds in the client's business before accepting the audit engagement.

B. Second Schedule – Professional Misconduct of Serious Nature

- 1. Clause 1 – Gross Negligence in Professional Duties:** If an auditor fails to exercise due diligence or care expected of a professional accountant, he can be held guilty of professional misconduct.
- 2. Clause 2 – Misstatement of Material Facts:** An auditor must not make any material misstatement in audit reports or certificates knowingly or recklessly.
- 3. Clause 3 – Failure to Obtain Sufficient Information:** Issuing a report without obtaining sufficient audit evidence or verifying necessary details amounts to professional misconduct.
- 4. Clause 4 – Failure to Maintain Independence:** If an auditor accepts an appointment where he has a personal, financial, or business relationship with the client, his independence is compromised.
- 5. Clause 5 – Violation of Auditing and Accounting Standards:** Non-compliance with the standards issued by ICAI is considered a serious ethical violation.
- 6. Clause 6 – Non-Cooperation with ICAI Council:** Failure to respond to notices or provide information to the ICAI during disciplinary proceedings is also a misconduct.
- 7. Clause 7 – Misuse of Firm Name or Professional Designation:** An auditor should not allow others to use his name in connection with activities that are not professional or ethical.

3. Ethical Responsibilities in Professional Conduct

Apart from the legal and statutory provisions, auditors must adhere to the following ethical responsibilities to maintain the trust of the public and clients.

- Independence in Thought and Appearance:** The auditor must remain independent, both mentally and in appearance, while performing audits. Even the perception of bias or conflict of interest should be avoided.
- Professional Competence:** An auditor should take up only those assignments which he is competent to perform. He must continuously update his knowledge to keep pace with changes in accounting and auditing standards.
- Due Diligence and Care:** The auditor should perform his duties with due diligence and care, ensuring that every opinion and report issued by him is based on adequate verification and sound reasoning.
- Avoiding Conflict of Interest:** The auditor should not undertake any assignment that may conflict with the interests of another client or compromise his independence.
- Confidentiality of Client Information:** All information obtained during the audit must be treated as confidential. The auditor should not use it for personal gain or disclose it without consent unless required by law.
- Truthfulness in Reports:** The auditor's report should be truthful, factual, and free from misrepresentation. He must ensure that the report presents the true and fair view of the company's financial position.
- Social Responsibility:** An auditor serves not only his client but also the society at large. He must ensure that his work promotes public confidence in financial reporting and corporate governance.

OTHER ENTITIES: AUDIT PROCEDURE OF NGOS

Audit Procedure of NGOs (Non-Governmental Organizations)

The audit of Non-Governmental Organizations (NGOs) is a vital process that ensures accountability, transparency, and proper utilization of funds received from donors, governments, or other agencies.

NGOs are not-for-profit entities that work for social, cultural, educational, or charitable causes. As per the guidelines of the Institute of Chartered Accountants of India (ICAI), an auditor must ensure that all receipts and payments are genuine, all grants are properly utilized, and activities are conducted as per the stated objectives.

Meaning of NGO Audit: The audit of an NGO refers to the systematic examination of the books of accounts, records, receipts, payments, and other relevant documents of the NGO to ensure that:

- ✓ The funds have been used for the intended purpose.
- ✓ The financial statements present a true and fair view of the financial position.
- ✓ There is compliance with statutory, donor, and regulatory requirements.

Objectives of NGO Audit

1. **To ensure proper utilization of funds:** The auditor verifies that funds have been used strictly for the purpose for which they were granted by donors or funding agencies.
2. **To check transparency and accountability:** The audit ensures that all transactions are transparent and accountable, helping maintain public trust in the organization.
3. **To detect errors and frauds:** It helps in detecting misappropriation, frauds, or misuse of donations and grants.
4. **To verify compliance:** The audit ensures compliance with laws like the Societies Registration Act, 1860, Indian Trusts Act, 1882, Companies Act (Section 8 Companies), Foreign Contribution Regulation Act (FCRA), and Income Tax provisions.
5. **To evaluate financial performance:** It helps management assess the efficiency of financial operations and internal control systems.

Audit Procedure of NGOs (The audit procedure of NGOs can be divided into several stages)

1. Preliminary Work

- *Understanding the nature of the organization:* The auditor must understand the objectives, activities, structure, and sources of income of the NGO.
- *Reviewing legal documents:* The auditor examines trust deeds, registration certificates, Memorandum of Association, and Rules & Regulations.
- *Understanding internal control system:* Auditor evaluates the internal control and accounting system to determine its reliability.

2. Examination of Books of Accounts

- The auditor examines Cash Book, Ledger, Receipts and Payments Account, Income and Expenditure Account, and Balance Sheet.
- Ensures that double-entry accounting principles have been followed.
- Verifies the correctness of journal entries, vouchers, and supporting bills.

3. Verification of Income

- *Donations:* Verifies whether all donations received are properly recorded and utilized for intended purposes.
- *Grants:* Checks whether grants are sanctioned by government or agencies, whether conditions attached to them are fulfilled, and utilization certificates are prepared.
- *Membership fees:* Ensures that fees collected from members are properly accounted for.
- *Income from investments:* Verifies interest, dividends, and rent income.

4. Verification of Expenditure

- Ensures that expenditures are authorized, properly classified, and supported by documentary evidence.
- Checks that administrative expenses are reasonable and within approved limits.
- Confirms that project-related expenditures are incurred for specific projects and are supported by vouchers and bills.

5. Verification of Assets

- *Fixed assets:* Verifies existence and ownership of assets such as buildings, furniture, equipment, and vehicles.
- *Investments:* Checks that investments are in approved securities as per the trust deed or law.
- *Cash and bank balances:* Confirms cash balance physically and bank balance through confirmation statements.

6. Verification of Liabilities

- Verifies outstanding expenses, creditors, and unutilized grants.
- Ensures that liabilities are properly disclosed in the balance sheet.

7. Verification of Foreign Contributions (FCRA Audit)

- If the NGO receives foreign contributions, the auditor ensures compliance with the Foreign Contribution Regulation Act (FCRA), 2010.
- Verifies that separate bank accounts are maintained for foreign contributions.
- Checks that utilization of foreign funds is as per the approval of the Ministry of Home Affairs.

8. Examination of Statutory Compliance

- Verifies registration under the Societies Registration Act or Indian Trusts Act.
- Ensures filing of returns with the Registrar of Societies or Charity Commissioner.
- Checks compliance with Income Tax Act, such as registration under Section 12A/12AA, and claim for exemptions under Section 80G.

9. Scrutiny of Internal Control System

- Evaluates segregation of duties, authorization of expenses, and approval procedures.
- Ensures that adequate safeguards are in place to prevent misuse of funds.

10. Preparation of Audit Report

- The auditor prepares an Audit Report stating whether the financial statements present a true and fair view.
- The report should include remarks on any irregularities, non-compliance, or misuse of funds.
- A utilization certificate is often prepared for grants to confirm that funds have been used for specified purposes.

Special Considerations in NGO Audit

1. Donor-specific audit requirements: Many funding agencies specify their own formats and conditions for audit reporting. The auditor must comply with them.
2. Project-wise accounting: Separate accounts should be maintained for each project to facilitate proper tracking of income and expenditure.
3. In-kind donations: Auditor must verify valuation and recording of non-cash donations like materials, goods, or services.
4. Transparency and governance: Auditor must ensure that financial statements reflect the true state of affairs and that governance practices are strong.

AUDIT PROCEDURE OF CHARITABLE INSTITUTIONS

Meaning of Audit of Charitable Institutions

The audit of charitable institutions refers to the systematic and independent examination of the financial records, books of accounts, and supporting documents of a charitable trust or society. The main purpose is to ensure that the income received has been properly applied for the objectives for which the institution was created.

