



GOVERNMENT OF TAMIL NADU

**HIGHER SECONDARY SECOND YEAR
VOCATIONAL EDUCATION**

Auditing

PRACTICAL

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Department of School Education

Untouchability is Inhuman and a Crime

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OVERVIEW OF VOCATIONAL AUDITING PRACTICAL

Auditing Practical

Auditing is an independent examination of books of accounts, vouchers, documents, and statutory records of an organisation to ascertain whether the financial statements represent a true and fair view of the state of affairs of the business concern. The scope of the subject *Auditing Practical* involves examination of the system of accounting, checking the accuracy of transaction, verification of the assets and liabilities and ensuring the truthfulness and correctness of the items in Profit and Loss Account and Balance Sheet with a view to express an opinion thereon.

Auditing Practical is an important paper for Commerce students. This book explains basic concepts about auditing in a simple and easy to understand manner. The subject is explained with a practical approach by means of illustrations. All important concepts have been explained in detail with diagrams and flowcharts. Further, summarized form of advantages and limitations to important concepts has been given to make the students remember and recollect the points easily. At the end of each chapter, *summary* has been given to give a clear understanding to the students. A *Glossary* of the key terms used in the book is given at the end of the book.



HOW TO USE THE BOOK?

Objectives	 The book explains basic concepts about practical auditing in a simple and easy to understand manner.
Text Book	The book provides practical approach about the subject with detailed explanation.
Message Box	In depth and additional information are provided within boxes to provide a broad perspective about the subject.
Activity	 Students activity are suggested to acquire practical skill in the subject.
E Resources and QR Code:	E-Resources and QR Code provided in between the chapters which will enable the students to sharpen and enhance knowledge of the subject.
Summary	Summary has been given at the end of each chapter to facilitate easy capitulation.
Key Terms	 Key terms used in each chapter with brief explanation about the concepts are highlighted.
Points to Recall	 Outline of the previous chapter are recalled in Points to Recall at the beginning of next chapter.
Examples	The subject is explained with a practical approach by means of illustrations.

Diagrammatic Presentation	Diagrams, Flowcharts and tabular columns are used for the purpose of quick understanding.
Legal Decisions and Case Studies	Important legal decisions and case studies has been provided to acquire in-depth knowledge about the subject.
Glossary	Key terms used in the subject are arranged alphabetical order in English to Tamil language.
References	Reference books are suggested at the end of each chapter for students to acquire additional knowledge on the subject.



CAREER GUIDANCE AFTER +2



Commerce is that part of business which is concerned with exchange of goods and services and includes all those activities which directly or indirectly facilitate that exchange. With globalisation and digitalisation of economy the importance of commerce and finance has enhanced providing greater opportunities for students pursuing commerce subject.

DEGREE COURSES

- B.Com : Bachelor of Commerce
- B.Com : Bachelor of Commerce – Accounting and Finance
- B.Com : Bachelor of Commerce – Computer Applications
- B.Com : Bachelor of Commerce – Information Systems Management
- B.Com : Bachelor of Commerce – Honours
- B.Com : Bachelor of Commerce – Marketing Management
- B.Com : Bachelor of Commerce – Co-operation
- BCS : Bachelor of Corporate Secretariship
- BBA : Bachelor of Business Administration
- BBM : Bachelor of Bank Management
- BMS : Bachelor of Management Science
- BBS : Bachelor of Business Studies
- BSW : Bachelor of Social Work
- BA : Bachelor of Arts - Economics

PROFESSIONAL COURSES

CHARTERED ACCOUNTANCY – CA

Chartered Accountancy deals with the management of money and provides financial advice. They maintain records of financial transactions which every organisation is required to keep by statute and also carry out company audits.

Education Pathway:

The Chartered Accountancy Course is regulated by the Institute of Chartered Accountants of India (ICAI) and exam is conducted in three stages.



Career Opportunities:

1. Independent Auditor
2. Accounts Manager / Executive
3. Finance Manager / Executive
4. Chief Financial Officer (CFO)
5. Financial Analyst
6. Financial Consultant
7. Financial Controller

PROFESSIONAL COURSES

COST AND MANAGEMENT ACCOUNTANT - CMA

Cost Accountant creates budgets to manage costs and maximise profitability of a company. They provide detailed cost information that management needs to control costs and further aids management to take decisions.

Education Pathway:

The Cost and Management Accountant Course is regulated by the Institute of Cost Accountants of India and exam is conducted in three stages.



Career Opportunities:

1. Cost and Management Accountant
2. Cost Controller
3. Cost Auditor

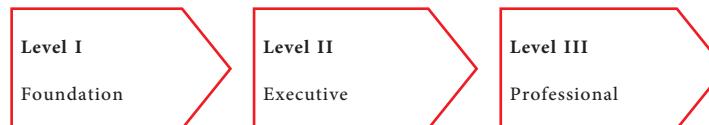
PROFESSIONAL COURSES

COMPANY SECRETARY - CS

Company Secretary is one of the principal officer of the company. They keep the company's records, complete tax returns, advise the Board of Directors of their legal obligations and ensure that companies comply with statutory legislation.

Education Pathway:

The Company Secretary Course is regulated by the Institute of Company Secretaries of India (ICSI) and exam is conducted in three stages.



Career Opportunities:

1. Company Secretary
2. Legal Advisor
3. Corporate Policymaker
4. Administrative Officer

PROFESSIONAL COURSES

CORPORATE LAWYERS

Corporate lawyers undertake all legal processes related to the formation, operation and governance of a corporation. They are responsible for all aspects of corporate law practice.

Education Pathway:



Career Opportunities:

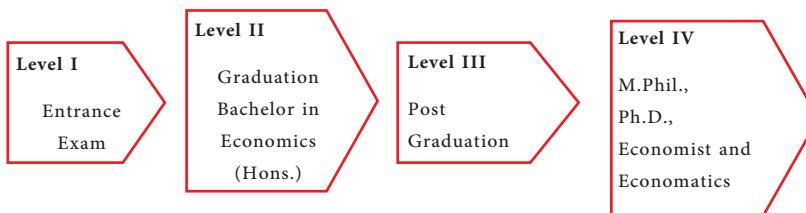
1. Lawyer
2. Legal Advisor
3. Legal Consultant

PROFESSIONAL COURSES

ECONOMIST

Economist provides advice and practical information that will aid managerial planning and decision-making tasks. They analyse and interpret complicated numerical and financial information.

Education Pathway:



Career Opportunities:

1. Economist
2. Analyst
3. Research Associate

PROFESSIONAL COURSES

ACTUARY

Actuarial Science is a course that uses mathematics and statistics to determine risks in sectors like insurance, finance and other relevant fields. The Institute of Actuaries of India (IAI) is the Government body responsible for actuarial education in India.

Education Pathway:



Career Opportunities:

1. Chief Actuary
2. Analyst
3. Intern
4. Associate

POST GRADUATION COURSES

- M.Com : Master of Commerce
- MBA : Master of Business Administration
- MMS : Master of Management Science
- MSW : Master of Social Work
- MCS : Master of Corporate Secretaryship

INTERNATIONAL COURSES

- CMA : Certified Management Accountant
- CPA : Certified Public Accountant
- ACCA : Association of Chartered Certified Accountants
- CFA : Chartered Financial Analyst

AFTER POST GRADUATION COURSES

- B.Ed., M.Ed.,
- M. Phil
- Ph.D.

Career Opportunities:

1. Post graduate teacher
2. Assistant professor of College/Universities in India/Foreign Countries
3. Research Associate in Universities in India/Foreign Countries

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E-book



Assessment



DIGI links



Lets use the QR code in the text books ! How ?

- Download the QR code scanner from the Google PlayStore/ Apple App Store into your smartphone
- Open the QR code scanner application
- Once the scanner button in the application is clicked, camera opens and then bring it closer to the QR code in the text book.
- Once the camera detects the QR code, a url appears in the screen.Click the url and goto the content page.

Auditing

PRACTICAL

Chapter

1

INTERNAL CHECK



Learning Objectives

- To understand the meaning, objectives, advantages and disadvantages of Internal Check system.
- To Analyse the Auditor's duties with regard to Internal Check System.
- To Evaluate the Application of internal check system with respect to Cash and Trading transactions.

1.1 Introduction

In business concerns there are chances of misappropriation and manipulation of accounts. In order to overcome such irregularities and to prevent or minimise the occurrence of errors and frauds, a checking system is designed to have a check on the irregularities. Such a check which operates continuously as part of the routine system is called as Internal Check. This chapter highlights the principles of good internal check system and explains in detail the procedure of internal check with regards to cash and trading transactions.

1.2 Meaning Of Internal Check



The term internal check refers to allocation of duties to the employees in an organisation in such a way that the work of one person is automatically

Internal check system when cash is withdrawn from bank against a cheque

Firstly, the Cheque is produced at the counter where the clerk issues a token and enters the token number on the back side of the cheque and in the token book.

Secondly, the cheque is then passed on to the ledger clerk who verifies the credit balance in the account of customer and makes the debit entry therein for the amount of the cheque.

Thirdly, the cheque is sent to an officer, who compares the signature on the cheque with the specimen signature of the account holder and passes it for payment.

Lastly, the cheque is sent to the cashier who makes the payment against the token and records it in the cash register.

Thus, withdrawal of cash from a bank account is undertaken by four different persons such that work of one person is checked by other person in order to avoid the occurrence of errors and frauds. The system of internal check is exercised in such a way that no individual person does the entire work and the process is as follows.



and independently checked by the other person from the beginning to the end. It denotes such an arrangement of duties among the staff that the work performed by one individual is independently checked by another in the routine course, such that errors and

frauds are prevented or discovered. Under the system of internal check, care is taken to ensure that no one person handles a transaction completely from beginning to end and the work of every person is in the ordinary course checked by another person.

Internal Check System on Account of Cash Sales

Firstly, Sales Department makes an entry in the Sales Register for name of the customer, date of sale, quantity and amount of sale and issues a Sales Invoice.

Secondly, The store keeper in Stores Department makes an entry for material issued in the stores ledger.

Thirdly, at the factory gate the gate keeper makes an entry when the goods are sent out or delivered.

Fourthly, in Accounts Department the person records the sale transaction based on sales invoice.

Finally, the cashier on receipt of cash makes an entry in Cash Book and issues receipt acknowledging cash received.

Thus, the transaction is passed through five different persons from different departments, and hence the work of one person is automatically checked by the other person in order to avoid errors and frauds.

1.3 Definition

- L.R. Disksee defined Internal Check as, "Internal Check is an arrangement of accounting routine that errors and frauds are automatically prevented or discovered by the very operation of book-keeping itself."
- According to F.R.M Depaula, "An 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 the other members of the staff".
- According to Speicer and Pegler, "A system of internal check is an arrangement of staff duties whereby no one person is allowed to carry through and to record every aspect of the transaction, so that, without collusion between two or more persons, fraud is prevented and at the same time the possibilities of errors are reduced to the minimum".

1.4 Principles (or) Features of Good Internal Check System



1. Division of Work: Division of work refers to dividing the total work among various staffs in such a way that no single person is allowed to perform the work from the beginning to the end. The work should be allocated to the employee based on the capacity of each person.

2. Authority and Responsibility: Authority, duties and responsibilities of each person should be clearly defined and there should not be any overlapping or duplication of duties and responsibilities.

3. Automatic Check: Work allocated to the staff should be in such a way that the work

performed by one person is automatically checked by another person.

4. **Rotation of Employees:** A good system of internal check should provide transfer or rotation of employees from performing one work to another at frequent intervals.
5. **Proper Training to Employees:** An effective system of internal check should carefully select the employees to the organization. The employees should be properly trained and clear instructions should be given to them to perform their work in an effective and efficient manner.
6. **Proper system of Documentation:** Internal check system should provide

for proper system of filing vouchers, correspondences etc. in a systematic manner.

7. **Periodical Review:** The system of internal check should at frequent intervals (be reviewed) and suitable changes should be introduced.
8. **Usage of Electronic Equipment:** The system of internal check should provide for usage of labour saving electronic devices such as calculating machines, personal computers, time recording clocks, book-keeping machines etc. The proper training should also be given to the employees for using these devices.

Example: picture showing the flow of internal check system in a textile showroom.



1.5 Objectives of Internal Check

The objectives of internal check are as follows:

1. **Early Detection of Errors and Frauds:** The main objective of internal check is to detect and prevent the occurrence of errors and frauds at an early stage. This is possible as the work of each and every person is independently checked.

2. Minimization of Errors and Frauds: It is one of the primary objectives of internal check. As the work performed by each individual is checked by another person, there is a check on errors and frauds. Hence, the possibility of errors and frauds are minimised to a greater extent.

3. **Division of Work:** Internal check provides for proper division of work based upon each and every persons

skill, ability, specialisation and effectiveness.

4. **Fixation of Responsibility:** The total work is divided into smaller units and assigned to different persons. Each and every person knows what is expected from him/her and he/she will be held

responsible for any errors or fraud which takes place in it. Internal check provides clear determination of responsibility.

5. **Reliability of Records:** The system ensures that the books of accounts and other records maintained provides reliable source of information.



1.6 Advantages of Internal Check

The main advantages of Internal Check are given below.

1. **Proper Distribution of Work:** Internal Check helps in proper distribution of work among employees based on their qualification and experience. It enables the employees to perform the work efficiently.
2. **Detection and Prevention of Errors and Frauds:** The main object of internal check is to minimize the occurrence of errors and frauds, as no individual

person does the work from the beginning to the end and the work of one person is checked by another person.

3. **Increases Efficiency:** A good system of internal check, increases the efficiency of work of employees as the right work is allocated to the right person taking into account his skill and experience.
4. **Determination of Employees Liability:** Internal check system clearly determines the responsibilities of the employees. Hence, the liability of the employees can be easily fixed due to irregularities or negligence caused by the employee.

Advantages of Internal Check

- 1 Proper distribution of work
- 2 Detection and Prevention of errors and frauds
- 3 Increase the Efficiency
- 4 Determination of Employees Liability
- 5 Proper maintenance of Books of Accounts
- 6 Easy and Quick Presentation of Final Accounts
- 7 Facilitates the Auditor
- 8 Increases Profitability

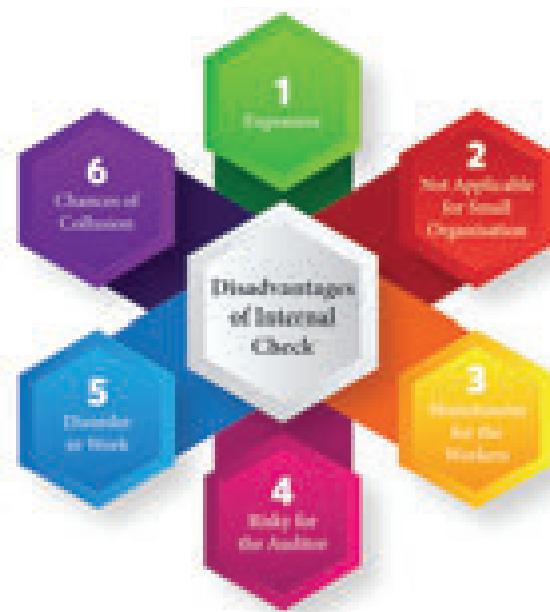
5. **Proper Maintenance of Books of Accounts:** Internal check system helps to maintain proper records and ensures accuracy of the entries in the books of accounts.

6. **Easy and Quick Presentation of Final Accounts:** Internal check enables quick presentation of final accounts i.e., Profit and Loss Account and Balance Sheet immediately after closing of the accounting period.

7. **Facilitates the Auditor:** When there is an effective internal check system the statutory auditor can rely on the system. He can avoid detailed checking of transactions. He can select limited sample of transactions. This enables him to finish the audit work within time.
8. **Increases Profitability:** Overall efficiency and economy of operations leads to increased earnings for the owners of the enterprise.

1.7 Disadvantages of Internal Check

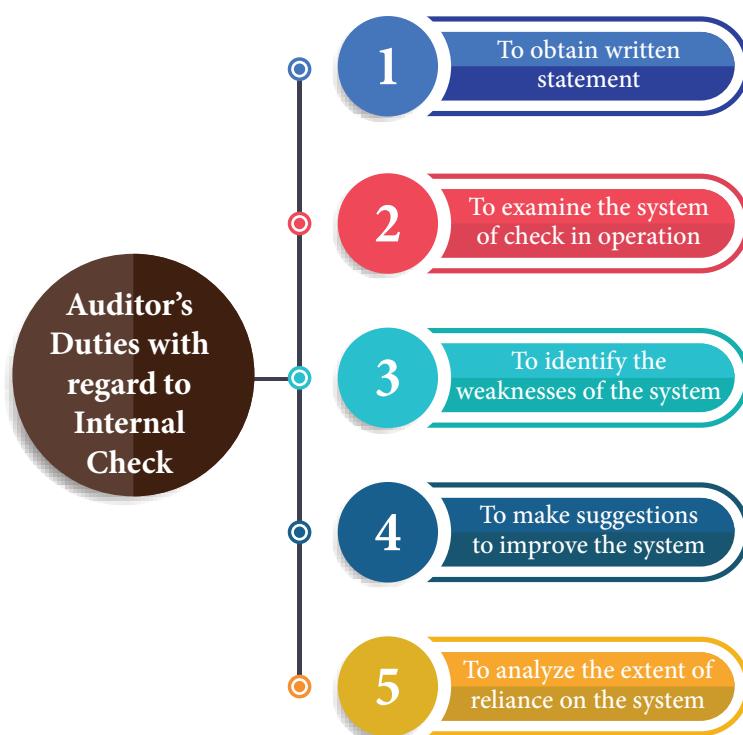
The disadvantages of internal check are given below.



