

# **T.Y.B.Com Sem-V**

## **AUDITING**

### **Chapter:2) Checking, Vouching and Audit Report**

#### Introduction

Many transactions in the business are recorded in the ledger. The most important part of the audit work is to check the authenticity of the records. The auditor has to rely on a number of documents to verify the authenticity of the transaction record. For example, invoices, receipts, purchase and sale documents etc. These documents are also called audit tools. Documents that are recorded in the books of accounts are examined in a number of ways, for which the auditors have to adopt various methods. The exact method of audit can be used according to the nature and scope of the business organization and the audit situation. In short, the basic methods of collecting and evaluating evidence are called 'audit techniques'.

#### **2.1 Test Checking**

##### 2.1.1 Meaning and Definition of Test Checking

It is not possible for an auditor to inspect all transactions in large businesses due to lack of time. A detailed examination of all transactions is neither practical nor necessary. This is because at present, management is aware about the need of keeping accurate accounts and use of internal control system. Therefore, the accountant selects some samples of same transactions and examines them to understand the authenticity of other transactions. Such an investigation is called a 'test investigation'. It depends on internal check system. Under it, only a few transaction records are checked. This investigation is based on probability theory. Although some errors or omissions are found in this investigation, other transactions are deemed to have such errors or omissions and then the other transactions are investigated. The opinion of the auditor is based on sample transactions which represent the whole population.

#### **Definition of Test Checking**

##### 1. Prof. Meigs

"Test checking means to select and examine a representative sample from a large number of similar items".

### **2.1.2 Safeguards for Application of Test Checking**

The adoption of test inspection greatly reduces the work of the auditor, but it does not reduce the responsibility of the auditor. If the audit reveals mistakes, lies and fraud in the accounts, then the auditor will be responsible.

#### 1. Random

Selection of sample should be random, it will represent whole sample to give correct opinion.

#### 2. Complete Examination

Some transactions like opening and closing entries, depreciation entries and non-recurring or exceptional transactions should be checked in depth. Here, test checks may not give correct results.

#### 3. Representative

Transactions from all the books and of all the clerks should be included in the sample.

#### 4. Extent of Test Checking

The use and extent of test checking is dependent on the system of internal check in operation for the business. More efficient the internal check system, lesser the extent of test checking.

#### 5. Size of Sample

Sample size can be determined with the help of statistical tools after determining the confidence level, precision level and tolerable error required by the auditor.

#### 6. Complete Coverage

The selection of transaction should be made in such a way that over a span of 4 to 5 years all the transactions come under the review of the auditor.

#### 7. Study the Processing

The selected transactions should be studied in detail from the beginning till the end.

#### 8. Materiality Level:

The auditor should set a materiality level to discover error.

### **2.1.3 Advantages and Disadvantages of Test Checking**

#### (1) Advantages of Test Checking

1. Saves time and labour of the auditor.
2. Understands the accuracy of transaction records.
3. Audit of many business organizations can be done in a certain period of time.
4. Testing allows the auditor to complete his audit in less time.
5. Creates frustration on the part of business employees. Because any transactions can be taken for investigation.

## **(II) Disadvantages of Test Checking**

1. Although the audit reduces the work of the auditor, it does not reduce his responsibility.
2. Testing does not reveal errors or deceptions in the balance sheet. This is because if there are no errors in the selected sample transactions, errors in other transactions will not be detected,
3. The adoption of test inspection will not allow the auditor to understand the true state of the financial affairs of the organization.

## **2.2 Voucher**

It is important to understand the concept of voucher before learning the concept of Vouching.

### **2.2.1 Meaning and Definition of Voucher**

- A voucher is a written paper or document in support of an entry in the books of accounts. It is the documentary evidence to support the various entries. Certain vouchers may be of primary nature while other of a collateral or secondary nature. A voucher is documentary evidence in support of any transaction in books of accounts. Voucher can originate within the organization or outside the organization i.e, they can be internal or external. It indicates accuracy of transaction. bill, pay-in slip, etc.

Examples of vouchers are cheque book, receipt, invoice,

### **Definition of Voucher**

"A voucher is any documentary evidence in support of transaction in the books of accounts".

### **2.2.2 Components of Voucher**

1. Supplier identification number

2. The amount payable
3. The date on which payment will be made
4. The accounts payable to record the liability
5. Any valid early payment discount terms
6. The approval signature or stamp

### **2.3) Vouching**

The act of examining documentary evidence in order to ascertain the accuracy and authenticity of entries in the accounts books is called 'vouching'.

In simple word vouching is examination of documentary evidence to ascertain the authenticity in the books of accounts. It is a technique used by an auditor to judge the truthfulness of the entries recorded in the books of accounts.

#### **Definitions of Vouching**

##### **1. Dicksee**

"Vouching consists of comparing entries in books of accounts with documentary evidence in support thereof.

##### **2)Ronald A. Irish**

"Vouching is a technical term which refers to the inspection by the auditor of documentary evidence supporting and substantiating a transaction."

##### **7)J.R.Batliboy -**

"Vouching means testing the truth of items appearing in the books of original entry.

#### **2.3.1) Objects of Vouching**

##### **1. Authentication of Transactions:-**

Verifying the genuineness of the transactions recorded is the basic object of vouching. The purpose is to certification and ensure that all transactions in the ledger are done by the person authorized to do so. Explanations about authorization related to the rights, responsibilities and liabilities of various persons in the business are given in the Constitutional Rules.

##### **2. Ensuring that the Transaction is Properly Recorded**

- Every transaction recorded in the book of accounts should be accurate, true and factual. The purpose of certification is also to ensure that the amount of the transaction is recorded correctly, the classification of the accounts is done properly and the transaction is recorded in the correct ledger at all times.

### 3. Ensuring that the Transaction is related to the Trade

- All transactions recorded in the accounts are related to the respective trades. The purpose of the certification is to ensure that personal transactions are recorded and that no business-related transactions are left unregistered in the books of accounts.