Objectives of Auditing Charitable Institutions

1. *Verification of Proper Utilization of Funds*: To confirm that donations, grants, and other receipts are spent only for the charitable purposes intended by the donors or governing body.
2. *Detection of Errors and Frauds*: To detect and prevent misappropriation, misuse, or diversion of funds for non-charitable activities.
3. *Ensuring Legal Compliance*: To ensure compliance with the Indian Trusts Act, Societies Registration Act, Companies Act (Section 8 Companies), Income Tax Act (Sec. 12A, 80G), and other applicable laws.
4. *Verification of Accounts and Records*: To check the correctness and completeness of the Receipts and Payments Account, Income and Expenditure Account, and Balance Sheet.
5. *To Report True and Fair View*: To express an opinion on whether the financial statements present a true and fair view of the state of affairs of the charitable institution.

Audit Procedure of Charitable Institutions

1. Preliminary Work

- The auditor should obtain a clear understanding of the nature, objectives, and activities of the charitable institution.
- Examine founding documents such as the Trust Deed, Memorandum of Association, or Rules and Regulations to understand the powers and functions of trustees.
- Review the accounting system, internal controls, and delegation of authority.

2. Examination of Books of Accounts

- Verify the maintenance of the following books:
 - ✓ Cash Book
 - ✓ Ledger
 - ✓ Donation Register
 - ✓ Investment Register
 - ✓ Fixed Assets Register
 - ✓ Receipts and Payments Account
- Ensure double-entry system and proper posting of all transactions.
- Vouch cash receipts and payments with proper supporting documents.

3. Verification of Income: The auditor must ensure that all sources of income are correctly recorded and utilized.

1. Donations and Contributions: Verify the donation register, receipts, and donor correspondence. Check whether donations are general or specific (earmarked for a project). Ensure that donations have been used for their specific purpose.
2. Grants and Subsidies: Verify sanction letters from government or funding agencies. Check whether conditions of the grant are fulfilled and utilization certificates are prepared.
3. Membership Fees / Subscriptions: Confirm that membership income is properly accounted for and there are no arrears.
4. Income from Investments: Verify interest, dividend, and rental income with investment registers and bank statements.
5. Other Receipts: Cross-check proceeds from charity shows, events, or publications with vouchers and bank entries.

4. Verification of Expenditure

1. Capital Expenditure: Check that expenditure on buildings, land, or equipment is properly classified and authorized by trustees.
2. Revenue Expenditure: Verify that all expenses such as salaries, maintenance, and administrative costs are legitimate and supported by bills.
3. Project-Specific Expenditure: Ensure that project funds are spent according to donor instructions and within budget limits.
4. Charitable Activities: Confirm that expenses on educational, medical, or relief activities are genuine and supported by records (like beneficiary lists).

5. Verification of Assets

1. Fixed Assets: Verify ownership and existence of land, buildings, and equipment. Ensure depreciation is charged properly.
2. Investments: Confirm that investments are made in approved securities as per trust law.
3. Cash and Bank Balances: Conduct physical verification of cash balance and reconcile bank statements.
4. Inventory / Stores: Verify consumables or materials used in charitable projects.

6. Verification of Liabilities

- Check outstanding expenses, creditors, and unutilized grants.
- Ensure that contingent liabilities (like pending legal cases) are disclosed in notes to accounts.

7. Checking Statutory Compliance

- Verify registration under the Trusts Act, Societies Registration Act, or Companies Act (Section 8).
- Ensure compliance with Income Tax Act, such as registration under Sec. 12A/12AA and approval for Sec. 80G benefits.
- If foreign funds are received, check compliance with Foreign Contribution Regulation Act (FCRA).

8. Examination of Internal Controls

- Evaluate internal checks on receipts, authorizations, and disbursements.
- Ensure segregation of duties between those who handle cash and those who maintain accounts.

9. Verification of Utilization of Funds

- Auditor must check whether funds have been spent for the objects stated in the trust deed or constitution.
- Verify preparation of Utilization Certificates for donor agencies and government departments.

10. Preparation of Audit Report

- The auditor should prepare an Audit Report giving his opinion on whether the accounts present a true and fair view.

- The report should mention:
 - ✓ Any irregularities or non-compliance observed.
 - ✓ Misuse or diversion of funds.
 - ✓ Weaknesses in internal controls.

The report may also include recommendations for improving financial and control systems.

Special Considerations in Audit of Charitable Institutions

1. *Endowment Funds*: Auditor must ensure that endowment or corpus funds are invested in approved securities and not used for general expenses.
2. *Foreign Contributions*: Separate accounts must be maintained for foreign donations and properly reported as per FCRA.
3. *Depreciation Policy*: Depreciation on fixed assets must be reasonable and in accordance with accounting standards.
4. *Transparency and Accountability*: Auditor must ensure that financial statements are free from bias and fully disclose all relevant information.
5. *Donor Reporting*: Many donors require audit reports in specific formats; the auditor must ensure compliance.

AUDIT PROCEDURE OF EDUCATIONAL INSTITUTIONS

Meaning of Audit of Educational Institutions

The audit of educational institutions refers to the independent examination of books of accounts, vouchers, receipts, and other relevant documents to ensure that all income and expenditure are properly recorded and that the financial statements give a true and fair view of the financial position. These institutions may be registered under the Societies Registration Act, the Trust Act, or as a Section 8 Company, and the auditor must comply with the respective legal requirements during the audit.

Objectives of Audit of Educational Institutions

- ✓ To verify that all income and expenditure are properly recorded.
- ✓ To ensure that funds are used for educational purposes only.
- ✓ To detect errors, frauds, or irregularities in the accounts.
- ✓ To ensure compliance with rules of government or university.
- ✓ To verify that the financial statements show a true and fair view of the institution's affairs.

1. Preliminary Work: Before commencing the audit, the auditor should:

- Obtain knowledge about the structure and functioning of the institution.
- Study documents such as the Trust Deed, Rules and Regulations, and minutes of the managing committee.
- Understand the internal control system regarding fee collection, salary disbursement, and purchases.
- Examination of Books of Accounts

The auditor should:

- Verify whether proper records are maintained such as Cash Book, Ledger, Fees Register, Salary Register, and Stock Register.
- Vouch all transactions with proper supporting documents like receipts, vouchers, and bills.
- Ensure that books are written up-to-date and properly balanced.

2. Verification of Income: The main sources of income for educational institutions include tuition fees, admission fees, grants, donations, hostel fees, and other miscellaneous income.

- Tuition Fees: Check students' strength, rate of fees, concessions, and scholarships properly authorized by management.
- Admission Fees: Ensure they are properly recorded and not treated as revenue if refundable.
- Grants and Subsidies: Examine sanction letters and confirm that grants are utilized for the intended purpose.
- Donations: Verify receipts, distinguish between general and specific donations, and check utilization of specific funds.
- Hostel and Mess Fees: Compare receipts with hostel occupancy and mess expenditure.
- Interest and Investments: Check interest/dividends are properly accounted for in income.

3. Verification of Expenditure: The main expenditures include salaries, scholarships, maintenance, and capital outlay.

- Salaries and Wages: Verify salary register, attendance records, appointment letters, and deductions (PF, ESI, TDS).
- Scholarships and Prizes: Ensure proper authorization and compliance with donor/government rules.
- Repairs and Maintenance: Verify vouchers, approval, and classification under revenue expenditure.
- Capital Expenditure: Check purchase bills, quotations, and ensure proper capitalization of fixed assets.

4. Verification of Assets

- Verify land and building with title deeds or lease agreements.
- Physically inspect furniture, laboratory equipment, and other fixed assets.
- Check depreciation calculation and accounting.
- Verify investments and ensure interest/dividends are properly received.
- Verify cash balances through surprise checks and bank balances with reconciliation statements.
- Check library books and stock registers with physical verification reports.

5. Verification of Liabilities: Verify outstanding liabilities for expenses, salaries, and statutory dues.

- Check student deposits, caution money, and advance fees properly classified as liabilities.
- Ensure statutory payments like PF, TDS, and ESI are made on time.

6. Examination of Internal Control System

- Evaluate internal checks in fee collection, cash handling, and expenditure.
- Ensure proper authorization for payments and purchases.
- Check division of duties to prevent fraud.
- Verify store records and stock control procedures.

7. Checking Statutory Compliance

- Education Department regulations.
- Income Tax provisions under sections 12A, 10(23C), and 80G.
- Labor and employment laws for staff and workers.
- Grant utilization certificates submitted to government authorities.