1. **Expensive:** The system of internal check is more expensive and time consuming.
2. **Not Applicable for Small Organization:** This system is not applicable for small organization where there are only few employees. Only large organization having number of departments and

- complexity of jobs can get benefit of this system.
3. **Monotonous for the Workers:** As same work is done by the employees continuously the job becomes boring and the employees lose their creativity.
 4. **Risky for the Auditor:** When the auditor relies on the system of internal check and does not conduct tests he will be charged for negligence.
5. **Disorder in Work:** If the system is not fully organized and if there is any failure in the system, it creates disorder and confusion hence, chances of errors and frauds increase.
 6. **Chances of Collusion:** Though internal check system prevents errors and frauds but in reality there may be chances of collusion between two or more employees to indulge in frauds or malpractices.

1.8 Duties of an auditor with Regards to Internal Check System



The system of internal check in an organisation determines the scope of work of a statutory auditor. The duty of an auditor is to verify the effectiveness of the system of internal check in operation. However, the auditor should perform the following work in this regard.

1. **To Obtain Written Statement:** An auditor should obtain a written statement about the working of the internal check system from the business concern.
2. **To Examine the System in Operation:** The auditor should carefully examine

the existence and operation of the internal check system.

3. **To Identify the Weaknesses:** The auditor should identify the weakness of the system which will result in occurrence of errors and frauds taking place.
4. **To Suggest for Improvements:** If the system of internal check is ineffective, the auditor should make suggestions to strengthen the system of internal check.
5. **To Analyse the Extent of Reliance:** The auditor should carefully analyse the extent to which he can rely on the effectiveness of internal check. If the system of internal check is effective, he can check sample transactions thus devoting his attention on other important audit areas.

may be misappropriated in the following manner:

- Cash receipts may not be entered in the cash book. Cash received may be understated by preparing duplicate receipts for amount less than what is actually received.
- Cash sales may be treated as credit sales.

The following system of internal check may be adopted as regards cash receipts.

1. All inward remittances should be opened by the cashier in the presence of a responsible officer.
2. On receipt of cash or cheque, it should be immediately entered in cash book or cheque received notebook.
3. All remittances (draft, cheque) must be crossed as 'account payee only'.
4. Cash and cheques received should be deposited immediately.
5. Bank pay-in-slips should be prepared by a separate person, who is not entrusted with the work of depositing cash in the bank.
6. Cash received after the banking hours should be kept in the locker of the business. The locker should be opened by the cashier in the presence of a responsible official.
7. Printed receipts should be issued for all remittances signed by the cashier and responsible official.
8. Unused receipt book should be kept under lock and key under the custody of the responsible official.
9. Cancelled or spoilt receipts should not be detached from the receipt book.
10. Cash balance should be physically verified by a responsible official by surprise check at frequent intervals.

1.9 Internal Check - Cash Transactions

Checking of all cash transactions should be given utmost importance because employees tend to involve in fraudulent activities by misappropriating cash and manipulating accounts in an organisation. Hence, the auditor should verify the system of internal check in operation with regard to cash receipts and cash payments, which is explained in detail below –

1.9.1 Internal Check-Cash Receipts

There should be proper system of internal check as regarding cash transactions as the employees tend to misappropriate cash in an organisation. Cash receipts

1.9.2 Internal Check-Cash Payments

There should be an effective system of internal check with regard to all payments made by the concern in the form of cash or cheque or bank transfers. Cash payments may be misappropriated in the following ways:

- Payments may be made against fictitious vouchers.
- Payments may be made against inflated vouchers.
- Payments may be made without receipt of goods.
- Revenue expenses maybe treated as capital expenditure.

Hence, a proper system of internal check is necessary. The following system of internal check may be adopted as regards cash payments.

1. The person in charge of making cash payments should not have any connection with the person responsible for receiving cash.
2. The person responsible for making cash payments should not have access to the books of accounts.
3. All the payments should be paid by way of crossed cheque.
4. After making payment against a particular bill or invoice, the voucher and the supporting bill or invoices should be stamped as 'paid' so that the same voucher is not passed again for payment.
5. Unused and cancelled vouchers and cheque books should be kept under the custody of a responsible person.
6. Person who is responsible for preparing the cheque should be clearly specified.

Before passing a bill for payment, it should be ensured that the goods have been received.

7. The bill for which payment is to be made should be sanctioned by the responsible official.
8. Confirmation of balances from the creditors should be made through direct correspondence.
9. Proper sanction should be obtained by directors from higher officials to make payment for transactions of special nature.
10. Bank reconciliation statement should be prepared to reconcile cash and bank balances from time to time.

1.10 Internal checks-Wages

Wages are very important item of expenditure. The system of internal check for wages should be devised in a planned and careful manner. There are great possibilities of frauds in a concern employing a large number of workers. A sound system of internal check for payment of wages may avoid errors and frauds which may be revealed from time and piece wages records.

The following system of internal check may be adopted as regards wages.

I. Maintenance of Wages Records

1. **Time Records:** It is a record maintained by the gate keeper who records the entry time and exit time of each worker. Foremen of each department also maintain records for time spent by an employee. When wages are paid on

the basis of time spent by a worker, the record maintained by the gate keeper and record maintained by foremen of each department are summarised for payment of wages.

2. **Piece-work Records:** This record is maintained by the foremen who records the actual work done by each employee. Each person is provided a job card who records the work done by him. Finally, the record maintained by the foremen and job card are used in determining wages.
3. **Overtime Records:** Overtime should be sanctioned in advance by a responsible person. Employees should be issued overtime slips bearing the name and number of worker. Such slips should be issued and initialled by some responsible official. At the end of the week such slips should be sent to the wage office.
4. **Pass-out Records:** The workers should not be allowed to leave the factory without the written permission. For this, a pass-out slip is issued to the worker by same authority. Such slips are handed over to the gate keeper. The wage office should also be given copy of it.

II. Preparation of Wage Sheet:

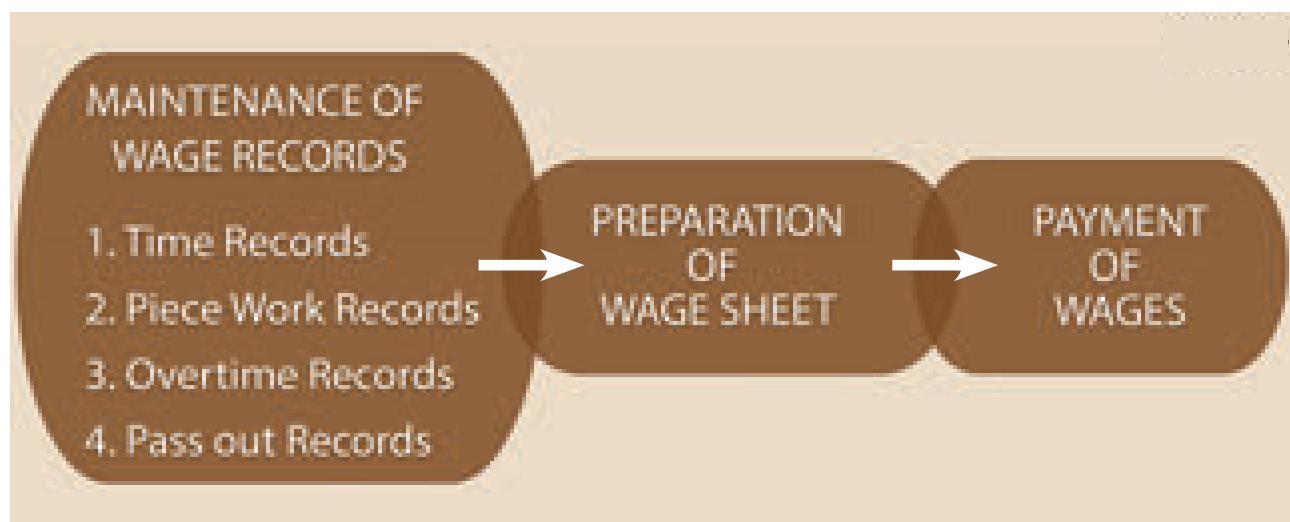
The wage sheet should not be prepared by one clerk alone. A set of clerks should compare the records maintained at the gate and the wage office and enquire about differences, if any. The following points should be taken into account.

1. **Base:** The wage sheets should be prepared with the help of attendance register, overtime slip and pass-out slip.

2. **Separate Sheets:** Separate wage sheets should be used for time-workers and piece-workers.
3. **Checking:** The wage sheet should be inspected and counter signed as correct by the works manager and foreman.
4. **Signature:** The wage sheet should be counter signed by those employees who has prepared it.
5. **Approval:** Each and every wage sheet should be approved by factory manager or managing director.

III. Payment of Wages:

1. The person who is in-charge for payment of wages should not have connection with the preparation of wages sheet.
2. Each worker should be asked to receive his wages personally in the presence of his foreman to identify him.
3. No payment is made to someone on behalf of a worker who is absent.
4. Wage payment should be made by cash department, not by other persons.
5. The amount of wages for each employee should be placed in an envelope bearing the name and number of person.
6. Special arrangements should be made for payment to the absentees.
7. Exact amount of money should be drawn from the bank for payment of wages.
8. Advances to workers should be discouraged and if it becomes unavoidable, they should be given through the petty cashier.
9. If casual workers are also employed in the factory a separate record should be maintained for them.
10. Undisbursed wages should be deposited immediately into the bank.



1.11 Internal Check Trading Transactions

1.11.1 Internal Check-Purchases

The following system of internal check may be adopted as regards purchases.

1. A purchase department should supervise and control the entire purchase transactions of the organisation.
2. The procedure for purchases should start with issuing purchase requisition, making enquiry about the terms and conditions of purchases from different suppliers.
3. Purchase requisition should be in a printed form and serially numbered. They should be given to all the departments in the organisation.
4. On receipt of requisition from various departments, the purchase department should send enquiry letter to the suppliers.
5. The purchase department, after verifying the quotation should place an order with the supplier.
6. All the purchase orders should be signed only by the Purchase Manager or any responsible person on his behalf.
7. Goods should be received by a responsible official and entered in the Goods Received Note and the same should be recorded in the stock register/stores ledger.
8. On receipt of invoice from the supplier, the purchase department should check the invoice with the goods received note and verify the rate, discount, quality and quantity of goods.
9. Goods received should also be entered in the stores ledger and entries should be made in the bin card.
10. The accounts department should verify the purchase invoice with the goods received note and purchase order before making payment.
11. After making payment, the accounts department should affix a rubber stamp on the invoices in order to avoid duplication of payments.
12. At frequent intervals a responsible person should check the entries in the purchase book with supplier ledger account.



1.11.2 Internal Check-Purchase Returns

- When goods are returned to the supplier it should be entered in purchase returns book.
- A credit note should be obtained from the supplier for each return of goods and the note should be attached to the invoice.
- The purchase department should check such advice note with invoice and enter in purchases returns book.
- When only part of the goods are returned to the supplier, the goods which are accepted alone should be entered in the stores ledger.



1.11.3 Internal Check-Sales



Sales are the most important source of revenue in a business and hence the possibilities of errors and frauds taking place are greater. Frauds maybe committed in the following ways:

- Sales may be omitted from recording in the sales book.
- Fictitious sales may be accounted.

- Sale of fixed assets may be treated as sale of goods.

In order to overcome the occurrence of such type of frauds, an effective system of internal check as regards credit sales is necessary which may be in the following manner.

1. On receipt of order from the customers, it should be numbered and the particulars entered in the order received book.
2. The order copy should be handed over to the dispatch department who makes necessary arrangements for delivery of goods.
3. When the goods ordered are ready for delivery the dispatch department should inspect the goods with the order copy and enter the details of goods delivered in the dispatch memo.

4. The invoice should be prepared based on the dispatch memo in three copies, one copy should be sent to the customer, second copy to the accounts department and third copy will be retained by the sales department.
5. A responsible official should check the particulars in the invoices and also confirm that the terms and conditions in the order have been duly followed and finally he should put his initial on the invoice.
6. The gatekeeper should record particulars of the goods leaving the premises in the goods outward book.
7. The persons who are responsible for preparing the invoices should not be allowed to post the entries in the customer's accounts.
8. At frequent intervals, the balances in the customers' accounts should be verified with the confirmations received from the customers.
9. A responsible official should verify that only sale of goods are accounted in sales day book and sale of assets are not accounted.
10. A responsible official should deal with customers' enquiries, overdue accounts and writing off bad debts.

1 Sales Department records the order received in Order Received Book.

2 Arrangement with Dispatch Department for delivery of Goods.

3 Preparation of Sales Invoice by Sales Department.

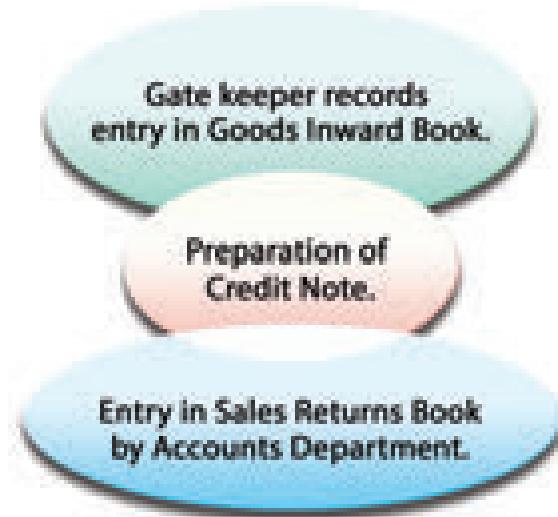
4 Invoice verified by a responsible officer.

5 Gate-keeper entry in Goods Outward Book.

6 Accounts Department records sales based on Invoice in Sales Day Book.

1.11.4 Internal Check-Sales Returns

1. The goods returned by customer should be entered in the sales return book and reason for the return should also be recorded.
2. The gatekeeper should also enter the goods received in the goods inward book.
3. A credit note should be prepared, duly checked and initialled by a responsible official.



STUDENTS ACTIVITY



1. Visit an Industry, discuss with Accounts Manager regarding internal check system followed for cash receipts and cash payments.
2. Visit an industry, with prior permission to verify internal check system followed with regard to purchase and sale transactions.
3. Set up a model bank in your class room and discuss the procedure for deposits, withdrawals and sanctioning of loans.

SUMMARY

Internal check refers to allocation of duties to the employees in an organisation in such a way that the work of one person is automatically and independently checked by the other person. The main object of internal check is to detect errors and frauds, to provide for division of work, fixation of responsibility, liability of records. Internal check is based on the principle of division of work, automatic check, rotation of employees, proper training to employees, periodical review and usage of electronic equipments. The drawback of the system are expensive, creates confusion and disorder in work. Internal check is exercised in case of cash transactions i.e., cash receipts and cash payments and trading transactions i.e., purchases and purchase returns, sales and sales returns to detect misappropriations of cash and goods.



KEY TERMS

- **Internal check:** The term internal check refers to allocation of duties to the employee in an organisation in such a way that the work of a person is automatically and independently checked by the other person.
- **Division of work:** The total work divided among various staffs based on their skill and expertise.
- **Purchase Returns:** When goods are returned to the suppliers.
- **Sales Returns:** Goods returned by customers.
- **Invoice:** Invoice is a statement. It is prepared by the seller of goods. It contains the information relating to name and address of the seller and the buyer, the date of sales, price and quantity of goods sold.
- **Debit note:** A debit note is a commercial document issued by a buyer to a seller. Debit note is the source document to the purchase returns journal.
- **Credit note:** A credit note is a commercial document issued by a seller to a buyer. Credit note is the source document to the sales return journal.



EVALUATION



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I. Multiple Choice Questions

1. A system in which the work of one person is automatically checked by another person is called as _____.
 - a. internal check
 - b. internal control
 - c. internal audit
 - d. interim audit
2. Objects of internal check are _____.
 - a. to minimise errors and frauds
 - b. to prevent errors and frauds
 - c. to allocate duties and responsibilities
 - d. all of the above
3. A good internal check system _____.
 - a. to reduce the liability of an auditor
 - b. reduces the work of an auditor
 - c. reduce the responsibility of an auditor
 - d. All of the above
4. The system of internal check is based on the principle of _____.
 - a. division of labour
 - b. unity of command
 - c. unity of direction
 - d. authority

5. Internal check is a kind of _____.
 a. complete audit
 b. division of work
 c. partial audit
 d. final audit
6. _____ is a valuable part of internal control
 a. internal audit
 b. internal check
 c. test check
 d. routine check
7. While making payment for purchases _____ are to be checked by a clerk.
 a. account sales
 b. invoices
 c. cash receipt
 d. none of these
8. When goods are returned to suppliers, a _____ should be obtained from them.
 a. debit note
 b. credit note
 c. account slip
 d. none of these
9. Goods returned by customers will be entered in _____
 a. goods inwards book
 b. purchases returns book
 c. goods outward book
 d. above all the books
10. Internal check system is useful to _____ business concerns.
 a. small scale
 b. large scale
 c. medium size
 d. all the above

Answers 1.(a), 2.(d), 3.(d), 4.(a), 5.(b), 6.(b), 7.(b), 8.(b), 9.(a), 10.(b)

II. Very short answer questions

1. What is meant by internal check?
 2. What are objects of internal check?
3. What is meant by Overtime records
 4. What is piece wage records?

III. Short answer questions

1. Define "internal check"?
2. Mention the principles of internal check system?
3. What are the objects of internal check?
4. State the procedure of internal check as Records Sales Returns.
5. Explain the duties of an auditor with regard to internal check system.

IV. Essay type questions

1. What are the advantages and disadvantages of internal check?
2. Explain a system of internal check as regards payment of wages?

3. Explain a system of internal check as regards cash receipts?
4. Explain a system of internal check as regards cash payments?
5. Explain the system of internal check as regards sales?
6. Discuss the features of a good internal Check System.
7. Briefly explain internal check procedure with reference to Purchases and Purchase Returns.

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Learning Objectives

- To understand the meaning, definition and objectives of internal control.
- To understand the advantages and disadvantages of internal control.
- To understand the principles of good internal control system.
- To evaluate the auditor's duty of internal control.
- To analyse the methods of evaluating internal control system.
- To identify the differences between internal check and internal control.