### 4) Verification

Ensuring that all records are authentic and that proper documentary evidence is available.

### 5. Accounting Entries

- Ensuring that every documented record in the accounts is available and related to the financial transaction for which audit is to be done.

### **2.3.2 Precaution to be taken while Examining the Vouchers by the Auditor**

- The part of core auditing is Certification. The success of the auditor depends on how effectively and efficiently certification is done by an auditor. The standard that is created as soon as the transaction takes place in the business is called the 'original standard' (E.g. cash voucher). The events that take place to record the transaction and the examples of such events are purchase order, agreement between the seller and the buyer, letter of delivery, acknowledgment of receipt of goods, etc. Basic standards and secondary standards in business are submitted to the auditor for certification.

- The auditor needs to consider the following while examining both of these criteria:

#### **1. Person Names should not be Authenticated-**

- The name of the person whose account is being audited should not be authenticated, but the name of the employees in the office and organization should be mentioned

#### **2) The Auditors should Check the Standards themselves and with the Help of their Colleague-**

- The auditor should never enlist the help of the organization's staff to check the standards. This work should be done by the auditor himself or assigned to one of his responsible colleagues.

#### **3. The Standard should Preferably be in Print-**

- The certificate submitted should be in the name of the concerned office and preferably in printed form. This certificate should be signed by the responsible officer concerned. If the certificate is not printed, the office should have a rubber stamp. It should also be stamped with authorized signature. Otherwise it will be considered as cancelled.

#### 4. Verification of Authenticity-

- The auditor should make sure that the certification submitted is approved by the appropriate authority. In order to ensure that the expenditure incurred is authorized, the person who has the authority must sign the standard. To check it, the auditor should verify the rules of the company, partnership agreement or company history book

#### 5. Check the Term and Date of the Standard-

- The date of certification should be in the year for which audit is conducted. The date on the standard and the date of entry in the original book should be the same. If an old transaction from a previous date was reported later, there is a possibility of a scam.

#### 6. Receipt Stamped should be-

- If the amount is more than 20, a receipt stamp of 20 should be affixed on the receipt. Only then will that receipt or standard be considered as acceptable.

#### 7. Check that Expenses are Properly Classified-

- There are many types of expenses which re-incurred in the business so proper classification/categorization of the expenses are needed.

#### 8. Certification Doubts Resolved-

- If any of the standards that are presented as documentary evidence during the audit are doubtful, the doubts should be completely resolved. The standards should be verified to be authentic and correct. Cashier Himself

#### 9. Certification by the cashier himself-

- At times in the business, the cashier has to create his own standard. Such standards should be carefully checked.

#### 10. Uncertified Entries-

- Sometimes some standards are not presented to the auditor. Ask for reasons why there are no standards and ask them to submit. If missing, find out the cause. An official copy of the certification should be requested as well as certified by the responsible officer.

#### 11. All Standards Presented Simultaneously-

- Only when the standard examination begins, the auditor call for all the standards at once and keep them with him till the end of his work. For example, when the auditor start checking the sales book, he should asked to bring all the receipts at once.

#### 12. Use of Tokens-

- The auditor should take care that not a single receipt will be re-submitted while certifying. For this, when the inspection of the standard is completed, a special symbolic mark should be made on it. Only the auditor should understand the meaning of that mark.

#### 13. The Standard should not be Removed from the Standard Book-

- There may be an error in writing the certificate from the accountant or the concerned employee or the certificate may become unusable for other reasons. In such a case, the useless standard should not be removed from the book. That standard should be in the same place as in the same book. The cancellation should be written and signed by the concerned officer.

#### 14. Examination of Standard Information, Handwriting, Numbers etc-.

- The text written in the standard should match the disclosure in the accrual book.

#### 15. Order Matching of Certificates-

- Prior to the audit, the auditor should sort out all the credentials and expenses separately and systematically according to by date, in the order of registration and give them serial numbers. So it is not a waste of time to find standards.

#### 16. Uncertified Certificates-

- If a certifier is found any certificate which is without a record, it should be noted and inquired and the certifier should be recorded if it is correct.

#### 17. Certification and Internal Inspection Methods-

- If the business has a system of internal control and the auditor has to check system of implementation. He can save time if he certifies the test by the test method. However, in accepting this approach, the auditor should not forget his responsibility.

## **2.4 Internal Check**

### 2.4.1 Meaning and Definition

Internal check is the important and integral part of the internal control system. It is an arrangement of the duties of members of staff in such a manner that the work performed by one person is automatically and independently checked by the other.

## Definitions of Internal Check

### 1. F. R. Mepaula

"Internal check means practically a continuous internal audit carried on by the staff itself, by means of which the work of each individual is independently checked by other members of the staff."

### 2.5) Vouching of Cash Book-

A Cash book is the primary book of record. It is a journal. It records all cash receipts and cash payments. It shows closing and opening cash balance on any particular day. Cash book is recorded in Double Column Cash book having Bank and Cash column. Some organization keep triple column cash book having additional discount column in it. Discount allowed is recorded to the debit side and discount received is recorded to the credit side.

An effective internal check system for cash receipts and payments should include the following:

1. Cash should be received by the cashier; however, he should not have any access to the ledger accounts.
2. Cash received should be entered in a rough cash book or diary.
3. Cash received should be acknowledged by the issue of a printed receipt and the organisation should have a counterfoil or carbon copy of such receipt.
4. Remittances received should be opened by the cashier in the presence of a responsible officer who should not be connected to the cashier's office.
5. All receipts of the day should be deposited in the bank at the end of the day or in the next morning.
6. Bank reconciliation statement should be prepared regularly.
7. All payments, as far as possible should be made by way of crossed cheques
8. While issuing a cheque, it should be presented to a responsible officer for his signature. The details of the account of the party to whom the payment is made should be presented to the officer.