8. Audit of Hostel, Mess, and Transport Accounts

Check separate accounts for hostel, mess, and transport.

- Verify receipts and payments with supporting vouchers.
- Ensure that funds are not mixed with the main institution's accounts.

9. Audit Report

Prepare a detailed report expressing whether the financial statements give a true and fair view.

- ✓ Mention irregularities, weaknesses in internal control, or non-compliance with rules.
- ✓ Provide suggestions and recommendations for improvement in financial management.
- ✓ Special Points to be observed by the Auditor
- ✓ Ensure all receipts are pre-numbered and properly accounted for.
- ✓ Concessions and scholarships should be duly approved.
- ✓ Grants and donations must be used for their specific purposes.
- ✓ Separate accounts for each fund or endowment should be maintained.
- ✓ Investments should comply with rules laid down in the Trust Act.
- ✓ Ensure there is internal audit and proper internal checks in the institution.

AUDIT PROCEDURE OF GOVERNMENT AND LOCAL BODIES

Meaning of Audit of Government and Local Bodies

The audit of government and local bodies refers to the independent examination of accounts maintained by government departments, municipal corporations, panchayati raj institutions, and other local authorities to ensure that public funds are properly utilized and financial statements present a true and fair view. It involves checking both the legality and propriety of expenditure and receipts.

Objectives of Audit of Government and Local Bodies

Types of Audit Conducted in Government and Local Bodies

- Financial Audit** – This audit checks whether financial transactions are properly recorded and whether the financial statements reflect a true and fair view of the accounts.
- Compliance Audit** – It examines whether the expenditure, receipts, and financial operations comply with applicable laws, rules, and regulations.
- Performance Audit** – It assesses whether the government programs and projects are carried out economically, efficiently, and effectively to achieve the intended objectives.
- Proprietary Audit** – It examines whether public money is spent wisely and in the best interest of the public.

Authorities Responsible for Audit: The audit of government accounts is mainly carried out by the Comptroller and Auditor General (C&AG) of India under Articles 148–151 of the Constitution. The C&AG audits all receipts and expenditures of the Government of India, state governments, and bodies substantially financed by them. In the case of local bodies, audits may be conducted by state audit departments or chartered accountants appointed by the local authority.

Audit Procedure for Government and Local Bodies

- Understanding the Nature and Scope of the Entity:** The auditor should first understand the legal status, constitution, and objectives of the government or local body. This helps to identify the scope of audit and specific laws applicable to the entity.
- Preliminary Examination of Documents:** The auditor should examine the enabling Act, rules, financial regulations, and government notifications. He should also study the accounting system followed, budgetary provisions, and the delegation of financial powers.
- Examination of Books of Accounts:** The auditor should verify that all books of accounts such as cash book, ledger, grants register, advances register, and asset register are properly maintained and reconciled. The auditor should check that all transactions are supported by proper vouchers and that books are written up to date.
- Vouching of Transactions:** The auditor should vouch both receipts and payments. For receipts, he should verify treasury challans, grants-in-aid, and revenue collections. For payments, he should ensure that the expenditure has been properly sanctioned, supported by vouchers, and incurred within budget limits.
- Verification of Grants and Expenditure:** The auditor should verify whether the grants received from the central or state government have been utilized for the specific purpose for which they were sanctioned. Unspent balances should be carried forward or refunded as per rules. He should also ensure that expenditure is classified correctly under the appropriate head of account.
- Verification of Assets and Liabilities:** The auditor should verify the existence and ownership of fixed assets like buildings, equipment, and land. He should check whether proper asset registers are maintained and depreciation is correctly calculated. The auditor should also verify liabilities such as loans, advances, and outstanding expenses.
- Checking Internal Control and Internal Audit System:** The auditor should evaluate the adequacy and effectiveness of internal control systems, including authorization, approval, custody, and record-keeping of transactions. In government and local bodies, internal audit plays an important role in preventing errors and fraud, so the external auditor should review internal audit reports and follow up on pending observations.

8. **Examination of Budgetary Control:** The auditor should examine whether the budget is properly prepared, approved, and implemented. He should compare actual expenditure with budgeted figures and investigate any material variations. This helps ensure that funds are used efficiently and not overspent.
9. **Compliance with Laws and Rules:** The auditor should check compliance with statutory provisions, financial regulations, and accounting rules issued by the government. He should ensure that all financial activities conform to the principles of legality, propriety, and regularity.
10. **Performance and Efficiency Review:** The auditor should examine whether government schemes, programs, and development projects have achieved their intended objectives economically and efficiently. This involves reviewing progress reports, comparing outcomes with targets, and assessing cost-effectiveness.
11. **Audit of Local Bodies:** In the case of municipalities, panchayats, and other local bodies, the auditor should verify sources of income such as taxes, fees, grants, and loans. He should check that expenditure on public works, education, sanitation, and health is properly supported by vouchers and approved by competent authorities. The auditor should also examine whether statutory financial statements and annual accounts have been submitted on time.
12. **Preparation of Audit Report:** After completing the audit, the auditor should prepare a detailed report highlighting important findings, deficiencies in the internal control system, cases of irregular expenditure, and non-compliance with rules. The report should also contain recommendations for improving financial administration and ensuring better utilization of public funds.

Special Considerations in the Audit of Government and Local Bodies

The auditor should keep in mind the following points while auditing:

- ✓ The accounting system should be in accordance with government accounting rules.
- ✓ All grants and subsidies should be utilized for the purpose for which they were sanctioned.
- ✓ Proper control over public money and property should be ensured.
- ✓ Unspent grants should be refunded or shown as liabilities.
- ✓ All advances should be adjusted within reasonable time limits.
- ✓ The auditor should report any instance of wasteful or unauthorized expenditure.
- ✓ The auditor should ensure that all financial statements conform to government formats and are submitted to the appropriate authorities.

AUDIT PROCEDURE OF COOPERATIVE SOCIETIES

Meaning of Audit of Co-operative Societies

The audit of a co-operative society means the independent examination of its books of account, records, and financial statements to ensure that transactions are properly recorded, the society's operations comply with its objectives and by-laws, and its financial position and performance are correctly reflected in its statements.

Objectives of Audit of Co-operative Societies

1. *To ensure correctness of accounts* – The auditor must verify that books of account are properly maintained and reflect a true financial position.
2. *To check compliance with laws and by-laws* – The auditor ensures that transactions are carried out in accordance with the Co-operative Societies Act and rules.
3. *To detect errors, fraud, and irregularities* – As co-operative societies involve member funds, detecting misuse or misappropriation is crucial.
4. *To verify utilization of funds* – The auditor examines whether funds and government subsidies are used for the intended purposes.
5. *To examine internal control system* – The auditor evaluates whether internal checks, supervision, and accounting systems are adequate.
6. *To certify the accounts* – The auditor certifies the final accounts and reports whether they show a true and fair view.
7. *To ensure equitable distribution of surplus* – The auditor ensures surplus profits are distributed as per statutory provisions.

Audit Procedure of Co-operative Societies

1. Preliminary Work:

- ✓ Obtain a copy of the registration certificate, by-laws, and audit order from the Registrar.
- ✓ Understand the nature of activities, membership structure, and objectives of the society.
- ✓ Study the previous audit reports to identify recurring weaknesses.
- ✓ Review the internal control system, accounting methods, and the responsibilities of management.

2. Examination of Books of Accounts

- ✓ Cash Book, Ledger, Journal.
- ✓ Members' Register, Share Register, and Loan Register.
- ✓ Receipts and Payments Book.
- ✓ Register of Fixed Assets and Investments.
- ✓ Stock Register (for societies engaged in trading or production).

He must ensure that the books are balanced and reconciled regularly, and that supporting documents like vouchers, receipts, and invoices are attached for every transaction.

3. Vouching of Transactions

- ✓ Receipts: Entrance fees, share capital, deposits, grants, and loan receipts should be verified with supporting records and acknowledgments.
- ✓ Payments: Payments towards purchase, salaries, interest, and expenses must be supported by proper authorization and vouchers.
- ✓ Ensure that payments are made only for society's objectives and within limits sanctioned by the management committee.