POINTS TO RECALL

RECAP

In the previous chapter, we have studied meaning and importance of internal check system and application of internal check system with respect to cash and trading transactions.

2.1 Introduction

Internal control is the overall control environment established by management of an enterprise for effective and efficient monitoring and control of its operations. It aims at adherence to management policies, safeguarding of assets of the enterprise, proper accounting and record of the business transactions. Internal check and internal control are vital components of the control system.

The auditor should properly understand and assess the internal control system to determine the degree of reliance to be placed on it and accordingly to plan the nature, timing and extent of audit procedures to be performed by him. If the internal control is found to be effective, the auditor may resort to selective verification. However, when internal control system is weak auditor has to verify the transactions in detail.



2.2 Meaning

Internal Control refers to the process of control exercised by the management either financial or non-financial to ensure proper accounting of business transaction and reliability of records. Internal control

has a wide coverage which includes checks and controls exercised to ensure efficient and effective functioning of the business organisation. In other words, it is a process implemented by the management to provide the following:

- i. Proper accounting and reliability of records,
- ii. Effectiveness and efficiency of business operations, and
- iii. Compliance with laws and regulations.

The scope of internal control system is vast. It comprises both administrative control as well as accounting control.

2.3 Definition

- **Auditing Practices (SAP-6) of Institute of Chartered Accountants of India:** “Internal control system refers to the whole system of controls, financial or otherwise, established by the management in the conduct of a business

including internal check, internal audit and other forms of control.”

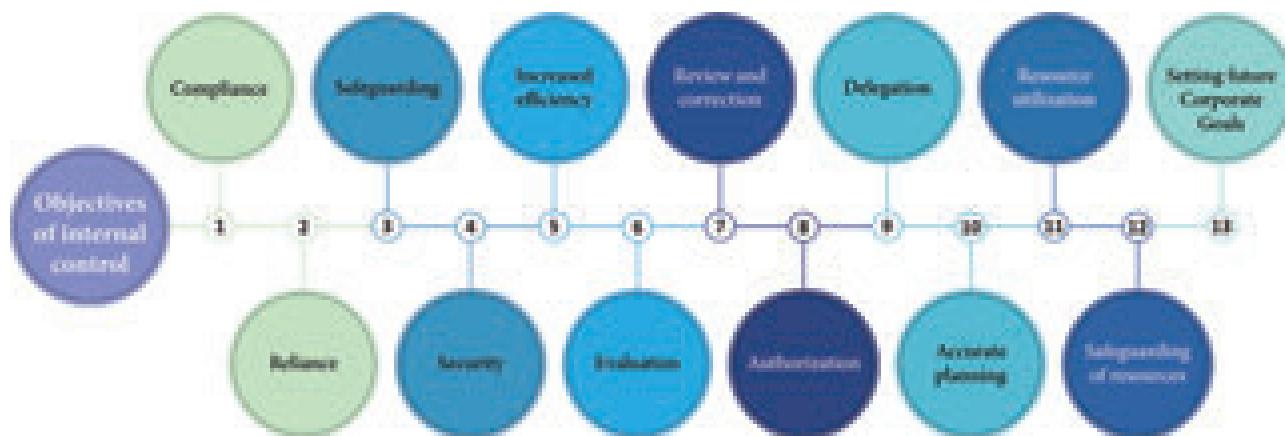
From various definitions, the following points emerge:

- Internal control is a system of control or practice put in place by management.
- Controls are established over financial and non-financial areas of business.
- Controls take the forms like internal audit and internal check.

2.4 Objectives of Internal Control

Each organization must have a system of internal control in place for achieving the preset goals. Other than accomplishing the desired goals and objectives of the organization, this system plays a very important role in any organization. The main objectives of internal control are as follows:



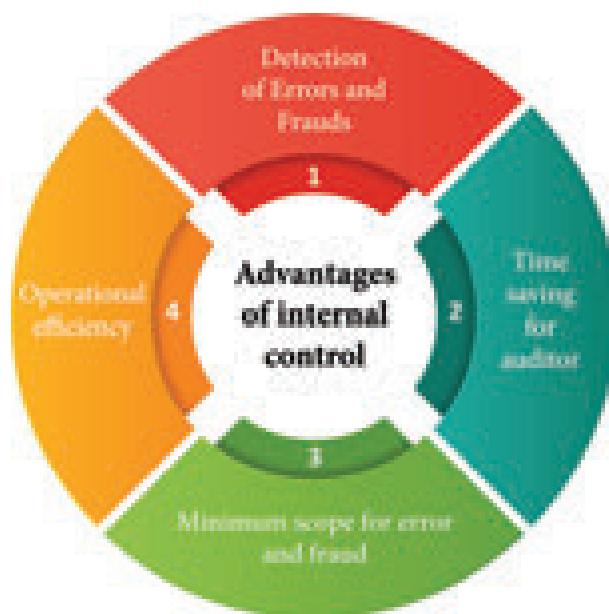


1. **Compliance:** To have compliance with law and accounting practices that is generally accepted and followed in the country. The accounting process also needs to be in compliance with these.
2. **Reliance:** To increase the reliance on the internal systems, accounting practices should be followed by the organization, so that the chances of frauds are reduced.
3. **Safeguarding:** To safeguard the organization's accounts, employees and assets by formation of fool-proof policies, rules and regulations.
4. **Security:** To provide security to customers, employees and property of the organization. Physical security systems like security guards, locks and anti-theft devices are used for providing protection.
5. **Increased Efficiency:** To assist in human resource and performance management, and to keep proper control over business activities to achieve maximum levels of efficiency.
6. **Evaluation:** To evaluate the accounting system for proper authorization of transactions.
7. **Review and Correction:** To review the working of the business, locate weak points in operations and to take corrective measures for proper working.
8. **Authorization:** To provide proper authority for purchase, sale, valuation, verification and possession of assets.
9. **Delegation:** To provide for division of duties among the employees where all staff members work cohesively.
10. **Accurate Planning:** To ensure that the auditor's and the accountants of the organization make all the financial reports correctly and to ensure that financial planning is done accurately.
11. **Resource Utilization:** To ensure that all the resources, i.e., men, material, money and machines of the organization are optimally used.
12. **Safeguarding of Resources:** To protect the resources of the organization against mismanagement or fraud and to ensure that the company's activities are in accordance with laws and regulations.

13. Setting future Corporate Goals: An efficient system of internal control helps the organization in goal setting. However, the organization should have certain policies, rules and regulations in place to achieve the preset goals.

2. Time Saving: Auditor can test check or sample check the transactions to ensure reliability, and accuracy of entries in the books. Hence, he can complete his audit work and prepare financial statements within the prescribed time.

2.5 Advantages of Internal Control



An audit control system can give the following advantages:

1. Detection of Errors and Frauds: Internal control systems are structured in such a way that work done by one employee in a process is checked by another without knowledge of the former. In such an environment, any fraud committed is brought to light unless there is collusion among fraudsters.

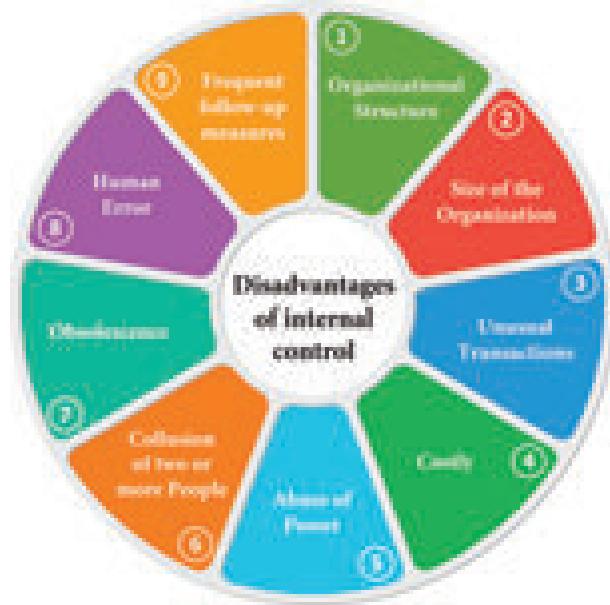
3. Minimum Scope for Errors and Frauds: Each employee does only a limited work assigned to him, moreover, consciousness of his work being independently checked by another keeps him to be always alert at work. In such a context, chances for commission of error or fraud are lesser.

4. Operational Efficiency:



It facilitates fixation of accountability, error – free work performance, accuracy reliability and authenticity of entries and eradicate inefficiency, fraud, theft, etc. Moreover, this system enables the management to assess the performance of employees. All these collectively contribute to enhance the operational efficiency of organization as a whole.

2.6 Disadvantages of Internal Control



An audit control system can give the following limitations or disadvantages:

1. **Organizational Structure:** Deficiencies in organizational structure make internal control ineffective.
2. **Size of the Organization:** Small organizations have very low levels of internal control, which are almost negligible due to more interference by owners and management.
3. **Unusual Transactions:** The internal control procedures normally fail to keep a check on unusual transactions.
4. **Costly:** The implementation of internal control procedures and processes involves incurring costs in terms of time, effort and resources.
5. **Abuse of Power:** Members at the top-level management may override or interfere with control.

6. **Collusion of two or more People:** It may lead to internal controls being over-ridden.
7. **Obsolescence:** Control system may become redundant with passage of time if not updated with change in the size and nature of business.
8. **Human Error:** Internal control fails as there are possibility of human errors.
9. **Frequent follow-up measures:** Follow-up procedures need to be frequent to ensure its effectiveness, which is extremely time-consuming.

2.7 Principles of Good Internal Control System



An effective or good system of internal control should have the following principles:-

1. **Well-designed Accounting System:** Internal control should provide for a well designed accounting system. The financial and accounting activities must be separated. For example, person who

is responsible in handling cash (cashier) and the person who accounts cash (accountant) should be done by two different persons.

2. **Competent Personnel:** In any internal control system, personnel are the most important element. When the employees are competent and efficient in their assigned work, the internal control system can be worked and operated efficiently and effectively even if some of the other elements of the internal control system are absent.
3. **Division of Work:** This refers to the procedure of division of work properly among the employees of the organization. Each and every work of the organization should be divided in different stages and should be allocated to the employees in accordance with their skill and expertise.
4. **Separation of operational responsibility from record keeping:** If each department of an organization is being assigned to prepare its own records and reports, there may be a tendency to manipulate results for showing better performance. In order to ensure reliable records and information, record-keeping function is separated from the operational responsibility of the concerned department.
5. **Separation of the custody of assets from accounting:** To protect against misuse of assets and their misappropriation, it is required that the custody of assets and their accounting should be done by separate persons. When a particular

person performs both the functions, there is a chance of utilizing the organisation's assets for his personal interest and adjusting the records to relieve himself from the responsibility of the assets.

6. **Supervision:** Directors should review the company's financial operations and position at regular and frequent intervals. Comparison with results for previous periods indicates discrepancies that call for further examination. Where budgetary control is in use, attention will be drawn to material variances and explanations required. From time to time, special reviews of particular items such as stocks, or the operation of the wages department, should be undertaken.
7. **Sound Practice:** Sound practices of administration require that established procedures, policies and delegation of responsibility should be open to all employees of the organisation. This helps in avoiding doubts, attempts to shift responsibility for unsatisfactory performance etc.
8. **Internal Audit:** Internal audit is a part of the whole system of internal control. It should operate independently of the internal check and in no circumstances; it should divert any one of responsibilities placed on him. It is the examination of accounts of a business concern by its employees specially appointed for the purpose. It is an independent appraisal of activity within an organization for the review of accounting, financial and other business practices.

2.8 Kinds of Internal Control



The type of internal control system to be employed in an organization depends upon the requirements and nature of the business. Generally, there are three types of Internal Control in an organisation preventive control, detective control and corrective control. These types of controls are essential for an effective internal control system. From a quality standpoint, preventive controls are essential because they are proactive and emphasize quality. However, detective controls play a critical role by providing evidence that the preventive controls are functioning as intended.

1. Preventive Controls: Preventive controls are designed to discourage errors or irregularities from occurring. They are proactive controls that help to ensure departmental objectives are being met. Examples of preventive controls are:

- **Segregation of Duties:** Duties are segregated among different people to reduce the risk of error or inappropriate action. Normally, responsibilities for authorizing transactions (approval),

recording transactions (accounting) and handling the related asset (custody) are divided.

- **Approvals, Authorizations, and Verifications:** Management authorizes employees to perform certain activities and to execute certain transactions within limited parameters. In addition, management specifies those activities or transactions that need supervisory approval before they are performed or executed by employees. A supervisor's approval (manual or electronic) implies that he or she has verified and validated that the activity or transaction conforms to established policies and procedures.
- **Security of Assets (Preventive and Detective):** Access to equipment, inventories, securities, cash and other assets is restricted; assets are periodically counted and compared to amounts shown on control records.
- 2. **Detective Controls:** They are designed to find errors or irregularities after they have occurred. Examples of detective controls are:

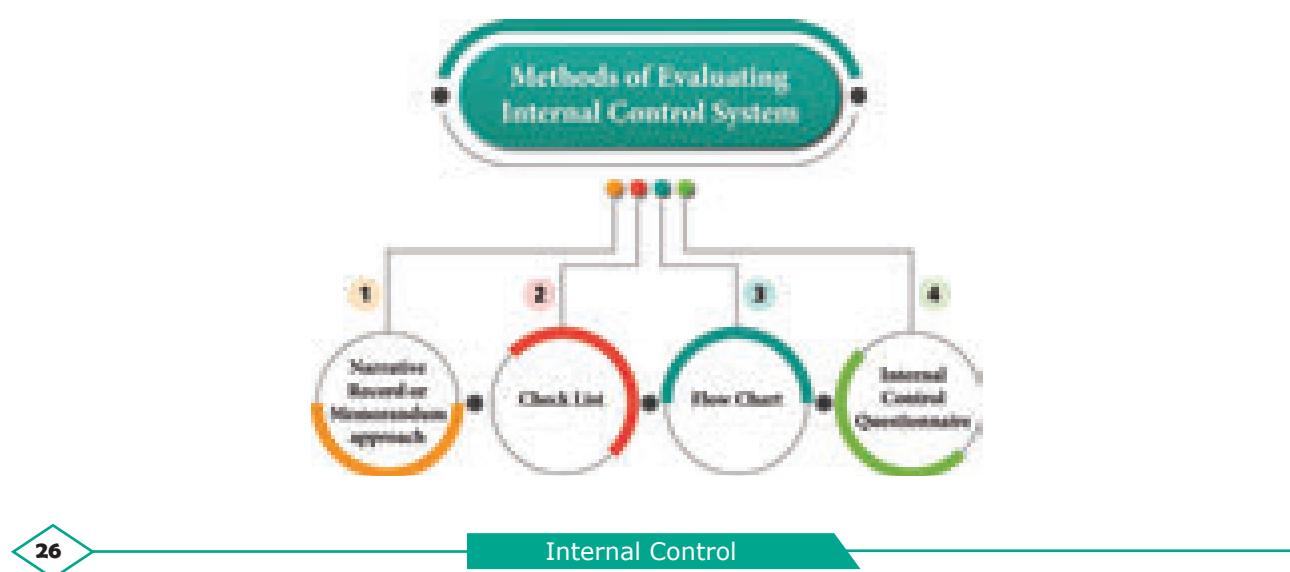


- **Reviews of Performance:** Management compares information about current performance to budgets, forecasts, prior periods, or other benchmarks to measure the extent to which goals and objectives are being achieved and to identify unexpected results or unusual conditions that require follow-up.
 - **Reconciliations:** An employee relates different sets of data to one another, identifies and investigates differences, and takes corrective action, when necessary.
 - Physical Inventories
 - Audits
- 3. **Corrective Controls:** Corrective controls target at the correction of errors and irregularities as soon as they are detected.

2.10 Auditor's Duty in Evaluating the System of Internal Control

1. **Understand the System:** The auditor should understand the control system by discussing with personnel at various levels in the organisation. He should also refer to organisation charts and manuals for this purpose.
2. **Determining the Reliability:** The management installs and maintains an adequate internal control system taking into account the nature and size of the business. It is the duty of an auditor to establish a basis or degree of reliance on the system of control.
3. **Determining the Adequacy:** The auditor should apply various compliance tests in order to determine the adequacy of internal control system.
4. **Review and Evaluation:** Auditor should critically review and evaluate the internal control system to determine the efficiency of its operations. If there is a good system of internal control the work of an auditor becomes easy.

2.9 Methods of Evaluating Internal Control System



The following are the methods of evaluating internal control system:

1. Narrative Record or Memorandum

Approach: It is a complete and exhaustive descriptive record of the system. It is appropriate in circumstances where a formal control system is lacking, like in case of small businesses. Gaps in the control system are difficult to identify using a narrative record.

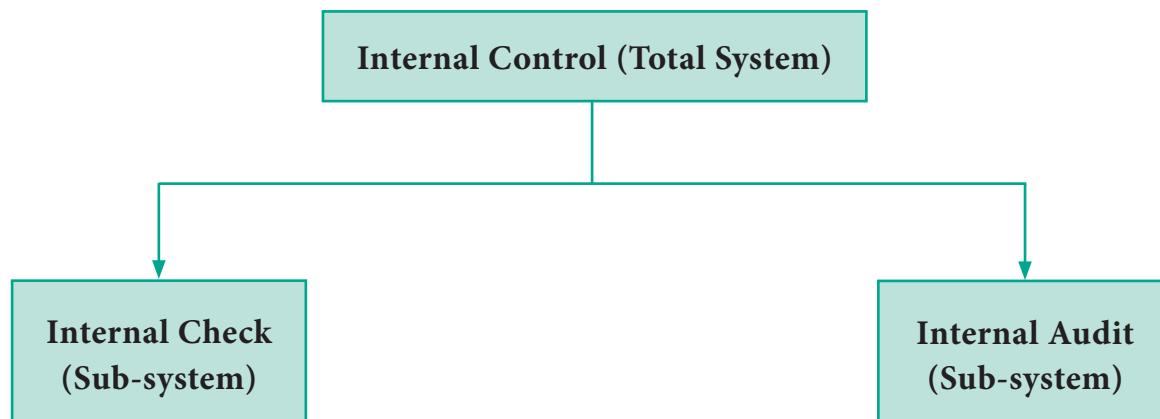
2. Check List: It is a series of instructions that a member of the audit staff is required to follow. They have to be signed or initialled by the audit assistant as proof for having followed the instructions given. A specific statement is required for every weakness area.