### 2.3: Process of Vouching of Cash Book

<b>Debit Side of the Cash Book</b>	<b>Credit Side of the Cash Book</b>
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<p><b>Opening balance</b></p> <ul style="list-style-type: none"> <li>• <b>Cash sales</b></li> <li>• <b>Cash received from debtors (credit sales)</b></li> <li>• <b>Rent received</b></li> <li>• <b>Bills receivable</b></li> <li>• <b>Sale of investment</b></li> <li>• <b>Commission</b></li> <li>• <b>Income from hire purchase agreement</b></li> <li>• <b>Income from investment</b></li> <li>• <b>Interest on deposits and loans</b> <ul style="list-style-type: none"> <li>• <b>Insurance claim</b></li> </ul> </li> </ul> <p><b>Subscriptions Process of vouching of cash book</b></p> <ul style="list-style-type: none"> <li>• <b>Proceeds from the sale of fixed assets</b></li> </ul>	<p><b>Payment of capital expenses</b></p> <ul style="list-style-type: none"> <li>• <b>Wages</b></li> <li>• <b>Time records</b></li> <li>• <b>Piece work records</b></li> <li>• <b>Travelling allowance</b></li> <li>• <b>Bill payable</b></li> <li>• <b>Insurance premium</b></li> <li>• <b>Freight and carriage</b></li> <li>• <b>Salary</b></li> <li>• <b>Custom duties</b></li> <li>• <b>Rent payable</b></li> <li>• <b>Payment to creditors</b></li> <li>• <b>Petty cash payment</b></li> <li>• <b>Miscellaneous receipts</b></li> <li>• <b>Director's Fees</b></li> <li>• <b>Postage</b></li> </ul>
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### **(A) Debit Side of the Cash Book/ Vouching of Receipt Side**

Auditor after satisfying about the efficiency of the internal check system regarding the receipts and payments of cash, should start the work of vouching the debit side of the cash book because it is more difficult. It has been accepted by accountants and auditors that the vouching of the debit side of the cash book is more difficult than that of the credit side, since only indirect evidences are available i counterfoils of receipts issues, carbon copies of receipts, contracts and letters from the debtors confirming the balances of their accounts etc

#### **Important Items on the Debit Side of the Cash Book**

##### **1. Opening Balance**

- The opening cash balance which is recorded in cash book is the closing cash balance of the previous year. This item can be vouched by reference to the duly audited balance sheet of the previous year. This is done to verify that the actual balance has been brought forward.

## 2. Cash Sales

- Opportunities for fraud under this head are many because the salesman may sell the articles and not enter in the cash book. i.e; misappropriation of money Therefore, the auditor should examine the effectiveness of the internal check system in operation in regard to cash sales.

## 3. Cash received from Debtors (Credit Sales)

- The cash received from customers to whom goods have been sold on credit in the past can be vouched with the help of counterfoils of the receipts issued to them.

## 4. Rent Received

- The auditor should examine the lease deed and agreement to ascertain the exact amount receivable and the due date. He should also verify provisions regarding repairs and the rent received as per the cash book and should be compared 'rent rolls' on the list of properties if maintained. In case the rent is collected by agent, then it should be vouched with the accounts submitted by him. If receipt are issued to the tenants for the rent received, the counterfoils of the receipt should also be checked.

## 5. Bills Receivable

- Sometimes, the debtors accept the bill of exchange payable. It means that after the expiry of this period, the amount becomes receivable on account of this bill of exchange. The amount so received on maturity after this expiry of the period, should be checked by comparing the bills receivable book with the cash book and the bank pass book. In respect of those bills which have been discounted before maturity, the bills discounted book should be checked. It is also possible that such bills might have been paid and the amount received might have been misappropriated by the cashier.

## 6. Sale of Investment

- The sale proceeds on account of the sale of investment should be vouched with the 'Broker sold note' or 'contract note'. This note is the most important

supporting evidence and will contain all the details about the actual amount received and the commission paid to the broker. If the sale has been effected through the bank, the banker's advice should be examined to know the details.

#### 7. Commission

- The auditor should obtain the list of parties from whom commission is receivable. The amount of commission received can be vouched with the counterfoils or the carbon copies of the receipts issued to the parties from whom the commission has been received. The copy of the agreement should be examined to ascertain the rate of commission. Counterfoils of the receipt should be compared with the amount entered in the cash book. In order to find out the correct amount of the commission, the auditor should make the calculations himself.

#### 8. Income from Hire Purchase Agreement

- Sometimes, assets are sold on a hire purchase agreement basis. In such a situation, the instalments are received as per the hire purchase agreement. The auditor should inspect this agreement in order to ascertain the amount of instalment, total number of instalments, the rate of interest and other terms and conditions. He should vouch the amount of instalment received with the help of a counterfoil or the carbon copy of the receipt issued. He should also see that the whole amount of the instalment received should not be credited to the sales amount but proper allocation should be made between 'sales and interest'.

#### 9. Income from Investment

- Interest and dividends received from investment in government securities and in the shares of limited companies, can be vouched with the counterparts of interest and dividend warrants or the letter covering the cheque.

#### 10. Interest on Deposits and Loans-

Interest on bank deposits will be vouched with the entry in the bank statement (bank pass book) and advice from the bank. The rate of interest should be inspected and calculations should be checked. The auditor should also check the interest received on the fixed deposits. The interest on fixed deposits is received as per the terms and conditions in each case.

#### 11. Insurance Claim

- Generally, business houses get their fixed and current assets insured against various kinds of risks. Insurance money received as compensation should be checked or vouched by means of correspondence and with the accounts rendered by the insurance companies or the authorized insurance agents. The auditor should also inspect the copy of the insurance claims lodged with the insurance company and the counterfoil of the receipts issued to the insurance.

#### 12. Subscriptions

- The membership subscribing received by a club or society should be vouched by means of counterfoil of receipts issued to the members and with the register of subscribers.