4. Verification of Loans

- ✓ Verify loan applications, sanction registers, and repayment schedules.
- ✓ Check whether loans are granted to members only, as per by-laws.
- ✓ Ensure proper security is obtained for each loan.
- ✓ Examine overdue loans and verify that provisions for doubtful debts are made.
- ✓ Verify interest calculations and confirm whether penal interest is applied for delays.

Example: If a society has advanced ₹10,00,000 in loans to 50 members, the auditor should verify repayment records. If ₹1,50,000 remains overdue beyond six months, he should check whether provision for bad debts is made for the overdue portion as per by-laws.

5. Verification of Investments

- ✓ Check that investments are made as per statutory provisions (for example, in government securities, co-operative banks, etc.).
- ✓ Verify investment certificates and interest receipts.
- ✓ Ensure income from investments is properly accounted for.

6. Verification of Members' Accounts

The auditor should:

- ✓ Check entries in members' share accounts, deposits, and loan accounts.
- ✓ Verify that all transactions relate only to registered members.
- ✓ Ensure dividends and bonuses are properly calculated and credited.

7. Verification of Cash and Bank Balances

- ✓ Physically verify cash in hand and reconcile with the Cash Book.
- ✓ Obtain bank confirmations and reconcile bank statements.
- ✓ Ensure that all receipts are deposited promptly and payments are authorized.

8. Verification of Assets and Liabilities

- ✓ Check existence and ownership of assets like land, buildings, furniture, and machinery.
- ✓ Ensure depreciation is charged as per accounting standards.
- ✓ Verify creditors, deposits, and outstanding liabilities through confirmation and supporting records.

9. Examination of Statutory Compliance

- ✓ Verify whether the society has complied with provisions of the Co-operative Societies Act, Rules, and by-laws.
- ✓ Check whether returns, statements, and audit reports are submitted to the Registrar within prescribed time limits.
- ✓ Ensure compliance with income tax, GST, and other applicable laws.

10. Examination of Surplus and Distribution of Profits

- ✓ Verify calculation of net surplus and its appropriation.
- ✓ Ensure that statutory reserves such as Reserve Fund, Education Fund, and Dividend Equalization Fund are created as required by law.
- ✓ Check that dividend is declared only after necessary reserves and provisions are made.

11. Examination of Internal Control and Internal Audit

- ✓ Evaluate the system of internal checks and delegation of authority.
- ✓ Review internal audit reports (if any) and ensure corrective actions are taken.
- ✓ Ensure segregation of duties among employees to prevent misuse of funds.

12. Preparation of Audit Report:

After completing the audit, the auditor must prepare a detailed report addressed to the Registrar or the society's management. The report should include:

- ✓ Whether accounts give a true and fair view.
- ✓ Observations on internal control and accounting deficiencies.
- ✓ Cases of fraud, irregularities, or non-compliance.
- ✓ Suggestions for improvement in accounting and management practices.

AUDIT PROCEDURE OF HOTELS, HOSPITALS AND CLUBS

Audit Procedure of Hotels, Hospitals, and Clubs (As per ICAI Study Material)

Auditing of service-oriented organizations like hotels, hospitals, and clubs requires a special approach because their operations differ significantly from manufacturing or trading entities. These institutions deal largely in services, have unique revenue and expense patterns, and often maintain specialized records. Hence, the auditor must have a clear understanding of the nature of the organization, its internal control system, and accounting practices before commencing the audit. Below is a detailed essay-type explanation of the audit procedure for each type of entity — hotels, hospitals, and clubs

1. Audit of Hotels: Hotels primarily earn income from accommodation, food and beverages, and other services like banquets, laundry, and recreational activities. The auditor must verify that all receipts and expenditures are properly recorded and internal control over cash and stock is adequate.

Objectives of Hotel Audit

1. To verify that all revenue from rooms, restaurants, and services is recorded.
2. To ensure proper accounting of stock (food, beverages, linen, etc.).
3. To confirm that internal control procedures over billing and cash collection are effective.
4. To verify expenses and ensure they are properly authorized.
5. To ensure assets like furniture, kitchen equipment, and rooms are properly maintained and depreciated.

Audit Procedure

- **Room Sales** – Verify guest registration cards, occupancy reports, and room tariffs. Match bills with cash/credit receipts. Ensure all occupied rooms are billed.
- **Restaurant and Bar Sales** – Check KOT (Kitchen Order Tickets), daily sales summaries, and cash registers. Ensure no suppression of sales.
- **Cash Receipts** – Verify daily cash summaries, reconciliation with bank deposits, and control over tips and service charges.
- **Purchases and Stock** – Check purchase bills for provisions, beverages, and consumables. Verify physical stock records and ensure periodic stock-taking.

- **Fixed Assets** – Verify rooms, furniture, air-conditioning units, and kitchen equipment with the fixed asset register. Check depreciation as per accounting standards.
- **Wages and Salaries** – Verify payroll, overtime, and gratuity provisions.
- **Internal Control** – Ensure segregation between billing, cash, and stores departments to prevent fraud.
- **Outstanding Liabilities** – Confirm creditors for supplies and verify outstanding wages or utilities.
- **Management Accounts** – Compare occupancy ratio, average room rent, and cost percentages with industry norms.

2. Audit of Hospitals: Hospitals are service institutions providing healthcare facilities to patients. They generate income through consultation fees, room charges, laboratory tests, surgeries, and donations. Their audit requires careful examination of patient records, fee receipts, donations, and expenditures on medicines and staff.

Objectives of Hospital Audit

1. To ensure that all fees and receipts from patients are properly accounted for.
2. To check that grants and donations are utilized for intended purposes.
3. To verify that expenditure on medicines, equipment, and salaries is properly authorized and recorded.
4. To examine internal control over drugs, cash, and equipment.
5. To ensure compliance with statutory requirements such as income tax, employee benefits, and medical regulations.

Audit Procedure

- **Receipts from Patients** – Verify patient registration records, OPD/IPD (Out-Patient and In-Patient) records, operation theatre logs, and fee receipts. Ensure all collections are deposited in bank.
- **Doctors' Fees** – Check agreements with consultants and ensure correct sharing of income between hospital and doctors.
- **Pharmacy Sales** – Verify sale of medicines, stock control, and purchase invoices. Ensure expired drugs are written off.
- **Donations and Grants** – Verify receipts with donor correspondence, and ensure donations for specific purposes (e.g., building fund, poor patient fund) are properly used.
- **Expenditure** – Check vouchers for purchase of equipment, consumables, and medicines. Verify payroll, overtime, and statutory deductions.
- **Fixed Assets** – Verify medical equipment, ambulances, and furniture with asset register. Ensure maintenance and depreciation are properly accounted for.
- **Internal Control** – Review controls over cash receipts, medicines, and patient billing. Ensure one person cannot handle both billing and cash collection.
- **Statutory Compliance** – Check compliance with labour laws, professional tax, and health regulations.
- **Financial Statements** – Verify treatment of charitable income, free treatments, and capital grants.

Example: If a hospital receives ₹10 lakh as a donation for purchasing dialysis machines, the auditor must ensure that the amount is used only for that purpose and properly disclosed under “Restricted Funds”.

3. Audit of Clubs: Clubs are non-profit organizations formed for recreational, cultural, or social purposes. Their income comes from membership subscriptions, entrance fees, bar sales, sports activities, and donations. The audit focuses on ensuring accuracy of receipts, control over bar and catering operations, and proper utilization of funds.

Objectives of Club Audit

1. To verify correctness of income from subscriptions, fees, and bar sales.
2. To ensure proper control over cash, stores, and stock (especially liquor and food).
3. To verify membership records and compliance with club by-laws.
4. To examine utilization of surplus funds and ensure they are used for members' benefit.
5. To check compliance with tax and excise laws.

Audit Procedure

- **Membership Register** – Verify admission of new members, entrance fees, and subscription renewals. Ensure accounts are updated and arrears are followed up.