3. Flow Chart: It is a pictorial representation of the internal control system depicting its various elements such as operations, processes and controls, which help in giving a concise and comprehensive view of the

organization's working to the auditor. A complete flow chart would depict the process of raising documents, personnel involved in doing so, the flow of documents through various departments, maintenance of records, flow of goods and consideration, and dealing with results. The internal control evaluation process becomes easier through a flow chart as a broad picture of all the controls involved can be gauged in a glimpse.

4. Internal Control Questionnaire: This is the most widely used method for collecting information regarding the internal control system and involves asking questions to various people at different levels in the organization. The questionnaire is in a pre-designed format to ensure collection of complete and all relevant information. The questions are formed in a manner that would facilitate obtaining full information through answers in "Yes" or "No".

2.11 Differences between Internal Check and Internal Control



The Points of distinction between internal check and internal control are as follows.

S.No	Basis	Internal Check	Internal Control
1.	Meaning	A system of allocation of responsibility, division of work, and methods of recording transactions, whereby the work of an employee is checked continuously by another.	It consists of all the methods and procedures adopted to assist in achieving the objective of efficient conduct of business. It includes internal check and internal audit.
2.	Scope	It operates in routine to double check every part of a transaction at the time of occurrence and recording of the same.	In internal control systems, work of one person is automatically checked by another.
3.	Objective	Its objective is to ensure that no employee has exclusive control over any transaction or group of transactions and their recording in the books.	Its object is to ensure adherence to management policies, safeguarding of assets, prevention and detection of frauds and errors, accuracy and completeness of accounting records.
4.	Point of Time	Methods of recording transactions are devised where work of an employee is checked continuously by correlating it with the work of others.	In internal control system, checking is done simultaneously with the conduct of work. Every transaction is checked as soon as it is entered.
5.	Thrust of System	The thrust of internal check system is to prevent errors.	The thrust of internal control lies in fixing of responsibility and division of work to avoid duplication.
6.	Cost Involved	It is a part of internal control and a method of division of work, therefore does not add to the cost.	The system proves to be costly in case of small businesses because more number of employees are engaged.
7.	Report	The summary of day to day transactions work as report to the senior.	Internal control provide for built in MIS reports.

Picture showing a sequence of food serving in a function.

Discuss whether it is internal control or internal check.



STUDENTS ACTIVITY



1. Discuss the internal control system for cash deposits and withdrawals in a bank.
2. Visit a company and discuss with stores manager regarding internal control system followed for material management.
3. MOCK Bank: Set up a model bank in your classroom and discuss the procedure for deposits, withdrawal and sanctioning of loans.
4. If you are residing in a gated community, discuss about the security system followed in your campus.

SUMMARY

- **Internal control** is the overall control environment established by management of an enterprise for effective and efficient monitoring and control of its operations. It aims at adherence to management policies, safeguarding of assets of the enterprise, proper accounting and record of the business transactions. The type of internal control system to be employed in an organization depends upon the requirements and nature of the business. Generally, there are three types of Internal Control in an organization namely; preventive, detective and corrective controls.

KEY TERMS

- **Internal Control** –A system refers to the whole system of controls, financial or otherwise, established by the management in the conduct of a business including internal check, internal audit and other forms of control.
- **Preventive Controls**– It is designed to discourage errors or irregularities from occurring.
- **Detective Controls**- It is designed to find errors or irregularities after they have occurred.
- **Narrative Record** - It is a complete and exhaustive description of the system. It is appropriate in circumstances where a formal control system is lacking, like in the case of small businesses.
- **Flow Chart** - It is a pictorial representation of the internal control system depicting its various elements such as operations, processes and controls, which help in giving a concise and comprehensive view of the organization's working to the auditor.
- **Internal Control Questionnaire:** It is the most widely used method for collecting information regarding the internal control system and involves asking questions to various people at different levels in the organization. The questionnaire is in a pre-designed format to ensure collection of complete and all relevant information.



EVALUATION



I. Multiple Choice Questions:

1. Internal control is
 - a. Part of internal check
 - b. A part of internal audit
 - c. Whole system of control employed by management
 - d. Examination of reliability of transaction
 2. Which of the following is used for evaluation of internal control?
 - a. Internal questionnaire approach
- b. Flow chart method
c. Narrative approach
d. All of the above
3. Representation of the entire control system in diagram under evaluation system.
 - a Flow chart method
 - b Narrative approach
 - c Internal questionnaire approach
 - d All of the above

4. Under which of the following methods the auditor evaluates control by observation and writes down?
- Oral approach
 - Narrative approach
 - Flow chart
 - Questionnaire method
5. Check list contains the instruction to be followed by the _____
- Internal auditor
 - External auditor
 - Audit assistants
 - Employee of the organisation
6. An auditor should study and evaluate internal controls to
- determine whether assets are safeguarded
 - Suggest improvements in internal control
 - Plan audit procedures
 - express and opinion
7. A flow chart, made by the auditor, of an entity's internal control system is a graphic representation that depicts the auditor's.
- understanding of the system
 - understanding of fraud risk
8. factors
- c documentation of assessment of control risk
- d the auditor and his audit assistants
8. Internal Control Questionnaire contains the questions need to be followed by the _____.
- Employer
 - Employee
 - Auditor
 - Banker
9. The effectiveness of internal control system determines the extent of checking done by the _____
- Management
 - Auditor
 - Accountant
 - None of the above
10. Proper segregation of duties reduces the opportunities in which a person would both
- establish controls and executes them
 - records cash receipts and cash payments
 - perpetuate errors and frauds and conceals them
 - record the transaction in journal and ledger.

Answers 1.(c), 2.(d), 3.(a), 4.(c), 5.(c), 6.(c), 7.(a), 8.(b), 9.(b), 10.(c),

II. Very Short Answer Questions

1. What is internal control?
2. Define internal control
3. What is meant by narrative approach?
4. What is flow chart method of evaluation?
5. What is internal control questionnaire?
6. What is check list?

III. Short Answer Questions

1. State the objectives of internal control.
2. What are the kinds of internal control?

IV. Essay Type Questions

1. What are the advantages and disadvantages of internal control system?
2. Explain the principles of good internal control system.
3. Discuss the methods of evaluating internal control system.
4. Differentiate internal control from internal check.

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Chapter

3

INTERNAL AUDIT



Learning Objectives

- To understand the meaning, definition, objectives, benefits and drawbacks of internal audit.
- To identify the differences between internal check, internal control and internal audit.

POINTS TO RECALL

RECAP

In the previous lesson, we have studied meaning and importance of internal Control, advantages and disadvantages, Principles of good internal control system, kinds of Internal Control, Methods of evaluating internal control system and Difference between Internal Check and Internal Control.

3.1 Introduction

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

Internal auditing is a catalyst for improving an organization's governance, risk management and management controls by providing insight and recommendations based on analysis and assessments of data and business processes with commitment to integrity and accountability.

Internal auditing provides value to governing bodies and senior management as an objective source of independent advice. The auditor's appointed to perform the internal audit activity are called as Internal auditor's.

3.2 Meaning

It is an audit conducted on a continuous basis by the employees of the organization appointed specially for this purpose, to review the operations and to offer suggestions to improve the efficiency. Audit which is conducted internally, i.e., within the organisation on behalf of the management is called as Internal Audit. The person who



conducts such an audit is called as Internal Auditor.

Internal auditor need not be a Chartered Accountant and need not possess the qualifications prescribed by the Companies Act. The appointment, scope of work, remuneration etc. of an internal auditor are determined by the

management. The internal auditor works as a part of the employee and is remunerated in the form of salary by the management. Internal auditor works on a continuous basis verifies the transactions that takes place in a company and after examination submits a report to the management called as Internal Audit Report.

The term Management refers to the Chairman, Directors, Board of Directors, Chief Executive Officers (CEO) of the company.

3.3 Definition

- According to **Walter B. Meigs** “Internal auditing consists of a continuous critical review of financial and operating activities by a staff of auditor’s function as full-time salaried employees”
 - According to **The Institute of Internal Auditor’s, USA**, “Internal auditing

is an independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization. It is a type of control which functions by measuring and evaluating the effectiveness of other types of control”



3.4 Objectives of Internal Audit

The objectives of Internal Audit or the duties of an Internal auditor are as follows:



1. Verify the Accuracy of Accounts:

The primary aim of internal audit is to verify the correctness and accuracy of the financial records and accounts that are being presented to the management.

2. Detection of Errors and Frauds:

Internal auditor has to adopt suitable techniques and measures to detect errors and frauds, which are likely to be committed in the organization.

3. Review the Internal Check and Control System:

The auditor has to review and comment on the effective function of the internal check and internal control system within the organization. Any deviation in the function of the system should be reported to the management and the auditor should initiate suitable recommendations.

4. Verify the Assets of the Company:

Internal auditor should verify the existence of the assets in the company

and should verify that proper measures are taken to protect or maintain the assets. He should also verify that assets are purchased or sold or replaced only with the approval of an authorized person.

5. Verify the Liabilities: The internal auditor has to verify that the liabilities incurred by the organization are legitimate and they are likely to be incurred for the organizational activities.

6. Adherence to Accounting Standards:

Internal auditor has to ensure that the Accounting Standard practices are followed by the organization are strictly adhered.

7. Review the Managerial Functions:

Internal auditor has to review the managerial functions of an organization and has to report on them to the management.

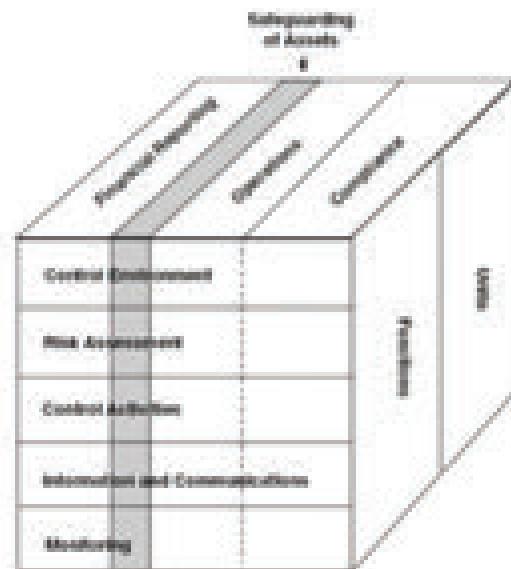


3.5 Scope (or) Functions of Internal Auditor



- 1. Evaluating of Accounting and Administrative Control:** Internal auditing ensures effective and efficient system of accounting control, standard costing, budgetary control and all other administrative controls.
- 2. Protection of Assets:** Internal auditing besides ensuring proper accounting and custody of companies asset's it is concerned with the protection of the assets. It reports to the management about the utilization of the asset and the adequacy of return from the investment.

- 3. Compliance with Established Policies and Procedures:** Internal auditing is concerned with reporting to the management about the compliance of the predetermined policies, procedures and standards of performance.
- 4. Reliability and Validity of Reports:** Internal auditing ascertains the reliability of financial and operating reports prepared throughout the enterprise. It also provides assurance to the management of the validity of the reports and records. Internal auditing brings to light the inadequacies in the check and control system in operation to the management. Further, it provides advisory services to the management for the improvement of the system.



Comparison between Internal Audit and External Audit

Internal Audit

- Audit conducted internally i.e., by the management to ensure that the company complies with the policies, procedures and principles.
- The person who conducts internal audit is called as Internal Auditor, who is appointed by the management. The scope of work, powers and duties of internal auditor are determined by the management.
- Internal Auditor need not be a qualified Chartered Accountant and is remunerated in the form of salary as he is an employee of the company.
- Internal auditor has to submit an Internal Audit report to the management.



External Audit

- Audit conducted externally i.e., by the shareholders to examine the accuracy of the books of accounts, records and financial statements.
- The person who conducts external audit is called as Statutory or External Auditor who is appointed by the shareholders of the company. The scope of work, powers and duties of statutory auditor are determined by the Companies Act.
- Statutory Auditor should be a qualified Chartered Accountant and is remunerated in the form of audit fees as he is an independent person.
- Statutory auditor submits Statutory Audit report to the shareholders of the company.

3.6 Advantages of Internal Audit

The advantages of conducting an Internal audit are as follows:



1. **Detection of Errors and Frauds:** Internal audit is a continuous and critical examination of books of accounts and records of the organization; hence errors and frauds can be easily detected and prevented.

2. **Quick Presentation of Accounts and Reports:** Transactions and postings in the books of accounts reviewed on a regular basis, which facilitates quick presentation of accounts and reports to the management. It also enables the external auditor to finalize the accounts quickly as the external auditor relies on the report submitted by the internal auditor.

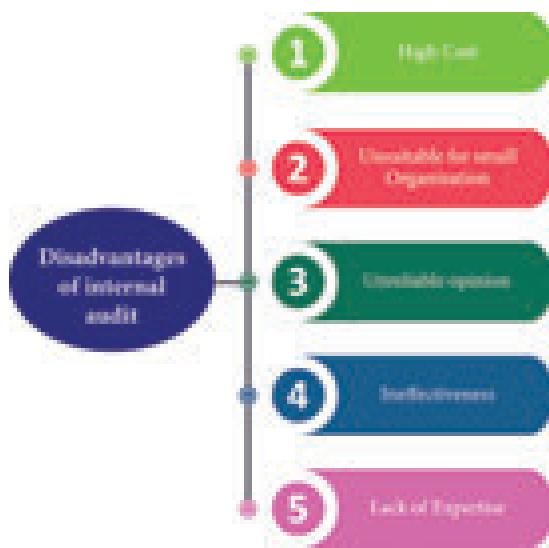
3. **Advisory Services to Management:** Internal auditor who possess in depth knowledge of the business organization provides advisory services to the management like introduction of new product, improving the system of internal check and control to operations, etc.

4. **Proper Co-ordination and Control:** Internal audit coordinates the various operational or functional areas of business. It is the duty of the internal auditor to appraise and evaluate the efficiencies of the various control systems established in the organization. Hence, internal audit enables proper control and coordination in the organization.



3.7 Disadvantages of Internal Audit

The following are the limitations or disadvantages of Internal Audit:



1. **High Cost:** The cost of establishing and operating an internal audit in an organization is very expensive.

2. **Unsuitable for Small Organization:** Internal audit due to involvement of high cost is not suitable for small organizations.
3. **Unreliable Opinion:** Internal auditor's are employees of the organization and hence the report given by them may not be true and fair. Often, external auditor has reservations about the opinions expressed by the internal auditor.
4. **Ineffectiveness:** When the records of operations are not checked immediately after they are completed or when there is time lag between two audits, internal audit may become ineffective.
5. **Lack of Expertise:** Internal audit staff lacks the required skill and expertise as they are not professionally qualified chartered accountant.

3.8 Differences Between Internal Check and Internal Audit

S.No.	Basis	Internal Check	Internal Audit
1.	Meaning	Internal check is an arrangement of work in such a way that another person automatically checks the work of one person.	Internal audit is an independent appraisal of the operations of the company.
2.	Objects	The object of internal check is to prevent the occurrence of errors and frauds.	The object of internal audit is to detect errors and frauds.
3.	Scope of work	Internal check is considered as a device for doing the work.	Internal audit is a device for checking the work.
4.	Discovery of errors and frauds	In internal check errors and frauds are discovered during the course of doing the work.	In internal audit errors and frauds are discovered after the completion of the work.



S.No.	Basis	Internal Check	Internal Audit
5.	Commencement of work	Internal check is in operation during the course of transactions.	Internal audit commences only when accounting process is completed.
6.	Performance of work	In internal check no new staff is appointed to perform the work.	In internal audit the work is performed by a separate group of persons specifically appointed for this purpose.

3.9 Differences Between Internal Control and Internal Audit

S.No.	Basis	Internal Control	Internal Audit
1.	Meaning	Internal control is an arrangement of duties allocated in such a way that the work of one employee is automatically checked by another.	Internal audit is an independent review of operations and records undertaken by the staff specially appointed for this purpose.
2.	Objective	The system of internal control is devised in such a way that errors and frauds are minimized.	In internal audit errors and frauds already committed are discovered.
3.	Scope of work	In internal control the work is allocated to different employees in such a way that the work of one person is independently checked by other.	In internal audit the work of a clerk is checked by an internal auditor only after the former has completed his work.
4.	Work performance	In internal control there is no separate staff engaged to carry out the system.	In internal audit a separate staff is specially engaged for carrying out the work.
5.	Conduct	Internal control is a device for keeping a check on work.	Internal audit checks the work done in the light of policies and procedures as laid down by the management.



STUDENTS ACTIVITY



1. Prepare a flow chart for accounting your family expenditure based on monthly income.
2. Visit a nearby large scale industry and discuss with internal auditor's regarding their appointment and their scope of work.
3. Arrange for a guest lecture with an internal auditor of a company and discuss the control over accounts and reporting to the management.

SUMMARY

- **Internal Audit – Meaning:** Internal audit is an audit which is conducted on a continuous basis by the employees of the organization appointed specially for this purpose to review the operations and records of the organization and to offer suggestions to improve the efficiency.
- **Objects of Internal Audit:** The objects of internal audit are to check the accuracy of accounts, to review the internal control system, to protect the company assets, and to ensure that the company adheres to the accounting standards.
- **Advantages:** Internal audit helps in early detection of errors and frauds, quick presentation of accounts and reports, provides advisory services to management, benefits staff members and provides for proper co-ordination and control.