#### 13. Proceeds from the Sale of Fixed Assets

Generally fixed assets are sold through a broker or auctioneer. The auditor should vouch this item by examining the correspondence with the party, sale contracts with the party or auctioneer's account. In case there is any profit or loss it, should be adjusted in the relevant accounts. He should see that the appropriate fixed asset account is credited with the cash received. He should also check properly the adjustments made about the prepaid expenses in respect of assets. The auditor should also see that the sale of the assets has been duly sanctioned by appropriate authorities.

#### 14. Miscellaneous Receipts

- Any other receipts i.e. bad debts recovery, share capital, income from hire-purchase agreements and royalty etc. can be vouched with correspondence

along with contracts with the parties or other relevant documents or evidence available.

## **B)Credit Side of the Cash Book/Payment Side**

The auditor should strategically examine the vouchers presented to him and see that all vouchers are numbered serially and filed in order. The following are some of the important and main items on the credit side of the cash book:

### (I) Payment of Capital Expenses

- Payment made for acquiring fixed assets are in essence capital expenditure. The auditor should see that payments in this connection are in order, have been properly authorized and are properly capitalized.

#### 1. Freehold and Leasehold Property and Building

- The auditor should vouch this item with the help of the agreement for the purchase of property, the lease deed or conveyance and the title deeds. All these documents will provide correct information in respect of the property and buildings purchased.

#### 2. Plant and Machinery

- The auditor should examine invoices, receipts in respect of payments made and other similar evidences giving full particulars of the transaction. He should make sure that the purchase of the item has been properly authorised.

#### 3. Patents

- In case patents have been purchased, the auditor should examine the agreement for the purchase of patents and verify the receipts acknowledging the payment.

#### 4. Investments

- The auditor should vouch the payment made for the purchase of investments with the 'broker's bought note'. He should examine the investments physically.

## 5. Loans

- The auditor should examine documents concerning a loan agreement and the receipt given by the borrower. This will enable him to know the terms and conditions of loan, the rate of interest and the date of repayment of loans.

### (II) Payments of Wages

- The vouching of payment of wages is of great importance in case of a large manufacturing concern. The amount of payment involved is also very large, Therefore, the vouching of this item requires special attention on the part of the auditor.

#### 1. Time Records

- In case wages are to be paid according to the time spent by the worker, the correct and exact time spent by him on the job must be recorded. This can be done by means of 'time recording clocks'. It is also important that a responsible official should see that the workers come in time and also leave the factory in time. This will reduce the chances of fraud.

#### 2. Piece Work Records

- In case wages are to be paid according to the piece wage system, each worker should be given a card and the details regarding the amount of work done should be entered in the piece-work card or sheet by each worker. This card should be signed by the worker and the foreman in charge. These cards should be passed on to the wage office, for the preparation of the wage sheets.

### (III) Travelling Allowance

- The auditor should examine the rules and regulations framed by the firm or the company regarding the payment of travelling allowance to the senior and junior staff. He should see that travelling allowance bills have been duly

checked and signed by a responsible officer in the light of the approved rules and regulations. He should also see that the voucher is supported by full details of the travelling expenses and is supported by the necessary evidences.

#### (IV) Bill Payable

- The auditor should check the cancelled bills returned, bank pass book and bills payable book can also be checked to ascertain the date of payments.

#### (V) Insurance Premium

- The auditor should examine the premium notice, the insurance company's receipts towards the payment of premium and the insurance policies. Details about the amount of premium payable, mode of payment and the date of maturity of the policy can be verified from the insurance policy. Where the policy is not renewed, the auditor should know the reasons.

#### (VI) Freight and Carriage

The payment made on account of this item should be vouched with the statements rendered by the shipping agent or carrier together with the supported vouchers, agents' bill and the receipt.

#### (VII) Salary

The auditor should examine the 'salary register' which contains details regarding the monthly salary and compulsory deductions in respect of each employee. He should compare the cheque drawn for payment of salaries with this register and variation if any should be looked into. He should see that the cheque is drawn for the net amount

#### VIII) Custom Duties

- The system of payment of custom duty should be investigated. Normally, custom duty is paid by the clearing agent on behalf of his client. If the clearing agent has paid these duties, the amount of the custom duty paid will be included in the bills of the clearing agents which are submitted by him monthly or fortnightly. The bill of entry duty stamped by the customs department should also be checked.

#### (IX) Rent Payable

- The agreement with the landlords and receipts from them should be examined. The auditor should see that the voucher is properly authorized.

#### (X) Payment to Creditors

- Money paid to the creditors can be vouched with the receipts issued by the creditors acknowledging the receipt of money. He should also check the amount due to them with the accounts of the creditors and the invoices received from the suppliers of goods. He should also see that the invoices received from the suppliers of goods. He should also see that the vouchers have references of bills against which payment is made.

#### (XI) Petty Cash Payment

- The auditor should examine the system of internal check in respect of petty cash. He should see that petty cash book is kept upon the imprest system. Cash can be misappropriated easily as there are no vouchers for a number of petty payments. He should verify the validity and accuracy of the transactions. He should vouch the cheques drawn for petty cash by reference to the cash book.

#### (XII) Bank Account

- These days, settlement of payment between the parties is done through banks. Therefore the vouching of this item is very important otherwise there can be manipulation in accounts. In a business, cash or cheques are sent to the bank for deposits or collections as well as money is withdrawn from the bank to meet day to day expenses.

### (XIII) Director's Fees

- Directors of a company are not entitled to get any monthly salary. However, the director of a company can claim any fees or remuneration for attending the board meetings. In that case, the auditor should examine the Articles of Association to know whether directors can be paid fees for attending such meetings or not.

### (XIV) Postage

- The auditor should verify the postage register. He should compare the postage register with the cash book in order to ascertain the purchase of stamps. Closing balance of stamps in hand should be counted and verified.