- **Subscription Income** – Match receipts with membership records. Check whether outstanding subscriptions are properly accounted for.
- **Bar and Restaurant Sales** – Verify stock records of liquor and consumables. Check KOTs and reconcile with cash collections.
- **Events and Tournaments** – Verify income from events, sponsorships, and donations with supporting documents.
- **Fixed Assets** – Check existence and maintenance of club facilities like gym equipment, sports gear, and furniture. Verify depreciation and repair expenses.
- **Salaries and Wages** – Verify payroll for administrative, kitchen, and service staff.
- **Internal Control** – Ensure segregation between store, billing, and collection departments. Review control over bar stock and cash receipts.
- **Statutory Compliance** – Ensure compliance with excise, entertainment tax, and other applicable laws.
- **Final Accounts** – Verify that surplus, if any, is transferred to general fund and not distributed as profit.

Example: If a club earns ₹5 lakh from a fundraising event, the auditor must check whether the entire amount is recorded, related expenses are deducted properly, and net proceeds are utilized for club development or charity, not for personal benefit of members.

AUDIT PROCEDURE OF BANKS.

Meaning and Importance of Bank Audit

A bank audit refers to the independent examination of the books of accounts, records, and transactions of a bank to verify their accuracy, completeness, and compliance with applicable laws and accounting standards.

It is highly important because banks handle deposits from the public and lend funds, making them vulnerable to errors, misstatements, and fraud. The audit helps in maintaining public confidence, ensuring transparency, compliance, and financial discipline.

Objectives of Bank Audit

1. Verification of accuracy and reliability of accounts – to ensure that books are correctly maintained.
2. Detection and prevention of frauds and errors – by evaluating controls and transaction flow.
3. Compliance with statutory and regulatory requirements – especially with RBI norms.
4. Evaluation of internal control systems – to ensure efficiency and minimize operational risks.
5. Assessment of provisions and reserves – to ensure adequate provisioning for doubtful assets.
6. Ensuring true and fair presentation – of financial position and performance in financial statements.

Types of Bank Audit

1. **Statutory Audit** – Mandatory under the Banking Regulation Act; conducted by qualified auditors appointed as per law.
2. **Concurrent Audit** – Continuous audit of transactions on a regular basis to detect errors immediately.
3. **Internal Audit** – Conducted by internal staff or appointed firms to check compliance and efficiency.
4. **Revenue Audit** – Ensures accuracy of income and expenditure; checks that no income leakage occurs.
5. **Stock Audit** – Conducted for borrowers who have taken loans against stock or inventory.
6. **Information System Audit** – Examines the reliability, security, and integrity of computerized banking systems.

Audit Procedure of Banks: The audit procedure consists of several systematic steps that an auditor follows to ensure thorough examination and verification.

1. Preliminary Work
 - ✓ Study the Memorandum and Articles of Association, previous audit reports, and RBI circulars.
 - ✓ Understand the accounting system, internal control structure, and key operations.

- ✓ Obtain a trial balance, list of accounts, and details of major assets and liabilities.
- ✓ Identify key risk areas such as advances, investments, and contingent liabilities.

2. Verification of Cash and Bank Balances

- ✓ Physically verify cash in hand, including cash in ATMs and transit.
- ✓ Confirm balances with RBI and other banks through confirmation letters.
- ✓ Ensure there are no fictitious entries or cash shortages.
- ✓ Check cash reconciliation statements and investigate any discrepancies.

3. Verification of Investments

- ✓ Check that all investments are authorized, recorded, and valued as per RBI guidelines.
- ✓ Verify the existence of securities and ensure they are held in safe custody.
- ✓ Confirm interest or dividend income has been properly accounted.
- ✓ Check that provisions for depreciation on investment have been made properly.

4. Verification of Loans and Advances

- ✓ Examine loan applications, sanction letters, and security documents.
- ✓ Verify that advances are properly sanctioned and recorded.
- ✓ Check classification of advances – Standard, Sub-standard, Doubtful, or Loss assets.
- ✓ Ensure provisions for non-performing assets (NPAs) are made as per RBI norms.
- ✓ Verify interest calculation and income recognition.

5. Verification of Fixed Assets

- ✓ Verify ownership and existence of assets such as land, buildings, and machinery.
- ✓ Check purchase invoices, title deeds, and asset registers.
- ✓ Confirm depreciation is calculated as per applicable accounting standards.
- ✓ Ensure proper disclosure if any asset is pledged or hypothecated.

6. Verification of Liabilities

- ✓ Check customer deposits under savings, current, and fixed deposit accounts.
- ✓ Verify interest payable on deposits and its accuracy.
- ✓ Confirm borrowings from RBI and other banks with supporting documents.
- ✓ Ensure proper classification and recording of liabilities.

7. Verification of Income and Expenditure

- ✓ Check that all interest, commission, and service charges are recorded correctly.
- ✓ Ensure accrued income and expenses are properly adjusted.
- ✓ Examine vouchers for expenditure to ensure authenticity and authorization.
- ✓ Look for any prior period or extraordinary items requiring disclosure.

8. Verification of Contingent Liabilities

- ✓ Examine guarantees, letters of credit, and acceptances issued on behalf of customers.
- ✓ Ensure proper disclosure of contingent liabilities in financial statements.
- ✓ Verify whether adequate provisions have been made for potential losses.

9. Evaluation of Internal Control System

- ✓ Review segregation of duties, authorization procedures, and supervisory controls.
- ✓ Assess efficiency of audit trails in computerized environments.
- ✓ Identify weaknesses and suggest improvements for control systems.

10. Compliance with RBI and Legal Norms

- ✓ Ensure compliance with RBI prudential norms regarding income recognition, asset classification, and provisioning.

- ✓ Verify adherence to Capital Adequacy Ratio (CAR), Cash Reserve Ratio (CRR), and Statutory Liquidity Ratio (SLR).
- ✓ Confirm compliance with KYC norms, Anti-Money Laundering (AML) laws, and other regulatory guidelines.

11. Reporting

- ✓ Prepare a detailed audit report as per Banking Regulation Act and ICAI guidelines.
- ✓ Report on the true and fair view of financial statements.
- ✓ Highlight any non-compliance, frauds, or control weaknesses.
- ✓ Provide recommendations for corrective action.

Common Errors and Frauds in Banks

- Overstatement or understatement of income or expenses.
- Misclassification of loans or NPAs.
- Forged documents or unauthorized transactions.
- Non-compliance with RBI guidelines.

The auditor should exercise professional scepticism and perform substantive checks to identify irregularities.

Module5:
Audit Report & Professional Ethics

Audit Report:

An **audit report** is the final and most important stage of the audit process. It is a **written statement issued by the auditor** after examining the books of accounts, financial statements, and relevant records of an organization. The report expresses the auditor's **professional and independent opinion** regarding the **truth and fairness** of the financial statements.

According to the **Institute of Chartered Accountants of India (ICAI)**, an audit report is a formal medium through which the auditor communicates the results of the audit to the stakeholders such as shareholders, management, and regulatory authorities.

INTRODUCTION-MEANING AND ELEMENTS OF AUDIT REPORT

❖ Introduction – Meaning and Elements of Audit Report

An audit report is the final and most important output of the auditing process. After completing the examination of books of accounts, vouchers, and relevant documents, the auditor expresses his professional opinion on the financial statements through an audit report. It serves as a formal communication between the auditor and the shareholders or stakeholders of an organization. According to the **Institute of Chartered Accountants of India (ICAI)**, an audit report is a written document that contains the auditor's opinion on whether the financial statements give a **true and fair view** of the company's financial position and performance in accordance with applicable accounting standards and statutory requirements.

The audit report provides credibility to the financial statements and enhances the confidence of investors, creditors, and other users of financial information. It reflects the auditor's **independence, objectivity, and professional judgment** and ensures transparency and accountability in financial reporting.

❖ Meaning of Audit Report:

An audit report is a statement issued by an auditor after examining the books of accounts and related records of an organization. It expresses the auditor's opinion on whether the financial statements are free from material misstatement and prepared according to the applicable framework such as the **Companies Act, 2013** and **Accounting Standards** prescribed by ICAI.

In simple terms, it is the **formal conclusion of the auditor's work** and acts as a certificate of reliability for the company's financial information.