- **Disadvantages:** The draw backs of internal audit are it involves high cost, unsuitable for small organization, lack of expertise, conflicts between internal audit staff and other staff.
- **Difference between Internal Check, Internal Control and Internal Audit:** Internal Check, Internal Control and Internal Audit are complementary to each other as both are the two parts of the whole system of internal control. There exists a difference between the two systems.



KEY TERMS

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



EVALUATION



318XGP

I. Multiple Choice Questions:

1. The Internal Audit is conducted by _____
 - a. Government Auditor
 - b. External Auditor
 - c. Internal Auditor
 - d. Cost Auditor
2. The main objective of Internal Audit is _____
 - a. Detection of errors and frauds
 - b. Regular recording of business transactions
 - c. Preparation of financial statement
 - d. Preparation of audit report
3. Internal Auditor is appointed by _____
 - a. Board of directors
 - b. The business concern
 - c. Shareholders
 - d. Government
4. The internal audit is carried at _____
 - a. The end of the year
 - b. Throughout the year
 - c. Regular intervals
 - d. After the accounts are closed



5. The objective of internal audit is

 - a. To verify the accuracy of accounts
 - b. To review the internal control system
 - c. To detect errors and frauds
 - d. All the above
6. Which ensures the effective and efficient system of accounting control
 - a. Internal Audit
 - b. Internal Control
 - c. Internal Check
 - d. Computerised Accounting
7. Which audit ensures the reporting to the management about compliance of policies and standards of performance
 - a. Internal Audit
 - b. Internal Control
 - c. Internal Check
 - d. Annual Audit
8. Which provides advisory services to the management for its improvement
 - a. Internal Check
 - b. Internal Audit
 - c. Internal Control
 - d. Audit Report
9. Internal Audit is not suitable for
 - a. big organizations
 - b. small organisations
 - c. private Companies
 - d. Public Companies
10. Internal Audit is not suitable for small organisations because it is
 - a. Costly
 - b. Cheaper
 - c. Done by employee of the concern
 - d. none of the above

[Answers 1.(c), 2.(a), 3.(b), 4.(b), 5.(d), 6.(a), 7.(a), 8.(b), 9.(b), 10.(a)]

II. Very Short Answer Questions

1. What do you mean by internal audit?
2. Define Internal Audit.
3. Who is an Internal Auditor?
4. How is an Internal auditor appointed?
5. Write a note on Internal Audit Report.

III. Short Answer Questions

1. Briefly explain the scope of Internal Audit.
2. What are the Advantages of Internal Audit?
3. What are the Disadvantages of Internal Audit?
4. Write a short note on Internal Audit.



IV. Essay Type Questions

1. What are the advantages and disadvantages of internal Audit?
2. Explain the duties of an Internal Auditor.
3. Discuss the objectives of Internal Audit.
4. Differentiate Internal Check with Internal Audit.
5. Differentiate Internal Control with Internal Audit.

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Learning Objectives

- To determine the meaning of verification and valuation of assets.
- To describe the procedure of verification and valuation of various fixed assets.
- To explain the procedure of verification and valuation of investments.

POINTS TO BE RECALL

RECAP

The following points are to be recalled before learning Verification and Valuation of Fixed Assets:

- Meaning and Definition of Internal Audit.
- Objectives of Internal Audit.
- Advantages and Disadvantages of Internal Audit.
- Difference between Internal Check and Internal Audit.
- Difference between Internal Control and Internal Audit.

4.1 Verification

4.1.1 Meaning

Verification means the act of assuring the correctness of value of assets and liabilities in the organization. It refers to the examination of proof of title and their existence or confirmation of assets and liabilities on the date of Balance Sheet. It usually indicates verification of assets of any organization, which can be done by examination of values, ownership, existence, possession of any assets and also ensures that the assets are free from any charge. In simple words,

verification means, ‘proving the truth or confirmation’.

4.1.2 Definition

- **Spicer and Pegler** defines Verification as, “An inquiry into the value, ownership and title, existence and possession and the presence of any charge on the asset”.
- **J. R. Batliboi** defines it as, “The auditor must satisfy himself that assets really existed at the date of the Balance Sheet and were free from any charge and that they have been properly valued”.

- **The Institute of Chartered Accountants of India** defines verification as, “It aims at establishing (a) existence, (b) ownership, (c) possession, (d) freedom from encumbrances, (e) proper recording, (f) proper valuation”.

4.1.3 Objectives

The objectives of verification are as follows:

1. To show the correct value of assets and liabilities.
2. To know whether the Balance Sheet exhibits a true and fair view of the state of affairs of the business.
3. To find out the ownership, possession and title of the assets appearing in the Balance Sheet.
4. To find out whether assets are in existence.
5. To detect frauds and errors, if any while recording assets in the books of the concern.
6. To find out whether there is an adequate internal control regarding acquisition, utilization and disposal of assets.
7. To verify the arithmetic accuracy of the accounts.
8. To ensure that the assets have been properly recorded.

4.1.4 Auditor's Duty Regarding Verification

The auditor of a business is required to report in concrete terms that the Balance Sheet exhibits a true and fair view of the state of its affairs. In other words, he has to examine and ascertain the correctness of the money value of assets and liabilities appearing in the Balance Sheet and this

examination is known as verification of assets and liabilities. Therefore, an auditor has to keep in mind the following points while verifying the assets:

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

4.2 Valuation

4.2.1 Meaning

Valuation means finding out correct value of the assets on a particular date. It is an act of determining the value of assets and critical examination of these values on the basis of normally accepted accounting standard. Valuation of assets is to be made by the authorized officer and the duty of auditor is to see whether they have been properly valued or not. For ensuring the proper valuation, auditor should obtain the certificates of professionals, approved values and other competent persons. Valuation is the primary duty of company officials. Auditor can rely upon the valuation of concerned officer but it must be clearly stated in the report because an auditor is not a technical person. Without valuation, verification of assets is not possible.

If the valuation of assets is not correct, both the financial statements such as Balance Sheet and Profit and Loss Account cannot be correct. Hence, the auditor must take utmost care while valuing the assets to show true and fair view of the state of affairs of the financial position of the concern.

4.2.2 Definition

- **J.R.Batliboi**, “A company’s Balance Sheet is not drawn for the purpose of showing what the capital would be worth if the assets were realized and liabilities paid-off, but to show how the capital stands invested”.
- **Joseph Lancaster**, “The valuation of assets is therefore an attempt to equitable distribution of the original outlay on the period of the assets usefulness”.

4.2.3 Objectives of Valuation

1. To assess the correct financial position of the concern.
2. To enquire about the mode of investment of the capital of the concern.
3. To assess the goodwill of the concern.
4. To evaluate the differences in the value of the asset as on the date of purchase and on the date of Balance Sheet.

4.2.4 Methods Of Valuation

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

1. Cost Price Method

In this method, valuation of assets is made on the basis of purchase price of the assets. This price refers to the price at which an asset is acquired plus expenses incurred in connection with the acquisition of an asset. It is a very simple method of valuing assets.

2. Market Value Method

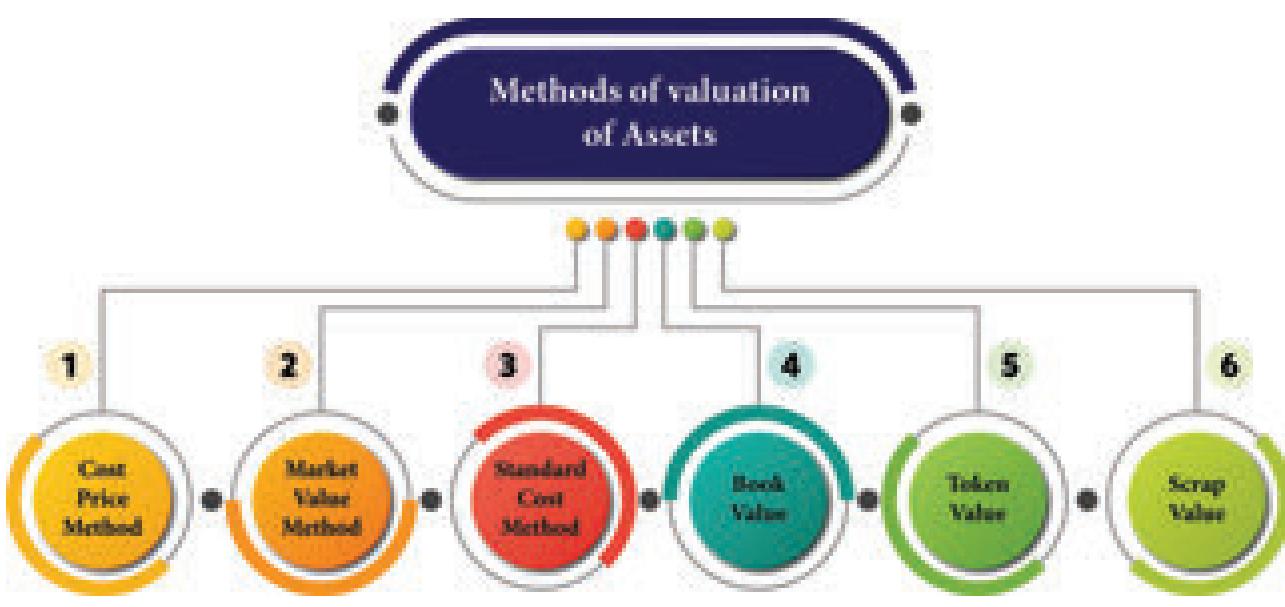
Valuation of assets can be made on the basis of market price of such assets. But if same nature of assets is not available in the market, it is very difficult to determine the value of such assets. So, there are two methods related to it. They are:

i. Replacement Value Method

It represents the value at which a given asset can be replaced. This method of valuation of assets can be done only in the case of replacement of the same asset.

ii. Net Realizable Value

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



3. Standard Cost Method

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

4. Book Value

This is the value at which an asset appears in the books of accounts. It is usually the cost less depreciation written off so far.

5. Historical Value or Conventional Value or Token Value

It is equivalent to the cost less a reasonable amount of depreciation written off. No notice is taken of any fluctuation in the price of the assets. Reason for this is that these assets are acquired for use in the business and not for resale.

6. Scrap Value

This method shows the value realized from sale of an asset as scrap. In other words, it refers to the value, which may be obtained from the assets if it is sold as scrap.

| 4.2.5 Auditor's Duty as Regards Valuation

In a legal case against Kingston Cotton Mills Co: It was held that “although it is no part of an Auditor's' duty to value the assets and liabilities, yet he must exercise reasonable skill and care in scrutinizing the basis of valuation. He should test the accuracy of the values put by the officers of the business. In any case, the auditor cannot guarantee the accuracy of the valuation”.

It is not an auditor's duty to determine the values of various assets. It has been

judicially held that he is not a valuer or a technical man to estimate the value of an asset. But he is definitely concerned with values set against the assets. He has to certify that the profit and loss account shows true profit or loss for the year and Balance Sheet shows a true and fair view of the state of affairs of the company at the close of the year. Therefore he should exercise reasonable care and skill, analyse all the figures critically, inquire into the basis of valuation from the technical experts and satisfy himself that the different classes of assets have been valued in accordance with the generally accepted assumptions and accounting principles. If the market value of the assets are available i.e., in the case of share investment then he should verify the market value with the stock exchange quotations. If there is any change in the mode of the valuation of an asset, he should seek proper explanation for it. If he is satisfied with the method of valuation of the assets he is free from his liability.

| 4.2.6 Importance of Verification and Valuation of Assets

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

Importance of Verification and Valuation of Assets



valuation of assets is very important for business and their importance is highlighted below.

1. Showing the Actual Financial Position

Balance Sheet is prepared to show the actual financial position of a business. If proper valuation is not made, such Balance Sheet does not provide true and fair information. So, to provide information about the real financial position, verification and valuation of assets are essential.

2. Ascertaining the Real Position of Profit or Loss:

Depreciation and other expenses on assets will be incorrect if proper valuation of assets is not made. So, to calculate the actual amount of profit or loss, proper valuation of assets and liabilities is necessary.

3. Increase Goodwill

Proper valuation gives fair information about profitability and financial

position of a business. So, people can get information which creates positive attitude towards company. The positive attitude of public can increase the goodwill of the concern.

4. Assures Safe Investment to Shareholders

Verification and valuation provide actual information about assets and liabilities to the shareholders which assure safety of their investment.

5. Easy for Sale

At the time of sale of the company, it can be sold at the price which is enlisted in the Balance Sheet, but the assets whose valuation is not made need valuation before selling the company.

6. Easy to Get Loan

Companies disclose the Balance Sheet signed / examined by auditor for public knowledge which increases the trust on the company. Hence, companies can easily obtain loan from financial Institutions.

7. Easy to Get Compensation

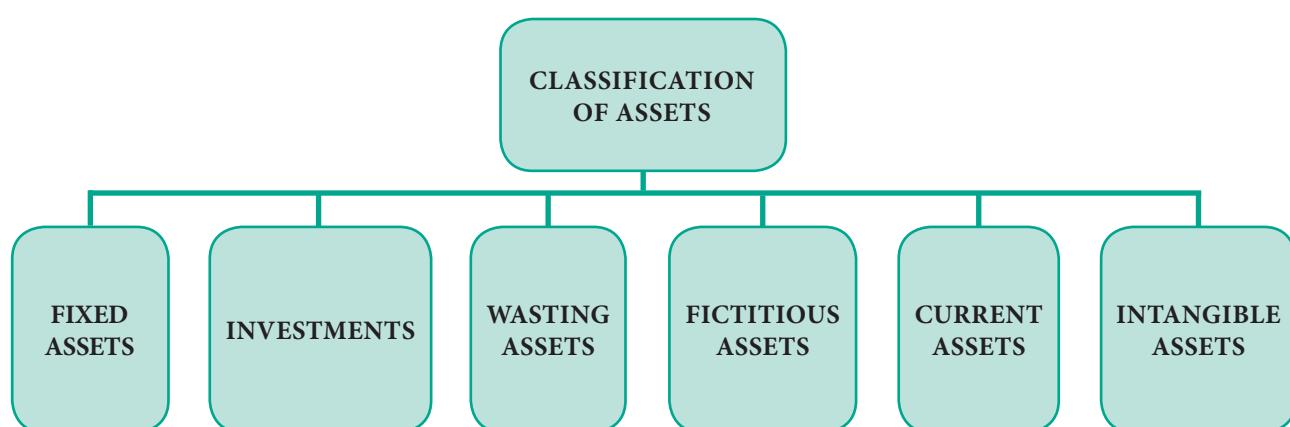
Whenever the loss occurs due to any incident, insurance company provides compensation on the basis of valuation of assets. So, the company can easily get compensation.

4.2.7 Differences Between Verification and Valuation

Verification and valuation are interlinked and interdependent. It is a combined process by which the position of different assets appearing in the Balance Sheet is examined. However, the following are the differences between the two terms.

S. No.	Basis	Verification	Valuation
1.	Meaning	Verification establishes existence, ownership and acquisition of assets.	Valuation certifies correctness of the value of assets and liabilities.
2.	Evidence	The title deed, receipt for payments constitutes documentary evidence for verification.	The Certificate offered by the owner or directors or experts is the documentary evidence for valuation.
3.	Checking	The auditor is required to verify whether the value ascertained is fair one or not.	Critical examination of the value of assets and comparative analysis of different assets.
4.	View	Verification includes apart from valuation, the examination of ownership right, the existence of the asset in the business and its freeness from any sort of charge.	Testing the exact value of an asset on the basis of its utility.
5.	Work	Verification is a final work.	Valuation is the initial work and it need to be verified subsequently.
6.	Personnel	Verification is the work of auditor.	Valuation is the work of concerned authority or board(company).
7.	Time	Verification is made at the end of the year.	Valuation is made throughout the year.

4.3 Classification of Assets



1. Fixed Assets

Fixed assets are utilized to create incomes.

2. Investments

Investments are expected to fetch income from external agencies.

3. Wasting assets

Wasting assets are of a fixed nature but depleted or consumed gradually.

4. Fictitious Assets

Assets, which have no market values, are known as fictitious assets. They are shown in the Balance Sheet on the asset side of it under the head "Miscellaneous Expenditure".

5. Current Assets.

Current assets are those which are utilized or converted into cash within one year period.

6. Intangible Assets

They are long-term resources of an entity, but have no physical existence. They derive their value from intellectual or legal rights, and from the value they add to the other assets.

LEGAL DECISIONS

Case Study: The duty of the auditor with regard to the verification of assets came before the court in the famous case of:

The London Oil Storage Co. Ltd.

Vs.

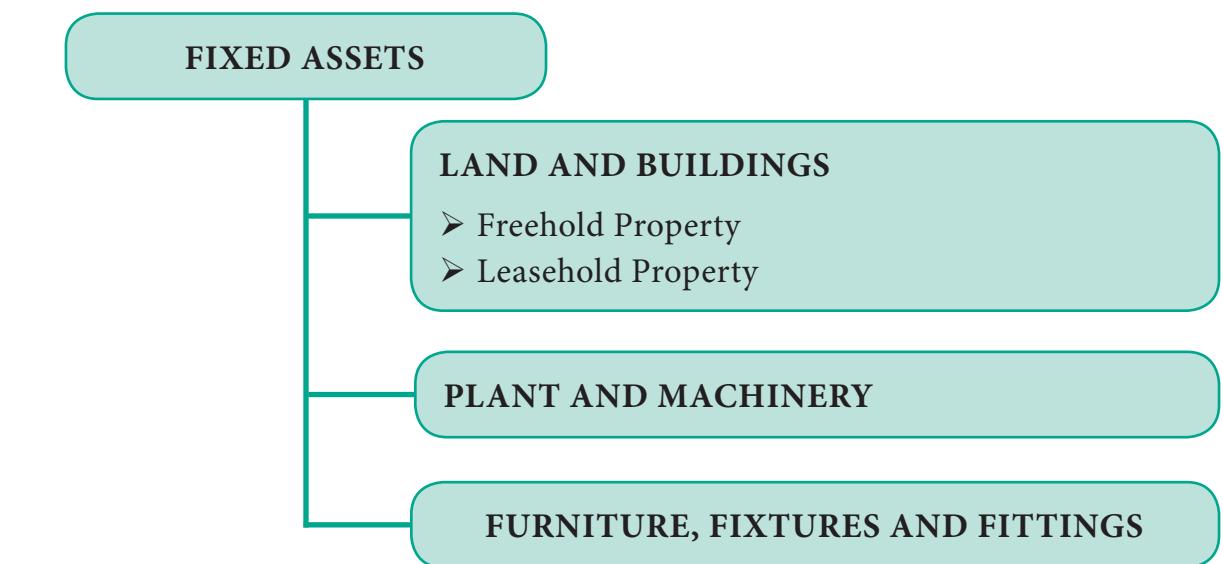
Seear Hasluck and Co. (1904)

It was then held that it is the duty of the auditor to verify the existence of assets stated in the balance sheet; and that he (Auditor) will be liable for any damage suffered by the client if he fails in his duty.