## 2.6) Verification and Valuation of Assets and Liabilities .

### 2.6.1 Introduction

- After a thorough examination of the books of accounts pertaining to their correctness and authenticity of the transactions recorded in them, the auditors should start verification of the assets and liabilities appearing in the balance sheet. In order to do this, he should first satisfy himself about the actual existence of assets and liabilities because the record of the assets and liabilities as appearing in the balance sheet may not be correct.

### 2.6.2 Verification

#### Meaning

- Verification means to confirm the truth or accuracy and to substantiate. It is a process by which the auditor satisfies himself not only about the actual existence, possession, ownership and the basis of valuation but also ensures that the assets are free from any charge or lien. Verification means the procedures normally carried out at the year end, to confirm the ownership, valuation and existence of items at the balance sheet date.

- In simple words verification means, 'proving the truth or conformation.'

The verification of assets include the following:

1. Verifying the existence of the asset on the date of balance sheet.
2. Ensuring that they are free from charges, if not then a mention of the charge created must be made in the balance sheet. their value.
3. Verifying Their value.
4. Assets are acquired for the business. **Definitions of Verification**

### **1. Spicer and Pegler**

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

### **3. Tendon**

"Verification or measurement of property is to prove the authenticity of property".

## **2.6.3 Verification of Assets and Liability**

### **1. Existence**

- It is not possible for the auditor to verify the physical existence of the tangible assets. It is the responsibility of the management. After verifying the efficiency of internal control system, the auditor can rely on the work of internal auditor. He needs to examine the records with reference to the documentary evidence.

### **2. Ownership**

The auditor needs to examine the title deeds to ensure that the clients is the owner of the said assets. In case of such assets as debtors, cash etc., auditors should design audit procedures.

### **3. Possession**

- Auditor should find out whether the client is in possession of the assets. If it is found that the assets are possessed by someone else, the auditor should find out if it was authorized.

#### 4. Disclosure of Charges

- If any charge is created on fixed assets, the auditor should ensure that sufficient disclosure has been made in the books for the same.

#### 5. Valuation

- Auditor should ensure that assets have been valued as per the Generally Accepted Accounting Principles (GAAP).

### **Objectives of Verification**

#### (A) Objectives of Property Verification

1. Ensuring that all assets in the balance sheet actually exist.
2. Satisfaction for showing assets at fair value in the balance sheet.
3. Ensuring that there are no charges on the property.
4. Ensuring that all assets shown on the balance sheet belong to the business. property is used for business purposes only.
5. detecting a lie about property.

#### (B) Objectives for Verification of Liabilities

1. To ensure that all the debts of the trader / party are mentioned in the balance sheet.
2. To ensure that all debts shown on the balance sheet are genuine.
3. To ensure that all debts shown on the balance sheet are shown at fair value.
4. To detect a lie about liability.

### **2.6.4 Valuation**

- The fact has been established that the verification of assets also includes their proper valuation. The correct valuation of assets and liabilities is very important because the accuracy of the balance sheet of any concern also depends on it. At the same time, the correct profit or loss cannot be

calculated unless assets are properly valued. Setting of the exact value of an asset on the basis of its utility is known as valuation.

## **Definition of Valuation**

### **Battliboy-**

"Assessment or valuation is a meticulous examination and verification of assets in accordance with the general accounting principles of the business."

- The auditor should consider the following points while valuing the assets:

1. Original cost of the assets.
2. Expected working life of the assets.
3. Wear and tear of the assets.
4. Break-up value of the assets.
5. The chances of the assets becoming obsolete.

## **Methods of Valuation**

### 1. Cost Price

- The price which is paid for the acquisition of an asset is known as cost price. The expenses incurred in the purchase of an asset and its installation are added in the cost price.

### 2. Market Value

- A value which an asset can fetch in the market when sold is known as Market value.

### 3. Replacement Value

- It is a price at which a particular asset can be replaced.

### 4. Book Value

- A value at which an asset appears in the books of accounts is known as its book value. It is usually the cost less depreciation written off.

## 5. Historical Value

- It is equivalent to the cost less reasonable amount of depreciation written off.

## 6. Residual Value

- A value which will be realised in the market and received from the sale of an asset is known as its realisable or residual Value.

## 7. Scrap Value

- A value which is obtained from the asset if it is sold as scrap.

### **2.6.5 Mode of Valuation of Different Types of Assets**

- The mode of valuation of different types of assets differs depending upon the nature of the business and the purpose for which the assets are held. There certain accepted principles for the valuation of the assets for the purpose of balance sheet.

#### 1. Fixed Assets

- These assets are of a permanent nature with which the business is carried on and which are held for the purpose of earning income and not for re-sale in the ordinary course of the business. They are constantly used for the production of goods and services and are not consumed in the very process of manufacture.

#### 2. Current or Floating Assets

- Floating assets are those which are acquired or created in the normal course of the business. They are held temporarily for the purpose of re-sale or subsequent conversion into cash. For example, stock-in-trade, book debts, raw material, finished goods, work-in-progress, cash and bank balances and bills receivable etc.

#### 3. Wasting Assets

- These assets are of fixed nature and are depleted gradually or lose a part of their value in the process of working. For example, mines, quarries and oil wells etc.

#### 4. Intangible Assets

- Those fixed assets which have income producing ability but cannot be seen or touched are known as intangible assets. For example, goodwill, patents, copyrights, licenses and trade names etc. These test assets cannot be seen or touched or verified like land and building, furniture and machinery etc.

#### 5. Fictitious Assets

- Preliminary expenses, deferred revenue expenditure and discount on the issue of shares etc. are some of the examples of fictitious assets. The total expenditures incurred on each of these assets is treated as assets and this should be shown in the balance sheet until they are written off.

#### 2.6.6 Auditors Position regarding Valuation of Assets

"The auditor is not expected to have detailed knowledge and experience of specialists in other disciplines. In such cases, he can seek audit evidence from experts. One such area is the valuation of assets such as land and building, precious stones, stock valuation of work of art etc."