❖ Elements of an Audit Report: According to SA 700 (Revised) – Forming an Opinion and Reporting on Financial Statements, an audit report must contain the following key elements:

1. **Title:** The report should have a suitable title such as "*Independent Auditor's Report*". This indicates that the report is prepared by an independent and qualified auditor and helps distinguish it from reports issued by management or others.
2. **Addressee:** The report is usually addressed to the appointing authority, such as the shareholders or the Board of Directors, depending on the nature of the audit engagement.
3. **Auditor's Opinion:** This is the most critical part of the audit report. The auditor clearly states whether the financial statements present a **true and fair view** of the company's financial position and performance. The opinion may be **unmodified (clean)** or **modified (qualified, adverse, or disclaimer)** based on the auditor's findings.
4. **Basis for Opinion:** This section explains the reasons and evidence on which the auditor's opinion is based. It mentions the auditing standards followed, the scope of the audit, and the auditor's independence and ethical compliance.
5. **Management's Responsibility for Financial Statements:** The report specifies that the **management is responsible** for preparing and presenting the financial statements in accordance with the applicable framework and for maintaining internal controls.
6. **Auditor's Responsibility:** This part describes the **auditor's duty** to express an opinion on the financial statements based on the audit. It also includes a statement that the audit was conducted in

accordance with **Standards on Auditing (SAs)** issued by ICAI and explains the scope of the auditor's work.

7. **Other Reporting Responsibilities:** If there are additional reporting requirements under any statute (e.g., Companies Act, 2013), they are included under this section.
8. **Signature of Auditor:** The auditor signs the report, mentioning the **name of the audit firm, membership number, and firm registration number (FRN)** to authenticate the document.
9. **Date of the Report:** The date indicates when the auditor has obtained sufficient appropriate audit evidence to form an opinion. It is crucial for determining the responsibility of the auditor.
10. **Place of Signature:** The city or town where the audit report is signed is also mentioned for official identification and record.

TYPES OF AUDIT REPORT

The **audit report** is the final outcome of the auditor's examination of financial statements. It communicates the auditor's opinion on whether the accounts present a **true and fair view** of the company's financial position and performance. According to the **Institute of Chartered Accountants of India (ICAI)** and **Standards on Auditing (SA 700, SA 705, and SA 706)**, audit reports are classified based on the nature of the auditor's opinion and the extent of qualification or modification required.

1. Unmodified (Clean) Audit Report: An unmodified or clean audit report is issued when the auditor concludes that the financial statements give a true and fair view in all material respects and are prepared in accordance with the applicable financial reporting framework.

This type of report indicates that the auditor did not find any material misstatements or irregularities in the financial statements. It shows that the company's accounting records and statements comply with accounting standards, statutory requirements, and auditing standards.

Features:

- ✓ Financial statements are free from material misstatement.
- ✓ Proper accounting principles and statutory requirements are followed.
- ✓ Adequate disclosures have been made in the notes to accounts.
- ✓ The auditor has obtained sufficient and appropriate audit evidence.

Example of Opinion: "In our opinion, the financial statements give a true and fair view of the state of affairs of the company as at 31st March, 20XX, and of its profit/loss and cash flows for the year then ended."

2. Modified Audit Reports: When the auditor finds material misstatements or is unable to obtain sufficient audit evidence, the auditor issues a modified audit report under SA 705 (Revised) – *Modifications to the Opinion in the Independent Auditor's Report*.

Modified audit reports are of three main types:

(a) Qualified Audit Report: A qualified audit report is issued when the auditor concludes that, except for certain specific matters, the financial statements present a true and fair view.

This type of report indicates that there is a material misstatement or limitation in the audit scope, but it is not pervasive (i.e., it does not affect the entire financial statements). The auditor qualifies his opinion only to the extent of the issue.

Common reasons:

- ✓ Non-compliance with accounting standards in specific areas.
- ✓ Non-provision for doubtful debts or depreciation.
- ✓ Inadequate disclosure of contingent liabilities.

Example of Opinion: "Except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view..."

(b) Adverse Audit Report: An adverse audit report is issued when the auditor concludes that the financial statements do not present a true and fair view of the financial position and results of the company.

This type of report is given when the misstatements identified are **material and pervasive**, meaning they affect the overall reliability and usefulness of the financial statements.

Common reasons:

- ✓ Gross misstatement or manipulation of accounts.
- ✓ Non-compliance with statutory requirements or accounting standards.
- ✓ Deliberate falsification or omission of important financial data.

Example of Opinion: “In our opinion, because of the significance of the matter described in the Basis for Adverse Opinion paragraph, the financial statements do not give a true and fair view...”

(c) Disclaimer of Opinion

A **disclaimer of opinion** is issued when the auditor is **unable to obtain sufficient and appropriate audit evidence** to form an opinion on the financial statements.

In this case, the auditor refrains from expressing any opinion because of significant limitations on the scope of audit or lack of cooperation from management. The auditor states that he does not express an opinion due to insufficient evidence.

Common reasons:

- ✓ Non-availability of books or records.
- ✓ Denial of access to information or documents.
- ✓ Serious uncertainties like pending litigation or going concern issues.

Example of Opinion: “Because of the significance of the matter described in the Basis for Disclaimer of Opinion paragraph, we do not express an opinion on the financial statements.”

3. Emphasis of Matter and Other Matter Paragraphs (SA 706)

In addition to the above types of opinions, **SA 706** allows auditors to include additional paragraphs in their reports to draw users' attention to certain important issues **without modifying the opinion**.

- (a) **Emphasis of Matter Paragraph:** Used when the auditor wants to highlight a matter that is **appropriately disclosed** in the financial statements but is of such importance that it is fundamental to users' understanding (e.g., pending litigation, natural disaster loss, significant subsequent event).
- (b) **Other Matter Paragraph:** Used to highlight a matter **not presented or disclosed** in the financial statements but relevant to users' understanding of the audit, auditor's responsibilities, or the auditor's report (e.g., reporting on prior period financial statements audited by another auditor).

Summary Table:

Type of Audit Report	When Issued	Nature of Opinion
Unmodified (Clean)	Financial statements are true and fair	Positive
Qualified	Material but not pervasive misstatements	Conditional
Adverse	Material and pervasive misstatements	Negative
Disclaimer	Insufficient audit evidence	No opinion
Emphasis of Matter / Other Matter	Important disclosures or facts to highlight	Not a modification

INDEPENDENT AUDITOR'S REPORT AND THE ILLUSTRATION

The **Independent Auditor's Report** is one of the most significant deliverables of the auditing process. It is the **formal statement** issued by the auditor at the end of the audit, expressing his **independent opinion** on whether the financial statements of a company give a **true and fair view** of its financial position, performance, and cash flows.

According to the **Institute of Chartered Accountants of India (ICAI)**, the structure and content of the auditor's report are governed by three Important **Standards on Auditing**:

- **SA 700 – Forming an Opinion and Reporting on Financial Statements**
- **SA 705 – Modifications to the Opinion in the Independent Auditor's Report**
- **SA 706 – Emphasis of Matter and Other Matter Paragraphs in the Independent Auditor's Report**

In addition, the **Companies Act, 2013** (particularly Section 143) prescribes the **statutory requirements** for an auditor's report. The report must be clear, complete, unbiased, and in accordance with these legal and professional guidelines.

Meaning of Independent Auditor's Report

The Independent Auditor's Report represents the auditor's conclusion after performing the audit. It is based on audit evidence obtained through procedures and techniques as per auditing standards. The report provides assurance to stakeholders that the financial statements are prepared in accordance with the applicable financial reporting framework such as Indian Accounting Standards (Ind AS) or Accounting Standards (AS).

The term "independent" highlights that the auditor's opinion is objective and free from influence. The auditor must not be affected by management, directors, or any external parties. Independence ensures credibility and trustworthiness of the auditor's findings.

Objectives of the Independent Auditor's Report

- To communicate the auditor's opinion:** on whether the financial statements give a true and fair view.
- To enhance the credibility:** of financial statements among stakeholders such as shareholders, lenders, and regulatory bodies.
- To improve transparency and accountability:** in corporate financial reporting.
- To disclose material misstatements or qualifications:** if any, and to explain the auditor's reasoning.
- To comply with statutory and professional requirements:** ensuring that the audit adheres to legal and ethical standards.