4.4 Verification and Valuation of Fixed Assets

Fixed assets are a permanent nature with which the business is carried on and which are held for earning income and not for re-sale in the ordinary course of the business. It is a long-term tangible property that a firm owns and uses in its operations to generate income. Fixed assets are not converted into cash or consumed within a year. They are also

called as Capital Assets. Example: land and buildings, plant and machinery, furniture etc. These assets are to be valued at cost price less total depreciation in their value by constant use. Additions by way of purchase and deletions by way of sales should be taken into account. 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. Verification of Fixed Assets can be explained as follows:



4.4.1 Land and Buildings



Land means a long-term asset that refers to the cost of real property exclusive of the cost of any constructed assets on the property. The value of land has an appreciated value and is not subject to depreciation. A building is a noncurrent or long-term asset which shows the cost of a building (excluding the cost of the land). Buildings will be depreciated over their useful life of the asset.

- **Classified into two types**

Land and Buildings can further be classified as –

- A Freehold property.
- B Leasehold property

(A) Freehold Property

A property which is free from hold (Possession/Rights) is called as freehold property. This means that the property is free from the hold of anybody besides the owner who enjoys complete ownership.

Auditor's Duty

1. Where Freehold property has been purchased, the auditor should examine the title deeds e.g., purchase deed, certificate of registration, the broker's

note and auctioneer's account etc., to verify the correct position.

2. When the property has been mortgaged, the auditor should obtain a certificate from the mortgagee regarding the possession of title deed and outstanding amount of loan.
3. When the property has been acquired in the current year, then the cost may be verified with the help of the bank passbook. He should vouch all the payments made in this connection.
4. He should see that the property account should be shown in the Balance Sheet at cost price including the legal and registration charges less depreciation up-to-date.
5. He should also see that whether a separate account for building and land on which it is constructed is maintained. It is necessary because depreciation is provided for building and not for the land.

(B) Leasehold Property

Leasehold is an accounting term for an asset being leased. The asset is typically property such as a building or space in a building.

- The property which is on lease (rent).
- The property (plot/flat/villa/mall/factories) which is leased by the landlord for a certain period of time to the lessee (tenant /leaseholder/renter/occupant/dweller).
- The (tenants) have been given the right to use during that specified time by the landlord.
- The ownership of the property returns to the landlord when the lease comes to an end.

Comparison between Leasehold and Freehold property

Leasehold Property	Freehold Property
Land belongs to the state, leased to owner for a certain number of years	Land belongs to the owner
At the end of the lease period, owners must pay to extend the lease	Ownership is indefinite
Requires state consent (obtained at the land office) to transfer ownership	Does not require state consent to transfer ownership (except in certain specially earmarked properties)

Auditor's Duty

1. The auditor should verify this by inspecting the lease agreement or contract to find out value and duration. He should see that the terms and conditions of lease are properly complied with.
2. In case property has been mortgaged, the auditor should obtain a certificate from the mortgagee regarding the possession of title deed.
3. Where the leasehold property has been sub-let, the counter part of the tenant's agreement should also be examined.
4. The auditor should physically inspect the properties.
5. The auditor should also note that proper provision has been made for depreciation of lease problem and for any possible claims arising there under.

4.4.2 Plant and Machinery

A plant is an asset with a useful life of more than one year that is used in producing revenues in a business's operations. Plant is recorded at cost and depreciation is reported during their useful life.

Auditor's Duty

1. When the machines are purchased in the current accounting period, the invoices and the agreement with the vendors should be verified.
2. The auditor should examine the plant register in which particulars about the cost, records about sales, provision for depreciation, etc., are available.
3. He should prepare a list of each machine from the plant register and should get the list certified by the works manager as he is not a technical person and therefore he has to depend upon the advice of the works manager regarding their valuation, etc.
4. He should see that plant and machinery account is shown in the Balance Sheet at cost less depreciation after making proper adjustment for purchases and sales during the year under audit.
5. In case any plant and machinery has been scrapped, destroyed or sold, he should ascertain that the profit or loss arising thereon has been correctly determined.

A proforma of plant & machine register is given below

4.4.3 Furniture, Fixtures and Fittings

They are items of movable equipment that are used to furnish an office. Examples are chairs, desks, shelves, book cases, filing and other similar items.

Auditor's Duty

1. **Verify Invoices:** When assets have been acquired during the current accounting period, the auditor should examine the purchase invoice of the dealers.
 2. **Verify Furniture Stock Register:** He should verify furniture stock register

and ask the management to prepare an inventory to reconcile it with the stock register.

3. Verify Schedule of Previous Year:

He should compare furniture schedule of previous year with that of current year to ascertain the existence, purchase or sales of asset during the year.

4. Disclosure of Profit or Loss on Sale:

He should examine that any profit or loss on sale of furniture during the year is properly disclosed in books of accounts.

AUDITOR'S DUTY IN VERIFICATION

- 1 Verify Invoices
- 2 Verify Furniture Stock Register
- 3 Verify Schedule of Previous Year
- 4 Disclosure of Profit or Loss on Sale

VALUATION OF FIXED ASSETS

1. **Valuation of Land:** Land which does not have depreciated value, is valued at cost price.
2. **Valuation of Other Fixed Assets:** Other fixed assets like Buildings, Plant, machinery, office equipment, furniture and fixtures should be valued at going concern value.
3. **Depreciation:** Auditor should ensure that adequate amount of depreciation has been provided, taking into account the working life and usage of the asset.
4. **Disclosure in Balance Sheet:** He should verify that furniture, fittings and fixtures are disclosed in Balance Sheet at cost less depreciation.

4.5 Verification and Valuation of Investments

An investment is a monetary asset purchased with the idea that the asset will provide income in the future or will later be sold at a higher price for a profit. Investments

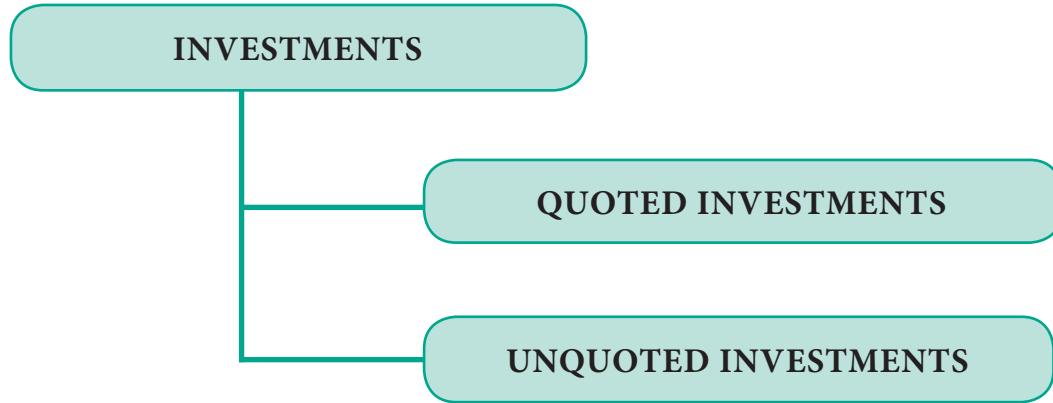
include Government securities, shares, debentures, etc. When the number of investments is very large, the auditor should ask for a schedule of investments held by the client containing various particulars like name of the securities, date of purchase, nominal value, cost price, market price, etc., and examine the same. He should ensure that the investment asset has been shown separately in the Balance Sheet.



The auditor should verify the existence of investments by personal inspection. At the same time, he should also ensure that the investments are registered in the name of the client and they are free from any charge. He should rely on the relevant vouchers and certificates to do so.

If the securities are with the trustees on behalf of the concern the auditor should examine the trust deed. In case they are under the safe custody of the banker then he should obtain the certificate from the banker and examine the same. If they are with the broker, he should examine the certificate received from the broker.

Having verified the securities, the auditor has to find out that the investments are properly valued. Generally, investments are valued at cost price or market price whichever is lower. In case there is a temporary fall in the price of the shares,



it should be ignored. But where such a fall is permanent, depreciation must be provided. Actually, the basis of valuations of investment will depend upon the purpose for which they are held. For instance, in case of trust company, the sole purpose of which is to earn interest and dividend, then such investment must be treated as fixed asset. In such cases, even the permanent fall in their value should be ignored.

The investments are classified as – (1) Quoted Investments, and (2) Unquoted Investment

4.5.1 Quoted Investment

A company's share is said to be "listed", or "Quoted" if its share can be traded on a stock exchange, i.e., Public Limited Companies.

Auditor's Duty in Verification

1. Verify the authorization for purchase of investment. Auditor should review board minute book (book which record the conclusion of meeting) for authorization.
2. Vouch the entries in brokers contract note, share certificate and cash book.
3. Examine the share certificate to ensure that the type of security and number of

share agrees with investment account and that the share held in the company with its name.

4. Verify that the investments are properly classified and disclosed as stated in Companies Act.

Auditor's Duty in Valuation

1. The auditor should satisfy himself that the investment has been valued in the financial statement in accordance with recognized accounting policies and practices and relevant statutory requirements.
2. The auditor should examine whether in computing the cost of investment, expenditure incurred on account of transfer fees, stamp duty, brokerage etc., is included in the cost of investment.

4.5.2 Unquoted Investments

A company share is said to be "unlisted" or "unquoted" if its stocks that are not listed on a stock exchange and so have no publicly stated price. Here, Investments are difficult to value, for example, shares that have no stock exchange listing i.e. Private Company etc.

Auditor's Duty in Verification

1. Auditor should verify the Memorandum of Association to ensure authority for purchase such investment.
2. Where investments are in large numbers, the auditor should obtain the schedule of securities certified by a senior officer of the company.
3. Obtain the schedule of investment comprises for information about the name of the securities / investment, date of their acquisition, nominal/ face value, cost price, book value, paid up value market value, rate of interest applicable, dates of interest due, tax deduction, etc., at the date of Balance Sheet.

Auditor's Duty in Valuation

1. The Auditor should examine the method adopted by the organization for determining the market value of such securities.
2. The Auditor should examine whether the method of valuation of securities by entity is one of the recognized methods of valuation viz., breakup value method, capitalization of yield method, yield to maturity method etc.

4.6 Verification and Valuation of Other Fixed Assets

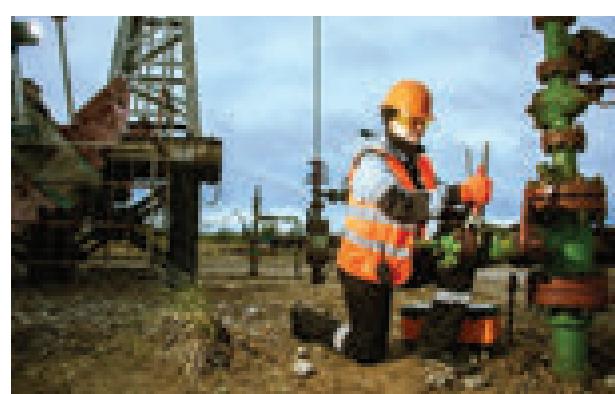
Verification and valuation of other fixed nature assets are classified into two categories such as wasting assets and fictitious assets.

The wasting assets are also known as depleting assets and it has both physical

and legal existence. The fictitious asset does not have market value but it has legal existence. The procedure for verification and valuation of both these assets are discussed below.

4.6.1 Wasting Asset

It is also known as depleting assets, wasting assets are of a fixed nature but depleted or consumed gradually. The process of earning income causes depletion or exhaustion in the value of the assets. Mines, Oil wells, Quarries are some of the examples of wasting assets.



There is a difference between fixed assets and wasting assets.

1. The Fixed assets are replaceable, whereas wasting assets is irreplaceable after its useful life is over.
2. The value of fixed assets decreases due to normal wear and tear, i.e.,

depreciates with time and use or due to obsolescence while the value of wasting assets declines as a result of gradual exhaustion or reducing stock.

Auditor's Duty

The auditor should confirm in this regard, the value of the wasting assets in the Balance Sheet is reduced by the estimated amount of yearly depletion. In other words, a wasting asset appears in the Balance Sheet as its estimated diminished value.

4.6.2 Fictitious Asset



The assets which do not have physical existence are called as Fictitious Asset. Examples of fictitious assets are - Preliminary Expenses incurred at the time of formation of the company, Development Expenses, Debenture Discount, Amount spent on special advertisement campaign, Brokerage, Underwriting Commission and deferred revenue expenditure.

Auditor's Duties

1. Auditor should verify that expenses incurred are properly authorised by a responsible person.
2. He should ensure that fictitious assets are treated as deferred revenue expenditure. Deferred Revenue Expenditure means temporary capitalization of revenue expenditure with the ultimate object of spreading the amount over several future years to which benefit of such expenditure will be available.
3. The auditor should confirm that the asset is disclosed in the Balance Sheet at the amount of expenditure incurred less amount written off.

LEGAL DECISIONS

- In Kingston Cotton Mills Co., it was held that “although it is not part of an auditor’s duty to value the assets and liabilities, yet he must exercise reasonable skill and care in scrutinizing the basis of valuation. He should test the accuracy of the values put by the officers of the business. In any case, the auditor cannot guarantee the accuracy of the valuation”.
- The London Oil Storage Co. Ltd. Vs. Seear Hasluck and Co. (1904), it was then held that it is the duty of the auditor to verify the existence of assets stated in the balance sheet; and that he (Auditor) will be liable for any damage suffered by the client if he fails in his duty.

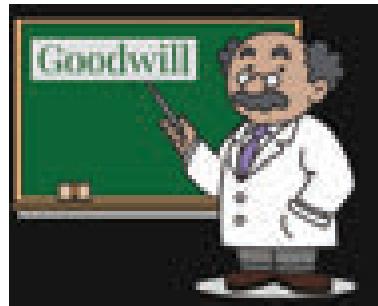


STUDENTS ACTIVITY



1. Visit the Auditor's office. Discuss and verify a plant register maintained in a company.
2. Ascertain various fixed assets of your educational institution and classify them. Prepare a chart.
3. Prepare a chart of tangible assets and intangible assets of an industry and discuss various documents to be verified for valuation.
4. Arrange for a guest lecture of a bank manager and discuss operation of mutual funds

Why is goodwill not a fictitious asset?



SUMMARY

The proper verification and accurate valuation of these assets is a paramount importance to show true and fair view of the financial position of the business concern. If there is incorrect valuation of fixed assets, it affects the company's life. The profits by improper valuation of fixed assets would falsify and distort the financial statements and affects the true financial position of the firm, by which the primary objective of auditing is "expression of independent opinion by the auditor on correctness and reliability of financial statements" cannot be achieved. Therefore, the auditor should take maximum care regarding verification and valuation of fixed assets.



KEY TERMS

- **Verification:** Verification is the act of assuming the correctness of value of assets and liabilities, title and their existence on the date of Balance Sheet in the organization.
- **Valuation:** Valuation is the act of determining the value of assets and critical examination of these values based on normally accepted accounting standard.
- **Fixed assets:** A fixed asset is a long-term tangible property that a firm owns and uses in its operations to generate income. Fixed assets are not easily converted into cash within a year.
- **Freehold property:** A freehold is the common ownership of real property, or land and all immovable structures attached to such land.
- **Leasehold property:** It is method of owning property for fixed term possession of the property will be subject to the payment of an annual ground rent. When the lease expires, ownership of the property reverts to the freeholder.
- **Investments:** It is the process of investing money for profit.