#### (D) Audit of Fixed Assets/ Property

- The audit procedure to be followed by an auditor for the verification of some of the fixed assets is given below.

##### 1. Plant and Machinery

#### (a) Existence

- The auditor should examine the existence of plant by inspecting the plant register that contains information regarding the original cost, rate and amount of depreciation. All the expenses incurred on custom duty, freight, erecting charges etc. should be debited to the machinery account. In case a part of machinery is sold, he should verify the authorization to sell, carbon copy or counterfoil of cash receipt.

#### b) Ownership

- For the new purchase of fixed asset the vouching of cash book with the cash receipt, authorization to purchase, i.e. resolution of the board, contract between the supplier and the client can be checked.
- For the ones bought in at some previous year, the plant register and last year's balance sheet may be examined.

#### (c) Possession and Lien

- If the client is in possession of the asset then physical inspection would reveal it. If machinery is in possession of someone else like some other business etc. then the auditor needs to find out the reason. It may be possible that the plant has been given on hire, in which case he should examine the agreement and other records and ensure that hire charges received on machinery have been credited to the revenue account.

#### (d) Valuation and Disclosure

- Plant has to be valued at cost less depreciation. The auditor should ensure that depreciation method has been consistently followed by the client. In case of profit or loss on sale of machinery, the computation is correct and the profit or loss is disclosed properly in the profit and loss account.

## 2 Building-

Building may be bought or may be constructed. The procedure to be adopted for the verification of building is stated below.

### (a) Existence and Ownership

- The auditor should examine the original title deeds and make sure that the building is in the name of the client. In case of purchase of new building, he should vouch the purchase transactions. In case of sale of building, he should verify the authorization letter, invoice, correspondence and agreement with the buyer etc.

### (b) Determine Lien

- The auditor should go through the register of charges to confirm lien on the asset. He must see if proper disclosure to this effect has been made in the balance sheet or not.

## 3. Freehold Property

#### (a) Existence and Ownership

The auditor should at first check if the land is in the name of the client. For this purpose the original title deed and purchase deed should be examined. Both should be in the name of the client. If new land has been purchased, the auditor should vouch the payments.

#### (b) Valuation

Land is a non-depreciable asset, hence is shown in the balance sheet at historical cost. The cost of land should include all charges of acquisition like broker's commission, stamp duties, registration fees, legal charges and also levelling, clearing and draining charges.

#### (c) Possession

The title deed should be in the custody of the client. In case land is mortgaged, the title deed would be in possession of the mortgagee. The auditor may get the confirmation from the mortgagee. Besides, the details of the charge created should be appropriately disclosed in the balance sheet.

### 4. Furniture and Fixture

Furniture is purchased not with a view to resale but running and managing the business activities. Fixtures are either fitted on the walls or the ground. The auditor should check the stock register to ascertain of both the furniture and fixtures.

#### (a) Existence and Ownership

Organizations keeps a stock register to record the details fitting bought by it. Each item of furniture is allotted a number for easy verification. The location and stock number allotted to the furniture. He must ensure that the auditor should go through the register and check the cost, rate of depreciation management prepares a statement of inventory on the basis of physical verification and reconciles it with details in the register.

#### (b) Valuation of furniture

Furniture is to be valued at cost less depreciation. The cost should include the invoice price and all incidental charges. Furniture sold or those that have become useless must be written profit and loss account.

## (II) Audit of Current Assets

### 1. Inventories

- Inventories are goods that are held for resale or are used in the process production for producing finished goods.

### 2. Debtors

Sundry debtors fall in the category of current assets. The task of verifying this asset would be reduced to a great extent in case there is an efficient internal check system for recording sales and writing off the sales ledger in operation.

### 3. Cash in Hand

- The most common practice to verify cash-in-hand is to obtain a certificate from the accountant about the actual cash balance in hand as adopted by the professional qualified auditor to verify this item. The council feels that is not a correct appreciation of an auditor's responsibility in regard to the verification of cash therefore, the auditor should actually count the cash-in-hand.

### 4. Cash at Bank

- The auditor should compare the balances as shown in the bank pass book with the balances as shown in the column of the bank cash book. In order to ascertain the correct position with regard to cheques issued by the organization but not yet presented for payment or the cheque deposited by the organization but not yet cleared, the auditor should prepare a bank reconciliation statement.

### 5. Bills Receivable

- Receivables are given a very important place in the sale of loans. In order to verify the receipts in the balance sheet, the auditor should ask for a certified appendix of the receipts in hand. All amounts in the appendix and balance

sheet should be checked. The auditor must ensure that each letter is properly written and signed by the recipient.

### (III) Audit of Intangible Assets

#### 1. Goodwill

- Goodwill is an intangible asset. It is the value of the reputation of the firm, which enables the firm to earn more than the normal rate of profit. Goodwill has been defined as "the excess of the price paid for a business as a whole over the book value, or over the computed or agreed value of all tangible net assets purchased. Normally, goodwill thus acquired is the only type appearing in the books of accounts and in financial statement".

#### 2. Copyright

This is a right to produce or reproduce literary work. The effects of such a copyright is that the author or the publisher gets an exclusive right to publish or reproduce the work for a certain number of years or even it may be on life time basis for the author or the publisher as the case may be.

#### 3. Patent Right

The patent rights should be verified with the certificates granting such rights or in case where patents have been purchased, the assignment of the interest or the assignment deed should be inspected. The auditor should see and be assured that they have been registered in the name of his client and are the property of the client.

#### 4. Preliminary Expenses

- Preliminary expenses are all expenses relating to the formation of an enterprise such as registration fees, cost of printing documents like 'Memorandum Association' and 'Articles of Association' and other expenses related to the formation of a company.

#### 5. Trademarks

A trade mark is verified by examining the assignment deed duly endorsed by the office of the registering authorities. The auditor should see that they are registered in the name of the client and is the property of the client.