Main Elements of the Independent Auditor's Report (As per SA 700)

1. Title: The report must have an appropriate title such as "Independent Auditor's Report." This title emphasizes the independent status of the auditor and differentiates the report from those issued by internal auditors or other officials. It assures readers that the opinion expressed is free from any internal bias.

2. Addressee: The report should be addressed to the person or authority for whom it is intended. In case of company audits, as per Section 143(2) of the Companies Act, 2013, the report is usually addressed "To the Members of the Company." This ensures that the report reaches the rightful users—usually shareholders—who rely on the auditor's opinion for decision-making.

3. Opinion Paragraph: The opinion paragraph is the core of the audit report.

Here, the auditor clearly states whether the financial statements give a true and fair view of the company's financial position, performance, and cash flows in accordance with applicable accounting principles.

Example: "In our opinion and to the best of our information and according to the explanations given to us, the financial statements give a true and fair view in conformity with the accounting principles generally accepted in India..."

This paragraph is crucial because it summarizes the entire audit process into a single professional conclusion.

4. Basis for Opinion: This section provides the rationale behind the auditor's opinion.

It confirms that the audit was conducted in accordance with the Standards on Auditing (SAs) issued by ICAI, that the auditor maintained independence and ethical compliance, and that the audit evidence obtained was sufficient and appropriate to form the opinion.

This paragraph enhances the credibility of the opinion expressed.

5. Key Audit Matters (KAMs): As per SA 701, listed company audits must include a section on Key Audit Matters (KAMs).

These are matters that, in the auditor's professional judgment, were of most significance during the audit. The inclusion of KAMs helps users understand the areas of higher audit risk, complex estimates, or significant management judgments.

Example: "Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements."

6. Information Other than the Financial Statements: According to SA 720, the auditor must report on “other information” such as the Board’s Report or Management Discussion and Analysis. The auditor’s responsibility is to determine whether this information is materially consistent with the audited financial statements. If inconsistencies are found, they must be disclosed in this section.

7. Responsibilities of Management and Those Charged with Governance

This section explains that the **management** of the company is responsible for:

- ✓ The preparation and fair presentation of financial statements in accordance with applicable accounting standards and laws.
- ✓ The maintenance of proper books of account and internal controls.
- ✓ The prevention and detection of frauds and errors.

The Board of Directors or those charged with governance are responsible for the oversight of the financial reporting process and for ensuring the integrity of the financial statements.

8. Auditor’s Responsibilities for the Audit of Financial Statements

This paragraph outlines the auditor’s own professional duties, which include:

- ✓ Obtaining reasonable assurance that the financial statements are free from material misstatement.
- ✓ Assessing accounting policies estimates and disclosures made by management.
- ✓ Evaluating the overall presentation of the financial statements.
- ✓ Testing internal controls and considering their effectiveness.
- ✓ Communicating with those charged with governance regarding audit findings, independence, and scope of work.

9. Report on Other Legal and Regulatory Requirements: Under Section 143(3) of the Companies Act, 2013, the auditor must include specific statements in the report, such as:

- ✓ Whether **proper books of account** have been maintained.
- ✓ Whether the **financial statements are in agreement** with the books.
- ✓ Whether **accounting standards have been followed**.
- ✓ Whether any **director is disqualified** under Section 164(2).
- ✓ Whether the **internal financial controls** are adequate and effective.

This section ensures that the auditor also complies with the **statutory audit requirements** beyond the opinion itself.

10. Signature, Date, and Place: Finally, the report must include the auditor’s signature, the name of the audit firm, membership number, firm registration number, and the place and date of signing.

These details authenticate the report and help establish professional responsibility.

Example: “Place: Mumbai

Date: 30th May, 20XX

For ABC & Co., Chartered Accountants

Firm Reg. No. 000123N

(Signature)

CA Ramesh Gupta, Partner

Membership No. 123456”

INDEPENDENT AUDITOR’S REPORT

Illustration: Independent Auditor’s Report (ICAI Format)

To the Members of XYZ Limited

Report on the Audit of the Financial Statements

We have audited the accompanying financial statements of XYZ Limited (“the Company”), which comprise the Balance Sheet as at 31st March, 20XX, the Statement of Profit and Loss, Cash Flow Statement, and a summary of significant accounting policies and other explanatory information.

Opinion: In our opinion and to the best of our information and according to the explanations given to us, the aforesaid financial statements give the information required by the Companies Act, 2013, in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India of the state of affairs of the Company as at 31st March, 20XX, its profit and cash flows for the year then ended.

Basis for Opinion: We conducted our audit in accordance with the Standards on Auditing (SAs) specified under Section 143(10) of the Companies Act, 2013. We are independent of the Company in accordance with the Code of Ethics issued by the ICAI and have fulfilled our ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Key Audit Matters [Include significant audit matters, such as valuation of inventory, recognition of revenue, or impairment of assets, as applicable.]

Responsibilities of Management and Those Charged with Governance for the Financial Statements

The Company's Board of Directors is responsible for the preparation and fair presentation of these financial statements in accordance with the Companies Act, 2013, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibilities for the Audit of the Financial Statement: Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion.

Report on Other Legal and Regulatory Requirements

As required by Section 143(3) of the Companies Act, 2013, we report that:

- (a) We have obtained all the information and explanations necessary for our audit.
- (b) Proper books of account have been kept by the company.
- (c) The Balance Sheet and Statement of Profit and Loss are in agreement with the books of account.
- (d) The financial statements comply with the Accounting Standards specified under Section 133.
- (e) On the basis of written representations received, none of the directors is disqualified under Section 164(2).
- (f) The internal financial controls system is adequate and operating effectively.

Place: Mumbai

Date: 30th May, 20XX

For ABC & Co., Chartered Accountants

(Firm Reg. No. 01234N)

CA Ramesh Kumar, Partner

(Membership No. 123456)

PROFESSIONAL ETHICS: CODE OF ETHICS-PROFESSIONAL ACCOUNTANTS IN PUBLIC PRACTICES AND BUSINESS

The Code of Ethics issued by the Institute of Chartered Accountants of India (ICAI) lays down the principles, values, and professional conduct expected from Chartered Accountants (CAs).

It ensures that members uphold integrity, objectivity, professional competence, confidentiality, and professional behavior in all their dealings.

The Code applies to two categories:

1. **Professional Accountants in Public Practice (PAPPs)** – those offering services like auditing, taxation, consultancy, etc.
2. **Professional Accountants in Business (PAIBs)** – those employed in business, industry, government, or education sectors.

This Code helps maintain **public trust** in the accounting profession by ensuring ethical conduct, independence, and transparency in all professional work.

1. Fundamental Principles of Ethics: The Code identifies **five fundamental principles** that all professional accountants must follow, whether in practice or business:

(a) Integrity: This principle requires accountants to be **honest and straightforward** in all professional and business relationships.

A CA must not associate with information that is false, misleading, or omits necessary facts.

For example, a CA should not manipulate financial data to present a better picture of the company.

(b) Objectivity: Objectivity means not allowing **bias, conflict of interest, or undue influence** from others to override professional judgments.

An auditor should remain impartial, even if management pressures him to modify the audit opinion.

(c) Professional Competence and Due Care: A professional accountant must maintain **knowledge and skill** at the required level to ensure competent service.

They should act diligently, follow applicable standards, and remain updated with changes in law and accounting practices.

(d) Confidentiality: A CA must respect the **confidentiality** of information acquired during professional work and should not disclose it without proper authority or legal obligation.

For example, revealing client financial data to competitors or media is a breach of this principle.

(e) Professional Behavior: This principle requires accountants to **comply with laws and regulations** and avoid any conduct that discredits the profession.

For instance, advertising or soliciting clients in a misleading manner is considered unethical.