EVALUATION



BXPJZL

I. Multiple Choice questions:

1. Verification means _____.
 - a. Proof of existence
 - b. Exact value of assets
 - c. Estimates
 - d. Accuracy
2. Valuation means _____.
 - a. Accretion of wealth
 - b. Correctness of value
 - c. Critical examination of the value
 - d. All of these
3. Plant and machinery fall under the category of:
 - a. Current Assets
 - b. Liquid Assets
4. Which one of the following is not an example of fixed assets?
 - a. Land & Buildings
 - b. Inventory
 - c. Plant & Machinery
 - d. Furniture & Fixtures
5. Furniture and Fixtures are shown in Company's Balance Sheet under the head:
 - a. Current Assets
 - b. Fixed Assets
 - c. Intangible Assets
 - d. Fictitious Assets

6. The price in which a fixed asset can be sold in the market is known as:
- Replacement Value
 - Realizable Value
 - Scrap Value
 - Book Value
7. The method of valuation of assets made on the basis of purchase price of the assets is called as:
- Cost Price Method
 - Market Value Method
 - Book Value Method
 - Going Concern Value Method
8. Going concern value of assets is also known as:
- Historical Value
 - Conventional Value
 - Token Value
 - All of these
9. Fixed assets should be valued at _____.
- Cost price less depreciation
 - Annuity method
 - Sinking fund method
 - Cost Price
10. Freehold property is the _____.
- Immovable property
 - Movable property
 - Structures
 - Intangible asset
11. Leasehold property means _____.
- Owner of holding
 - Possession of property
12. In the Balance Sheet, generally fixed assets must be shown at:
- Cost Price
 - Market Price
 - Cost or Market Price whichever is less
 - Written Down Value
13. Quoted Investment of shares refers:
- Listed on RBI
 - Listed on SEBI
 - Listed on Stock Exchange
 - Listed on SBI
14. Unquoted Investment of shares refers:
- Not listed on RBI
 - Not listed on SEBI
 - Not listed on Stock Exchange
 - Not listed on SBI
15. Verification of assets is generally made at:
- the beginning of the year
 - half year end
 - throughout the year
 - the end of the year
16. For valuation of plant and machinery, the auditor should depend upon the advice of:
- Managing Director
 - Board of Directors
 - Works Manager
 - Company Secretary
17. Ownership is indefinite in case of:
- Leasehold Property

- b. Freehold Property
c. Both
d. None of these
18. They are also referred to as capital assets:
a. Current assets
b. Fixed assets
c. Floating Assets
d. Circulating Assets
19. A monetary asset purchased with the idea that the asset will provide income in the future or will later be sold at a higher price for a profit is known as:
a. Machinery
b. Furniture
c. Loose Tools
d. Investments
20. The Certificate offered by the proprietor is the documentary evidence for:
a. Verification of Assets
b. Valuation of Assets
c. Verification of Expenses
d. Valuation of Expenses
21. Valuation of assets is the part of:
a. Assessment
b. Evaluation
c. Appraisal
d. Verification
22. Which of the following are the objectives of verification of assets?
a. To show correct valuation of assets
b. To find the ownership (title) of assets
c. To ensure that the assets have been recorded properly
d. All of these
23. Which of the following are the main advantages of verification of assets?
a. Avoids manipulation of accounts
b. Guards against improper use of assets.
c. Ensures proper recording and valuation of assets
d. All of these
24. Wasting assets are also known as:
a. Depreciating assets
b. Depleting assets
c. Appreciating assets
d. Inflating assets
25. Which one of the following is not an example of wasting asset?
a. Oil Wells
b. Mines
c. Quarries
d. Patent rights
26. All are fictitious assets written off except:
a. Preliminary expenses written off
b. Discount on issue of shares written off
c. Goodwill written off
d. Discount on issue of debentures written off
27. Fictitious assets are treated as:
a. Current Assets
b. Deferred Expenditure
c. Fixed Assets
d. Intangible Assets
28. Which one of the following is an example of fictitious asset?
a. Land
b. Goodwill
c. Underwriting Commissions
d. Buildings

29. The amount spent on special advertisement campaign is treated as:
- Fictitious Assets
 - Current Assets
 - Depleting Assets
 - Fixed Assets
30. Pick the odd one out:
- Expenses on Formation of Companies
 - Research and Development Expenses
 - Brokerage and Underwriting Commission
 - Plant and Machinery

Answers 1.(a), 2.(c), 3.(d), 4.(b), 5.(b), 6.(b), 7.(a), 8.(d), 9.(a), 10.(a) 11.(c)
 12.(b) 13.(c) 14.(c) 15.(d) 16.(c) 17.(b) 18.(b) 19.(d) 20.(b) 21.(d) 22.(d)
 23.(d) 24.(b) 25.(d) 26.(c) 27.(b) 28.(c) 29.(a) 30.(d)

II. Very Short Answer Questions

- Define the term 'Verification'.
- What is Valuation?
- What is the process of Verification?
- What do you mean by 'Fixed Assets'?
- What is Freehold property?
- What is Leasehold property?
- What is the position of auditor while verifying assets?
- What is an investment?
- What is fictitious asset? Give examples.
- What is wasting asset? Give examples.
- What is meant by Deferred Revenue Expenditure.

III. Short Answer Questions

- Enumerate the various Fixed Assets.
- State the differences between Freehold property and Leasehold property.
- What is the position of Auditor while valuing assets?
- Briefly mention the importance of Verification.
- State the points to be examined by the auditor in verifying 'Plant and Machinery'.
- Differentiate fixed assets from wasting asset.
- What is the general procedure for valuing the land and buildings?
- State briefly, how the furniture and fixtures of a business are verified and valued for Balance Sheet purpose.
- Explain the procedure for valuation of quoted investment and unquoted investments.
- What is verification? How would you verify (a) Fictitious assets; (b) Wasting assets.

IV. Essay type questions

1. What are difference between Verification and Valuation?
2. Explain the important factors considered for verification and valuation of assets.
3. Discuss the various methods of Valuation of Assets.
4. Define verification of assets. Explain the objectives of Verification.
5. Examine the role of Auditor on Verification and Valuation of Fixed Assets.
6. Write an essay on the valuation of investments for Balance Sheet purpose and examine the auditor's position in this respect.

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Learning Objectives

- To understand the meaning, definition and classification of Current Assets and Intangible Assets.
 - To know the procedure of Verification and Valuation of Individual Current Assets.
 - To determine the procedure of Verification and Valuation of Individual Intangible assets.

POINTS TO RECALL

RECAP

The following points are to be recalled before learning Verification and Valuation of Current Assets and Intangible Assets:

- Meaning and Differences between Verification and Valuation.
 - Meaning and Various Categories of Fixed assets.
 - Procedure of Verification and Valuation of Individual Fixed assets: Land, Buildings, Plant & Machinery, Furniture and Fixtures.
 - Procedure of Verification and Valuation of Investments.
 - Procedure of Verification and Valuation of Wasting and Fictitious Assets.

5.1 Introduction

This chapter provides an understanding about the various classifications of current assets and intangible assets. It also gives practical knowledge related to procedure of verification and valuation of current assets and intangible assets. This chapter also brings about the importance of generally accepted principles of accounting as determined by law, professional



pronouncements and prevailing practices for valuation and verification of current assets and intangible assets. It is very much helpful to show true and fair view of the financial position of the business enterprises.

5.2 Verification and Valuation of Current Assets

5.2.1 Meaning and Definition of Current Assets

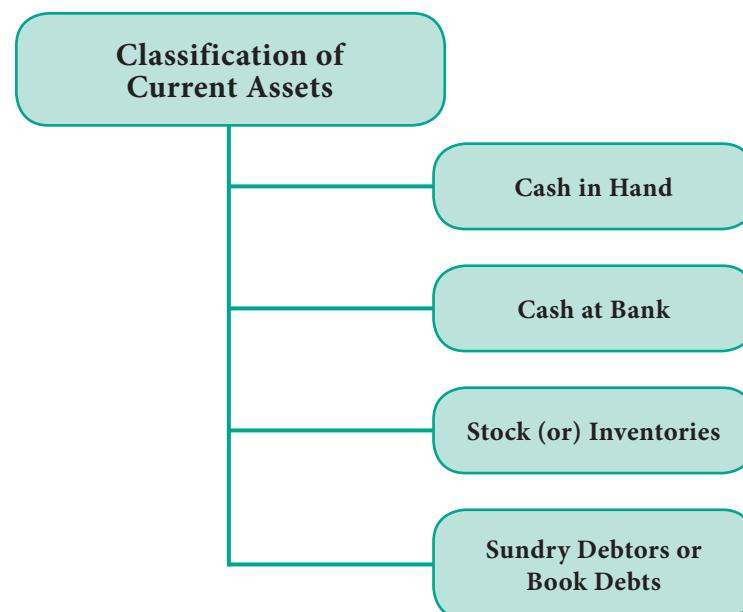
Operating assets that are used in the business and which can be converted into cash during a short duration are called 'Current Assets'. In other words, assets acquired through cash and easily convertible into cash during the normal course of business are termed as current assets. Current Assets are also known as floating or circulating assets. Current assets includes cash in hand, cash at bank, short-term marketable securities, short-term investments, bills receivables, sundry debtors, inventories, and prepaid expenses.

Current Asset is defined by various authors as -

- **Merriam Webster:** Assets of a short-term nature that are readily convertible to cash.
- **Collins Dictionary:** Current assets are assets which a company has which can convert it into cash within one year.
- **Accounting Dictionary:** A current asset, also called a short-term asset, is a resource expected to be used to benefit a company within a year or the current accounting period.

5.2.2 Classification of Current Assets

Current assets are assets which are utilized or converted into cash within one-year period. They are assets tangible with physical form. Based on their nature, currents assets are classified into following categories as: (1) Cash in hand (2) Cash at Bank (3) Stock or Inventories, and (4) Book Debts or Sundry Debtors.



5.2.3 Verification and Valuation of Individual Current Assets

Verification and valuation of current assets states that the Balance Sheet shows true and fair view of the financial position of business enterprise. The auditor must satisfy himself that various current assets disclosed in the Balance sheet have been valued according to the Generally Accepted Principles of Accounting.

1. Cash in Hand

The main cash and petty cash in hand are to be physically verified at the closing hours on the last day of the financial year. The auditor has to be very careful while verifying cash-in-hand. Defalcation or embezzlement of cash has become a very common technique of committing fraud. In this regard, the auditor may conduct a surprise verification of cash at any time during the course of audit. Therefore, while verifying cash, the auditor should ensure the following:

1. That the cashier is present at the time of verification.
2. That the temporary advances and payments on suspense accounts are excluded.
3. Count the cash-in-hand at one sitting and compare it with the cashbook balance. Simultaneously a statement is prepared with details of denominations and number of currency notes and coins. Both the cashier and audit staff must sign this statement. The copy of this statement is handed over to the cashier and the auditor may retain the original statement for future reference purpose. If in case of non-agreement

of cash balance, the auditor should demand explanation from respective cashier or accountant for non-agreement of physical cash balance and balance as per book.

4. Also count the petty cash book, stamps in hand and IOU's (I Owe You) slips for temporary advances made to the employees. If any discrepancy, he should get a certificate to that effect from the accountant.
5. As far as cash-in-transit is concerned, the auditor should verify this with the help of proper documentary evidences and correspondences.
6. Carryout verification of cash at the end of the year or by way of surprise check at any time during the year. The latter will enable the auditor to detect the embezzlement if any.
7. The practice of keeping large balance of cash on hand is not a sound practice and should be discouraged from the viewpoint of internal control.
8. To prevent difficulties of physically counting the cash, auditor should ask the client to deposit the entire cash Balance on balance Sheet date with a bank.
9. As per the guidelines of Institute of Chartered Accountants of India, the auditor should see whether duties are segregated among different persons to authorise cash transactions.
10. He should ensure that bank reconciliation is prepared periodically.

2. Cash at Bank

For the purpose of verification and valuation of cash at bank, the auditor should take following steps:

1. Compare the balances as shown in the passbook with that shown in the bank column of the cashbook.
2. Bank reconciliation statement is very helpful in detecting various types of frauds. Therefore, prepare a bank reconciliation statement as on the last day of the accounting year for ascertaining the current position of the cheques drawn by the company but not yet presented for payment or the cheques deposited by the concern but not yet cleared.
3. The auditor shall also carefully verify the post-dated cheques issued by the organisation before the end of the year and ensure that such cheques are not taken into account for the year under audit.
4. Examine that cheques issued for more than three months are treated as unpaid and the relative entries are reversed.
5. Obtain a certificate of balance in client's account as on the Balance Sheet date from the bankers.
6. When the organisation maintains accounts with more than one bank, the auditor should verify all the bank accounts individually.
7. Auditor should obtain separate certificates from the bank in respect of Fixed Deposit Account, Current Account, Savings Bank Account etc.
8. Scrutinise the fixed deposit receipts in respect of their date of issue, amount, rates of interest, date of maturity etc., and get interest accrued on deposits during the year duly adjusted.
9. If any charge created on the deposits or if the deposits made under any legal requirement, the auditor shall ensure that the fact is disclosed in the balance sheet.
10. Sometimes, due to legal restrictions one or more of the bank accounts of the organisation may be blocked. In such a case, the auditor shall ensure that the fact is disclosed in the balance sheet.

3. Stock

Stock-in-trade or Inventories is the life-blood of a business. Therefore, value of stock-in-trade has to be properly determined for ascertaining profit or loss for the year and also to disclose a true and fair financial position of the concern. Inventories or Stock-in-trade normally includes the following:

- **Raw-Materials:** Raw materials form a major input into the production. They are required to carry out production activities. For example, steel, copper, rubber, cotton, wool, timber, lime stone, coal etc.
- **Work-in-Progress:** The work in progress is that stage of stocks. Which are in between raw materials and finished goods. It means the total value of unfinished production at the end of each financial period. It is in the form of materials, which have absorbed varying amounts of labour and other overheads to reach the manufacturing stage at the time of counting of stock of work-in-progress. Work-in-progress should be shown in Balance Sheet separately and not as stock-in-trade.
- **Semi-Finished Goods:** Goods in a semi-finished condition on the date of Balance Sheet should be valued at cost of raw materials plus a reasonable proportion of factory overheads or

production overheads. The auditor should get a certificate from production manager about the portion of overheads related to semi-finished goods. He should also examine the method of absorption of overheads as a percentage of raw materials, labour and volume of production for fair allocation.

- **Finished Goods:** These are the goods, which are ready for the consumers. The stock of finished goods provides a buffer between the production and the market. If there is purchase of finished goods for resale, their valuation should be at purchase price and a reasonable proportion of direct expenses incurred on them, such as freight, duty, taxes etc., Whatever the method of valuation is adopted, the auditor must confirm that valuation of finished goods should never be at a rate higher than market price of identical goods in the market.
- **Consumable Stores and Spare Parts:** 'Spare' as the name suggests, refers to additional or extra to what is required for ordinary use. That purely means an item kept as standby, in case another item of the same type is lost, broken, or worn out. These are purchased for reducing the idle time of machineries and other auxiliary processes in case of sudden breakdowns or any other contingencies. The auditor should confirm the adequacy of spare parts according to plant capacity to reduce idle time by repairing the breakdown of machineries immediately, thereby increasing the production efficiency of concern. It is very helpful to reduce the idle time wages and increase the profitability position of the company.

• **Loose Tools:** These are part of current assets and will be typically found on any Balance Sheets that may be produced for the business. There is another definition of what qualifies as current assets and this is expected to be used within the next 12 months. In the context of verification of loose tools, the auditor should obtain a list of loose tools duly authorised by a responsible officer and examine the same. Revaluation of loose tools is the most appropriate method of valuation. The difference between the cost price and the current price should be treated as depreciation or loss to be charged to the profit and loss account.

Auditor's Duty in Verification

1. **Evaluation of Accounting and Internal Control System:** The auditor should study and evaluate the accounting system and internal controls relating to inventories. This would facilitate him in determining the nature, timing and extent of substantive procedures to be carried out by him. The auditor should review the following aspects of internal controls over stock-in-trade.

- **Custody:** There must be provision of adequate controls to guard the stock from loss through pilferage, exposure to weather and other hazards. The storage of various items of inventories should be sound enough to protect them against damage, deterioration, etc.
- **Records:** There should be adequate records of all stock movements, periodically reconciled with accounts and costing records.
- **Authorization:** All stock movements should be properly authorized.

Authorities for giving purchase orders and receipts of goods should be clearly laid down. Issues from stores should be made only against proper requisition notes approved by authorized managers.

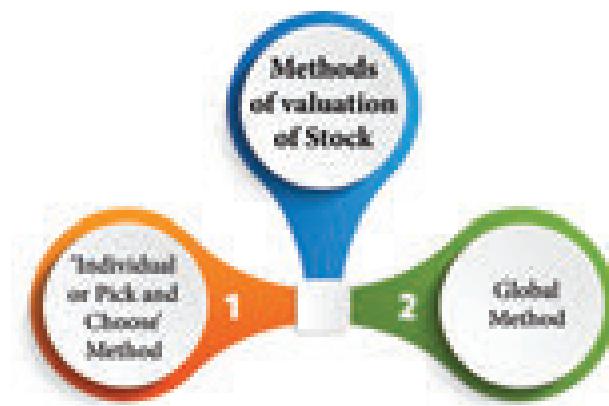
- **Insurance:** Different items of inventory should be adequately insured against fire, theft, etc. Insurance Premium should be paid in time and insurance policies should be kept in proper custody.
 - **Slow-Moving Stock:** There should be a regular review to identify and take action to get rid of slow-moving, obsolete or defective stock.
2. **Examine Existence of Stock:** Auditor should verify the existence of stock by exercising physical stock verification as on the date of Balance Sheet. While undertaking physical stock taking or verification the following points should be borne in mind:
- Ensuring that staffs involved are both knowledgeable about the stock and independent of the day-to-day handling or recording of the stock.
 - Issue of written stock taking instructions regarding counting procedures and clearly defining the responsibilities of all staff involved.
 - Computing and checking calculations and additions on stock sheets.
 - Continuous or periodic agreement of physical checks with records, and all material differences investigated.
3. **Verify Stock Records:** He should ensure that stock records are properly maintained and must verify receipts and issues of materials. He must also verify that Inspection Reports and Stock Sheets are authorised by a responsible person.

Auditor's Duty in Valuation

Stock-in-trade is a Current Asset and the auditor should ensure that stock-in-trade is valued at cost price or market price whichever is lower. The Institute of Chartered Accountants of India Accounting Standards - 2 (AS 2) "Valuation of Inventories" states that, stock of material is valued at cost or market price (Net Realizable Value) whichever is lower on the date of Balance Sheet.

Methods of Valuation of Stock

Valuation of stock-in-trade is ordinarily at cost price or market price whichever is less. Auditor generally adopts either of the two methods in valuing stock such as: (1) Pick and Choose Method (2) Global Method.



1. **'Individual or Pick and Choose' Method:** According to this method, the lower of cost price or market price is the basis in respect of each individual item and the total of the same is the value of the inventory.
2. **Global Method:** Under this method, first the cost of all items is determined and aggregated. Then, the market price of all the items is ascertained and aggregated. The lower of these two valuations is the value of the stock.

Illustration of Valuing Stock in-Trade at Individual and Global Method

Items of Stock	Cost ₹	Market Price ₹	Lower of Cost or Market Price ₹
1	250	300	250
2	400	350	350
3	550	520	520
4	650	775	650
Valuation	1850	1945	1770

- Value of Stock at Individual Method is ₹ 1,770/- which is the total of individual item valued at cost or market price whichever is less.
- Value of Stock at Global Method is ₹ 1,850/- which is valued at the lower of the aggregate value of cost price and market price.