### **2.6.7 Verification of Different Items of Liabilities**

- The verification of liabilities is of equal importance as that of an asset. The auditor has to satisfy himself that all liabilities whether existing or contingent, have been properly determined and disclosed in the balance sheet. In case liabilities are overstated or under-stated, the balance sheet shall not represent a true and fair view of the state of affairs of the company.

#### **Definition**

"Verification of liabilities is the process of examination of legal and official documents to ensure the existence, completeness, valuation and disclosure of liabilities of an entity".

#### **Objects of Verification of Liabilities**

##### 1. Existence

- To ensure that the liabilities shown in the balance sheet are actually payable.

##### 2. Completeness

- All liabilities have been accounted for in the books of the enterprise.

##### 3. Valuation

- Liabilities stated in the financial statement indicate fair and reasonable amounts.

##### 4. Disclosure

- Liabilities have been disclosed in the financial statements in accordance with the accounting principles and as per the requirements of the acts governing the enterprise.

## **Verification of Different Items of Liabilities**

### **1. Capital**

Capital is the amount of money invested in an enterprise by its owner. The owners may be sole proprietors, partners and shareholders in case of a public limited company. In case of a partnership firm, the auditor should examine the Partnership Agreement (Partnership Deed). He must find out the original capital contributed by each partner and the rate of interest payable on capital. He should see that capital accounts of the partners are correctly maintained and verify all transactions affecting the capital accounts. He should examine the cash book, pass book, withdrawals of the and profits and loss earned by the firm.

### **2. Loans**

- The auditor must ascertain the borrowing powers of the company and for this purpose, he should examine the Memorandum of Association and Articles of Association of the company. He should also see that any restriction on the borrowing powers of the company is not exceeded. He should check the agreements pertaining to borrowings as they may be loans secured or unsecured or may be for a short or a long period.

### **3. Trade Creditors**

- The auditors will verify trade creditors more or less on similar lines as in case of sundry debtors. He should take a statement of balances of the trade creditors duly signed by the authorized officer of the organization and should verify these balances with the bought ledger or the purchase ledger.

### **4. Outstanding Liabilities for Expenses**

- The auditor should obtain certificates from the authorized officer of the company, stating that all outstanding liabilities for goods purchased or for expenses incurred, have been brought into account.

## 5. Bills Payable

- These are acknowledgements of debts payable. The auditor should get a statement of bills payable and compare it with the bills payable book and bills payable account.

## 6. Contingent Liabilities

A future uncertain liability which is dependent on the happening of some other event is known as a contingent liability. In other words, liabilities which have not arisen up to the date of the balance sheet, but may arise out of the contingent contracts, such liabilities are called as contingent liabilities.

### 2.7 Audit Report

- The final stage in audit process is audit report. Audit report is a document prepared by an auditor to certify the financial position and accounting records of a firm. Audit report is the written opinion of an auditor regarding company's financial statements.

### **Definitions of Audit Report**

#### 1. Joseph Lancaster

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

#### 2. According to Cambridge Business English Dictionary

"Audit report is defined as a formal document that states an auditor's judgment of a company's accounts."

### 2.7.1 Form of Audit Report

#### 1. Title of the Report

The title of audit report should disclose the name of client to help the reader to identify the report. The title distinguishes the audit report from other reports.

## 2. Name of the Addressee

- The person who appoints the auditor is called as an appoints the auditor, the addressee should be shareholders. The complete address of the addressee is required as per law. Addressee for the statutory audit shall be shareholders and in case of Special Audit, it is Central Government.

## 3. Introductory Paragraph

- Auditor's opinion on the Financial statement should be included in the introductory paragraph which is audited by him. The period covered by financial statements should be stated with exact dates.

## 4. Scope

The audit examination should cover company's accounts, Profit and Loss Account, Balance Sheet and Cash Flow Statements This part should include the matter-of- fact relating to the manner in which audit examination was made. The examination should be as per the relevant law. The auditor should not curtail any examination.

## 5. Opinion

- The auditor's opinion on the books of account and financial statements examined by him is based on the information and should be free from any bias because many internal and external parties depends on his opinion.

## 6. Signature

- The personal name and signature of the auditor should be given. If the auditor is a firm, the signature in the personal name and firm name should be given.

## 7. Place of Signature

- This should include the location of the auditor or the auditor firm.

## 8. Date of the Report

- The date of completion of the audit work should be mentioned.

## 2.7 Types of Audit Report

### 1. Clean or Unqualified Report

An unqualified opinion is considered as a clean report. This type of report indicates that the auditors are satisfied with the company's financial reporting. Clean or Unqualified report will be given by the auditor if the auditor is satisfied about the accounts, Balance Sheet, Profit and Loss Account and Cash Flow statement, Most companies expect to receive this type of report.

### 2. Qualified Report

When an auditor isn't satisfied or confident about any specific process transaction that prevents him from issuing an unqualified, or clean report, then may issue a qualified opinion. Qualified report are not acceptable from Investors point of view, as it has Negative opinion about a company's financial status.

### 3. Disclaimer Report

- The auditor may disclaim or refuse opinion on the accounts, Profit and Loss Account and the Balance Sheet, when he does not have sufficient information to give his opinion.

This may happen on the following grounds:

(a) The auditor has not been able to obtain sufficient information to form his opinion.

(b) The audit examination is not adequate to form an opinion.

(c) There are some material un-determined item in audit examination.

(d) The auditor may not have been able to depict the correct nature of some transactions or to secure enough evidence to support good financial reporting.

(e) Auditors that aren't allowed an opportunity to observe operational procedures or to review particular procedures may feel like they're not able to express a definite opinion.

- As a result, it creates an adverse image of the company.

#### 4. Adverse Opinion-Adverse Audit Report

- The final type of audit opinion is an adverse opinion. An adverse audit report usually indicates that financial reports contain gross misstatements and have the potential for fraud. An auditor's adverse opinion is a big red flag. Auditors who aren't at all satisfied with the financial statements or who discover a high level of material misstatements or irregularities know that this creates a situation in which investors and the government will mistrust the company's financial reports.
- Auditors use all types of qualified reports to alert the public as to the transparency.