2. Threats to Compliance with Fundamental Principles

ICAI identifies five types of threats that may compromise compliance with the ethical principles:

- Self-Interest Threat:** When a financial or other interest influences professional judgment (e.g., auditor having shares in the client's company).
- Self-Review Threat:** When an accountant reviews his own previous work (e.g., auditing accounts prepared by his own firm).
- Advocacy Threat:** When the accountant promotes a client's position to the point that objectivity is compromised (e.g., representing a client in legal disputes).
- Familiarity Threat:** When close relationships with clients or personnel lead to undue sympathy (e.g., auditing a relative's company).
- Intimidation Threat:** When the accountant faces pressure or threats that deter objective judgment (e.g., threat of losing engagement).

3. Safeguards to Eliminate or Reduce Threats: To maintain independence and integrity, accountants must apply safeguards.

These safeguards are divided into two categories:

(a) Safeguards Created by the Profession or Regulation

- ✓ Mandatory continuing professional education (CPE).
- ✓ Monitoring and disciplinary procedures by ICAI.
- ✓ Corporate governance requirements.

(b) Safeguards in the Work Environment

- ✓ Rotation of engagement partners.
- ✓ Independent reviews of work.
- ✓ Policies for avoiding conflicts of interest.
- ✓ Internal quality control systems.

4. Code of Ethics for Professional Accountants in Public Practice

A **Professional Accountant in Public Practice (PAPP)** provides services to clients such as audit, taxation, or advisory work.

The Code prescribes specific guidelines for them:

(a) Independence: Auditors must be independent both in mind and appearance.

They should not have any financial or personal relationship with clients that may impair independence.

For example, accepting gifts or loans from a client violates independence.

(b) Fees and Remuneration: Fees should be fair and not contingent upon results.

Charging fees based on audit outcomes or profit levels can impair objectivity.

(c) Advertising and Solicitation: Members should not advertise in a way that is false, misleading, or self-laudatory. They should avoid claiming superiority over other members.

(d) Conflict of Interest: A CA must not represent clients with **opposing interests** without consent. For instance, representing two competitors in tax litigation is unethical.

(e) Professional Appointments: Before accepting an audit, a CA should **communicate with the previous auditor** to ensure there are no professional reasons for refusal.

This promotes transparency and respect among professionals.

(f) Custody of Client's Assets: A CA must safeguard clients' money or property and use them only for the intended purpose.

(g) Second Opinion: A member asked to provide a second opinion must obtain all facts and ensure the opinion is objective and supported by evidence.

(h) Gifts and Hospitality: Accepting gifts or hospitality from clients that may influence judgment is unethical. Minor, customary gifts may be acceptable if they don't affect objectivity.

5. Code of Ethics for Professional Accountants in Business

A **Professional Accountant in Business (PAIB)** refers to CAs employed in companies, government, or other organizations. Their ethical responsibilities are equally important since they influence business decisions and financial reporting.

(a) Preparation and Presentation of Information: Accountants should ensure that all information is fair, accurate, and complete. They must not misstate or omit material facts.

(b) Acting with Integrity: Accountants must reject involvement in **fraudulent financial reporting** or misleading practices.

(c) Pressure to Breach Ethics: If management pressures an accountant to manipulate results, the accountant must resist and, if necessary, report the matter to higher authorities or resign.

(d) Financial Interests: CAs must avoid situations where personal investments conflict with their official duties.

(e) Encouraging Ethical Culture: Senior accountants have a duty to promote ethical awareness and a culture of integrity within the organization.

6. Part C – Independence Standards (for Auditors): ICAI's Code includes specific provisions on independence requirements under Part C:

- ✓ **Financial Interests:** No direct or material indirect financial interest in the audit client.
- ✓ **Loans and Guarantees:** Prohibited between auditor and client.
- ✓ **Employment Relationships:** Partners or relatives should not be employed by the audit client in key positions.
- ✓ **Long Association:** Mandatory rotation of audit partners to maintain independence.
- ✓ **Provision of Non-Audit Services:** Restriction on providing certain services like bookkeeping or internal audit to audit clients.

7. Ethical Conflict Resolution

When ethical dilemmas arise, a CA should:

1. Identify relevant facts and stakeholders.
2. Consider fundamental principles involved.
3. Evaluate alternative courses of action.
4. Seek advice from ICAI or legal counsel if necessary.
5. Document the process and decision taken.

Example: If a finance manager is asked to overstate profits, he must consider integrity and objectivity principles and refuse unethical instructions.

8. Disciplinary Mechanism under ICAI

If a member violates the Code of Ethics:

- ✓ **Disciplinary Committee of ICAI** may initiate action.
- ✓ Punishments include **reprimand, fine, removal of membership, or cancellation of certificate of practice.** This ensures accountability and professional discipline.

FUNDAMENTAL PRINCIPLES OF PROFESSIONAL ETHICS.

Professional ethics form the cornerstone of the accountancy profession. They provide a framework for ethical conduct and professional responsibility that guides all Chartered Accountants (CAs) in both public practice and business. According to the ICAI Code of Ethics, every professional accountant must adhere to the following five fundamental principles to uphold the integrity, objectivity, and reputation of the profession.

1. Integrity: Integrity means being straightforward and honest in all professional and business relationships. It implies fair dealing and truthfulness in the discharge of professional duties.

- **Honesty in Actions and Statements:** A Chartered Accountant must not make misleading statements or falsify facts.
- **Fair Representation:** The professional must present information in an unbiased manner, avoiding manipulation or distortion of facts.
- **Trust and Transparency:** Integrity builds trust with clients, employers, and the public, ensuring confidence in financial reporting and auditing.

Example: When a CA discovers an error in financial statements, they must report and correct it rather than conceal it to favor a client.

2. Objectivity: Objectivity requires that a professional accountant should not allow bias, conflict of interest, or undue influence of others to override professional judgments.

- **Avoidance of Bias:** Decisions must be based on facts, evidence, and professional knowledge, not on personal preference or relationships.
- **Conflict of Interest:** A CA must identify and avoid situations where personal or financial interests could influence professional judgment.
- **Independence of Mind:** The accountant must remain free from any external pressures that could affect their objectivity.

Example: An auditor should not accept gifts or favors from a client that may compromise independent judgment.

3. Professional Competence and Due Care: This principle requires that a professional accountant maintain professional knowledge and skill at a level required to ensure that clients or employers receive competent professional service.

- **Continuous Learning:** CAs must stay updated with changes in accounting standards, laws, and regulations through Continuing Professional Education (CPE).
- **Skill and Diligence:** They should apply sound technical and professional standards diligently while performing duties.
- **Due Care:** Adequate time, attention, and effort must be devoted to ensure quality work.

Example: A CA preparing a tax return must ensure accuracy and compliance with current tax laws, not rely on outdated knowledge.

4. Confidentiality: Confidentiality means respecting the information acquired during professional and business relationships and not disclosing it to third parties without proper authority.

- **Non-Disclosure of Information:** Accountants must not disclose any confidential client information unless there is a legal or professional duty to do so.
- **Use of Information:** Information gained through professional relationships should not be used for personal advantage or third-party benefit.
- **Exceptions:** Disclosure may be permitted when required by law, for example, in cases of money laundering, fraud, or regulatory investigations.

Example: A CA must not share a client's financial data with competitors or use it for personal gain.

5. Professional Behavior: Professional behavior requires accountants to comply with relevant laws and regulations and avoid any conduct that discredits the profession.

- **Compliance with Laws:** The accountant should follow all applicable laws, rules, and standards relevant to the profession.
- **Avoidance of Misconduct:** Any act that may harm the public image or reputation of the profession must be avoided.
- **Advertising and Solicitation:** CAs should not make exaggerated claims about their services or criticize other professionals.

Example: A CA must not issue misleading advertisements or engage in unfair competition for professional assignments.

❖ **Importance of Fundamental Principles**

1. **Ensure Public Confidence:** These principles enhance public trust in the accounting profession.
2. **Promote Ethical Decision-Making:** They help CAs resolve ethical dilemmas objectively.
3. **Maintain Professional Standards:** They ensure high standards of performance and accountability.
4. **Protect the Reputation of the Profession:** Ethical compliance prevents misconduct and preserves integrity.
5. **Ensure Quality of Services:** Adherence leads to reliability and excellence in professional work.