#### 2.8 Audit Certificate

A certificate issued under the signature of a person implies that the person issuing or signing it vouchsafes the truth of the matters stated in the certificate. In other words, the person states that the facts are true. There is no room for the expert opinion of the person. If it is found later on that the certificate was wrong, he will be held responsible.

Examples certificate for the following:

- **Auditors is called for issuing**

1. Import and export certificate.
2. Bonus computation certificate.
3. Deposit return certificate.
4. Newspaper circulation certificate.

#### **Points to be considered while Preparing Audit Certificate**

1. Limitations of the examination should be stated.
2. Indicate the specific record covered by the auditor.
3. Fundamental assumption made for certifying.

4. Manner of the conduct of audit.
5. The information and explanations obtained.
6. Title of the certificate should be mentioned.
7. Certificate should be a self-contained document.
8. If figures from audited statements are made, then it should be mentioned in the certificate.
9. Auditor should address the certificate to the client or the public authority or person requiring it as the case may be.

## **2.9 Auditing and Assurance Standards (AAS: 1, 2, 3, 4, 5)**

### **2.9.1 Auditing and Assurance Standards in India**

- Auditing and Assurance standards are issued by ICAI ICAI set-up Auditing and Assurance Standard Board in 1982. The Central Government may prescribe the standards of auditing recommended by Institute of Chartered Accountants of India (ICAI) as per the Section 143(10) of the Companies Act, 2013. As constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority, these standards are set.

### **Compliance with Auditing Standards**

Every auditor shall comply with the auditing standards, as per section 143 (9) of the Companies Act, 2013. For any reason, if the member is unable to perform an audit in accordance with the generally accepted auditing standards, he would be held guilty of professional misconduct under clause 9 of Part 1 of the Second Schedule to the Chartered Accountants Act, 1949.

### **2.9.2 Objectives and Functions of the Auditing and Assurance Standards Board (AASB)**

Following are the Objectives and Functions of the Auditing and Assurance Standards Board (AASB):

1. To review the existing Standards and Statements on Auditing to assess their relevance in the changed conditions and to undertake their revision, if necessary.
2. To review the existing and emerging auditing practices worldwide.
3. To identify areas in which Standards on Quality Control, Engagement Standards and Statement on Auditing need to be developed.
4. To formulate Standards on Quality Control, Engagement Standards and Statement on Auditing.
5. To develop guidance notes on issues
6. To review the existing Guidance Notes to assess their relevance in the changed circumstances and to undertake their revision, as per suggestions.
7. To formulate General Clarifications, where necessary, on issues arising from Standards.

### **1. AAS-1: Basic Principles Governing an Audit**

- This Auditing and Assurance Standard (AAS) was the first standard on auditing issued by the (ICAI).
- This standard is effective for all audits relating to accounting periods beginning on or after April 1, 1985.

As the name suggests, it seeks to lay down and briefly explain the basic principles which govern the auditor's professional responsibilities and which should be complied with when an audit is carried out.

- These principles are as follows:
  - (a) Integrity, objectivity and independence,
  - (b) Confidentiality, skills and competence,
  - (c) Work performed by others,

- d) Documentation,
- (e) Planning,
- (f) Audit evidence,
- (g) Accounting system and internal control, and
- (h) Audit conclusions and reporting.

## **2. AAS-2: Objective and Scope of the Audit of Financial Statements**

- This Standard describes the overall objective and scope of the audit of general purpose of financial statements of an enterprise by an independent auditor.
- The Standard is effective for all audits relating to accounting periods beginning on or after April 1, 1985.
- The Standards deals with the following important aspects of an audit:
  1. Expression of opinion, the concept of true and fair view
  2. Responsibility of the management and auditor
  3. Factors determining scope, reliability and sufficiency of audit evidence, disclosure aspects, undiscovered material misstatements, etc.

## **3. AAS-3: Documentation**

AAS 3 is about whether the auditor should document matters which are important in providing evidence that the audit was carried out in accordance with the generally accepted auditing standards in India.

This AAS is effective for all audits relating to accounting periods beginning on or after July 1, 1985. The Standard explains as to what constitute working papers, need for working papers. The Standard also touches upon the following areas:

Form and Content: Factors affecting form and content, quantum of working papers, permanent audit file and current audit file.

Ownership and Custody of Working Papers.

#### **4. AAS-4: The Auditor's Responsibility to Consider Fraud and Error in an of Financial Statements Audit**

- As the name indicates, the purpose of this AAS is to establish standards on the auditor's responsibility to consider fraud and error in an audit of financial statements. The AAS is effective for all audits relating to accounting periods beginning on or after April 1, 2003. The appendices to this AAS contain examples of risk factors relating to misstatements resulting from fraud/ error, examples of modifications in auditor's procedures and indicators of possible fraud or error.

- The following would give an overview of the contents of the AAS 4:

- (a) Fraud and error and their characteristics
- (b) Responsibility of those charged with governance
- (c) Responsibility of management
- d) Responsibility of the auditor
- (e) Indication of possible misstatement
- (f) Evaluation and disposition of misstatements.
- (g) Effect on auditor's report
- (h) Documentation
- (i) Management representations
- (j) Communication

#### **AAS-5: Audit Evidence**

The purpose of this AAS is to establish standards that the auditor should obtain sufficient appropriate audit evidence through compliance and substantive procedures to enable him to draw reasonable conclusions on which to draft his opinion on the financial information.

- This AAS is effective for all audits relating to accounting periods beginning on or after January 1, 1989.

- The AAS also explains:

- (a) The concept of sufficient appropriate audit evidence and factors affecting.

- (b) Various types of assertions, internal and external evidence.

- (c) The Standard also deals with the methods of obtaining evidence namely, inspection, observation, inquiry and confirmation, computation and analytical review.