However, the following methods are used in determining cost price and market price of stock.

Methods of Calculating Cost Price: In the context of valuation of inventories, any one of the following methods is adopted to determine the cost price of stock.

1. Unit Cost Method or Actual Cost Method:

In this method, each item or batch of goods is valued at the actual price at which it was purchased. This method can only be applied where goods have been purchased in different lots. The cost price of unsold stock will be the cost price at which such a lot is acquired.

2. First in First Out Method (FIFO): In this method, issues are priced in the order of the purchase lots. The price of

the first lot is taken first, and when that lot is exhausted, the price of the next lot is taken and so on. Hence, items issued are valued at the earliest price or cost. As materials purchased at earlier rates are charged first, the value of closing stock is more or less nearer to the current market price.

3. Last in First Out Method (LIFO): In this method, issues are priced in the reverse order of purchase. The price of the last lot is taken first, and when that lot is exhausted, the price of the previous lot is taken and so on. Hence, items issued are valued at the latest price or cost. The inventory in hand remaining unsold is assumed to be out of the earliest lot and valued at the earliest price paid or cost incurred for the same.



- 4. Base Stock Price Method:** Under this method, a minimum quantity of stock known as base stock or safety stock is always held at fixed price. The fixed price is kept below the original cost of the 'base stock'.
- 5. Highest in First Out Method (HIFO):** This method is based on the assumption that issues are priced at the highest value of available consignments in the store. The closing stock of materials should always remain at the minimum value. The method is not popular as it always undervalues the stock, which amounts to creating secret reserves.
- 6. Average Cost Method:** When large volumes of materials are available in stores with largely varied prices, pricing based on actual cost may be difficult. In such cases average price methods can be followed. Following are the different average price methods which is used to value material issues.

- (a) **Simple Average Price Method:** According to this method, items

issued are priced at average of the prices of the different lots in stores, on the day of issue regardless of the quantity of each lot. It is assumed that materials received first are issued first, at the simple average price. Stock is valued at average of the prices of different lots in stores.

(b) Weighted Average Price Method:

In this method, the items issued are valued at weighted average price, which is calculated by taking into consideration both the quantities of items and the cost of the items. The costs of all items are added and the total cost is divided by the total quantity of items available. It is the most commonly used method for valuation of Inventories.

- 7. Standard Cost Method:** In this method stock is valued at some predetermined cost per unit called the Standard Cost.

- 8. Adjusted Selling Price:** In this method, the unsold stock is valued at the prevailing price out of which the normal profit plus the estimated cost of disposal, i.e., selling expenses and overhead expenses are deducted.

Methods of Calculating Market Price:

Market price of stock is determined by following any of the two methods:

- 1. Net Realisable Value:** It refers to the estimated price at which stock of goods can be sold in the market after deducting cost of marketing, selling and distribution expenses etc.
- 2. Replacement Cost:** It represents the cost of replacing the stock of identical items at the date of balance sheet.

4. Book Debts (or) Sundry Debtors

Sundry debtors fall in the category of current assets. The task of verifying this asset would be reduced largely in case there is an efficient internal check system for recording sales and writing off the sales ledger. According to the Companies Act, 2013 the book debts of a company should be shown as under:

1. Debts considered good in respect of which the company is fully secured.
2. Debts considered good for which the company holds no security other than the debtor's personal security.
3. Debts considered doubtful or bad.

The object of verification in case of Book Debts is to ascertain-

- (A) Correctness or Accuracy of the amount of book debt.

- (B) Validity or Confirmation of claims against recorded debtors.
(C) Collectability and determination of realisable value.
(D) Appropriate disclosure in accordance with legal provisions and professional pronouncements.

For verification and valuation of debtors or book debts, an auditor should carefully examine the following points:

(A) Accuracy of the amount of Book Debts or Debtors: Accuracy of the book debts amount or debtors amount shall be:

1. Auditor should obtain a list (Schedule) of debtors, duly certified by some responsible officer of the company.
2. Check whether the credit balance of the sales ledger is in agreement with the customers account or not.

LEGAL DECISIONS

- Lord Justice Lindley, while delivering the famous judgment in the case of Kingston Cotton Mills Ltd., (1896) observed. "It is no part of the auditor's duty to take stock. No one can contend that it is so. He must rely on other people for details of the stock-in-trade. In the case of a cotton mill, he must rely on some skilled person for the material necessary to enable him to enter the stock in trade at its proper value in the balance sheet".
- In the same case, Lord Justice Lopes observed, "An auditor is not bound to be a detective, or as was said to approach his work with a foregone conclusion that there is something wrong. The auditor was acquitted for breach of duty in connection with valuation and verification of stock-in-trade. It is observed from this case "An Auditor is a watch dog and not a bloodhound". He is justified in believing they tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest to rely upon their representations, provided he takes reasonable care".
- Re Westminster Road Construction & Engineering Co. Ltd. (1932), it was held that an auditor must make the fullest use of all materials available to him and although he is neither stock taker and nor a valuer of work-in-progress, he will be guilty of negligence if he fails to take notice of all available evidences from which it could be reasonably deduced that the work-in-progress was overvalued.

(B) Validity: Confirmation requires direct communication with the debtors. The auditor should carefully determine the method, the time of requesting such confirmation and the number of debtors to be requested after taking into consideration the following:

1. Undertake test checking of individual accounts, the balances of ledger accounts and some of the entries of customer accounts for common items.
2. Probability of response from the debtors.
3. Examine thoroughly the system of internal check in operation in relation to book debts.
4. Materiality of accounts.

The Institute of Chartered Accountants of India through its Standard of Audit recommends that the direct confirmation of balance should be done along the following points.

- a. Scrutinize the accuracy of the debtors list and verify the existence of debts by receiving directly the confirmation letters or statement of accounts from the debtors (or) arrangements should be made with the client for sending out these letters to the debtors. This may be done on selective basis. However, the confirmation of the balance by the debtor is not a guarantee as regards its realization.
- b. Confirmation procedures should be carried out within a reasonable period from the end of the year.
- c. Where the number of debtors is small, letters may be sent to all of them, but when there are numerous debtors these could be done on a test basis.

d. List of debtors selected for confirmation should be prepared in duplicate. A copy of this list should be handed over to the client for preparing request for confirmation, which should be fully addressed. In this regard, the client should enclose stamped envelope bearing the auditor's name and address for confirmation.

- e. Replies received should be carefully gone through and in cases, where balances do not agree, client should be asked to investigate.
- f. The auditor must pay special attention to those balances for which confirmations are not available. They might have been either fictitious or made to conceal a fraud.

(C) Collectability and Collection of Book debts or Debtors: Confirmation of a debt is not an evidence of its collectability.

1. In regarding with collectability, the auditor should make ageing analysis of the debts and classify them as those under 30 days, between 30 and 60 days, between 60 and 90 days, and 120 days and above. This will enable him to ascertain the collectability of individual debts.

Determination of non-collectability of any debt will depend on credit period allowed to the debtor, how regularly he is paying, how many times he has defaulted in payments, etc., Certain indications of doubtful or uncollectable debts may be as follows:-

- a. Continuous violation of the terms of credit.
- b. Old debts remaining unpaid while new ones are fully paid on time.
- c. Stopping of payments after withdrawal of credit facility.

- d. Insolvency, disease, or death of a debtor.
 - e. Closure of debtor's business or his disappearance.
 - f. Time-barred debts.
 - g. Handing over of old debts to company lawyer to file legal suit for recovery.
 - h. Finally, in case of writing down any bad debt or allowing excessive discount to any debtor, the auditor should carefully go through relevant correspondence and see that there is proper authorization for the same.
2. In regard with collection of debtors, the auditor must consider the following points:
- a. Make sure that all payments collected from debtors, particularly towards the closing of the year, are promptly credited to their accounts. Auditor should also see that duly authorized vouchers issued by the company acknowledging payments in respect of debts substantiate all such receipts.
 - b. Examine carefully amount paid by debtors, but not credited in their accounts if any.
 - c. Make sure that customer's account is duly debited for goods sold or credit.
 - d. Vigilantly enquire into disputed balances owing to some claims or complaints.
 - e. Check the adequacy of the provision for bad and doubtful debts made by the management by undertaking an analysis of the provision for doubtful debts. The auditor should allow a debt to be written off as bad debt when he is fully satisfied that it is irrecoverable. Inadequacy of provision for bad and doubtful

debts if any, must be brought to the knowledge of the owner of the business and highlighting the same in audit report.

(D) Disclosure in Balance Sheet

Book-debts must appear in Balance Sheet at their estimated realisable value. That means there should be deduction of the provision kept for Doubtful Accounts from the total book debts. According to Para III Schedule to Companies Act 2013, there should be disclosure of Sundry Debts in Balance Sheet as follows:

1. There should be separate statement of aggregate amount of trade receivable (book debts) not paid for more than six months from the date they became due.
2. Classification of Trade receivables must be as follows: (a) Secured, considered good, (b) Unsecured, considered good and (c) Doubtful.
3. There should be separate disclosure of allowance for bad and doubtful debts.
4. Debts owned by Directors or other officer of the company, or any of them either individually or jointly with any other person, or debts owned by firms or private companies respectively in which any director is a partner, a director, or member, should be separately stated.

5.3 Verification and Valuation of Intangible Assets

5.3.1 Meaning and Definition of Intangible Assets

Intangible assets are those assets, which do not have their form or physical existence. However, they are part of business and appear in the Balance Sheet, like any other assets, by

virtue of their utility to the business. Goodwill, Patent Rights, Copyrights, Trademarks are some of the examples of intangible assets. The cost of intangible fixed assets are amortized over their useful life.

Intangible asset is defined by International Accounting Standards Board as, “an identifiable non-monetary asset without physical substance”.



5.3.2 Classifications of Intangible Asset

Intangible assets do not have physical existence but it has legally existed with documentary evidence. It is broadly

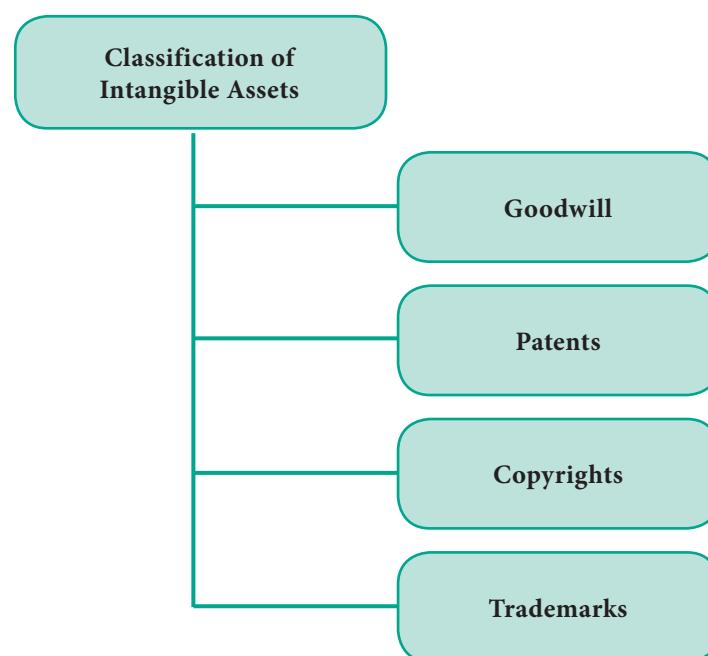
classified into two categories such as limited life intangibles and unlimited life intangibles. Limited life intangible assets include Goodwill, Patents and Copyrights. On the other hand, Trademarks is classified as unlimited life intangibles.

5.3.3 Verification and Valuation of Individual Intangible Assets

The Procedure of Verification and Valuation of individual Intangible Assets are explained in the following paragraphs.

1. Goodwill

Goodwill is an intangible concealed asset, which represents the earning capacity of the business. As a rule, this does not appear in the Balance Sheet except when it is actually purchased, or in case of a partnership when it is brought into the books of accounts in case of change in the partnership deed. It arises because of several reasons such as special popularity of a particular place, attractiveness of



the goods dealt in, the popularity of the firm and reputation of the owners of the business enterprise etc. It also refers to the monetary value of reputation of a business. Since, goodwill is not tangible it does not call for physical verification. The Goodwill is shown in company's Balance Sheet under the head Fixed Assets. Goodwill is used for attracting the customers. It attracts more customers and therefore, increases profits in future. It is an intangible real asset and not a fictitious asset. Goodwill is a valuable asset if the concern is profitable. On the other hand, it is valueless if the concern is in loss. Goodwill is to be verified and valued in the following manner.

AUDITOR'S DUTY IN VERIFICATION

1. Ascertain that the company is justified in creating goodwill in its books of accounts.
2. Where goodwill is generated in own business, the auditors should verify the particulars of expenses debited to Goodwill account.
3. In a partnership firm, the partnership deed should be verified by the auditor. He may also verify the changes made in the goodwill account from time to time based on the provisions made in the partnership deed.

AUDITOR'S DUTY IN VALUATION

1. Auditor should confirm himself that goodwill has not been shown in excess of its cost price.
2. Examine that the sum paid for goodwill does not exceed the difference between the total purchase consideration and the value of net tangible assets acquired.
3. He should see that it is valued as per method stated in partnership deed, purchase or agreement.

4. Goodwill may appear in the Balance Sheet at cost less amounts written off.
5. The amortization period and method of amortization should be reviewed at the end of each financial year.
6. An intangible asset should be eliminated in the books of accounts when no future economic benefits are expected from its use.

2. Patents

According to the Patent Act 1970, "A patent is an official document that guarantees to the inventor an exclusive right for a term of years to make, use or sell his invention".

AUDITOR'S DUTY IN VERIFICATION

While verification and valuation patent right the auditor must bear in his mind the following important points.

1. The auditor should examine the actual certificates issued by the patent office in respect of patents granted.
2. The auditor should ensure that patents are registered in the name of the client.
3. Obtain a list showing the description of each patent, registered number, date, patented item, renewal date and number of years to run etc., concerning each patent.
4. Where patents have been purchased from an individual, auditor should inspect the agreement for the purchase and note the age of various patents.
5. Auditor should carefully verify that none of the patent rights have lapsed. Care should be taken the lapsed patent are written off.
6. The original fees paid to purchase the patent right should be capitalised and should be debited to patent account

while the subsequent renewal fee should be treated as a revenue expenditure.

AUDITOR'S DUTY IN VALUATION

1. Patents must be valued at cost less depreciation. There may be three causes of depreciation, viz: (a) lapse of time, (b) obsolescence, and (c) the patented article going out of fashion.
2. At time a patent might become valueless due to obsolescence or failure to create a demand of the patented article. In such cases the auditor should see that its value is written off before the expiry of the period covered by the patent.

3. Copyrights

Copyright refers to the exclusive right to produce or re-produce or authorise for doing certain acts specified in the Copyright Act, 1957 in respect of some kind of literary, dramatic, musical, computer programme, cinematograph film, sound recording or artistic works. It is the legal right given to an author, which prohibits the publication of the work by other persons. The effects of such 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 for the life time of the author or the publisher as the case may be. The verification of this item will be on the lines similar to those described under patents.

AUDITOR'S DUTY IN VERIFICATION

The auditor should also inspect the original agreement between the author and the publisher. Where there is purchase of copyright, verification of price paid should be from written agreement.

AUDITOR'S DUTY IN VALUATION

1. Copyright must be revalued at the date of the Balance Sheet.
2. Copyright that has become obsolete should not be valued and shown in the Balance Sheet. Hence, it is clear that copyright is to be valued only based on profit earning capacity.
3. Auditor should ensure that copyrights, which have expired, are written off.
4. In the Balance Sheet, generally copyrights must be shown at cost less amounts written off from time to time.

4. Trademarks

A registered and legalised brand name or brand mark is what is known as Trade Mark. It provides a better protection for goods and services and for the prevention of use of fraudulent marks. A trademark is a distinctive mark attached to goods offered for sale in the market, to distinguish the same from similar goods and to identify them with a particular trader, or with his successor as owner of the particular business.



AUDITOR'S DUTY IN VERIFICATION

1. Examine the certificates of registration issued by the Registrar.
2. Examine the last renewal fee receipt to ensure that the trademark has not been

allowed to lapse. Verify that renewal fee has been charged to revenue expenditure.

AUDITOR'S DUTY IN VALUATION

1. Trademarks can be acquired like copyrights. The auditor should vouch the expenditure incurred in connection with their acquisition like registration fees, payments made to designer and artist, expenditure on account of salaries and overheads, attributable to the time spent in developing designs of trademark should be capitalised for arriving exact value of trademarks.

2. If the trademark has been acquired by assignment, vouch the amount paid for that with the assignment should be capitalised.
3. To judge the accurate value of trademarks the auditor should carefully note that proper distinction is made between capital and revenue expenditure. The incorrect allocation, which means the items of revenue expenditure are shown as capital expenditure or vice versa would falsify and distort the financial statements.



STUDENTS ACTIVITY



1. Visit a audit office and discuss with the auditor about stock verification.
2. Visit a centralized store of an industrial undertaking and have a discussion with the auditor and storekeeper about the stock verification.
3. Visit an audit office and discuss with the auditor about valuation of Debtors.
4. Arrange a meeting for the students along with an auditor for surprise visit to industrial units for checking of cash balance and cash at bank.
5. Have a group discussion on various aspects of valuation and verification on assets and liabilities.

SUMMARY

The present chapter discussed about verification and valuation of current assets and intangible assets. The proper verification and accurate valuation of these assets is a paramount importance to show true and fair view of the financial position of the business enterprises. If the correct valuation of asset is not done as per generally

accepted accounting principles, then it affects the company's life. The reason to overstate or underestimate the profits and financial position of the business would falsify and distort the financial statements and affects the true financial position of the company. Then the primary objective of auditing "expression of independent opinion by the auditor on correctness and reliability of financial statements" cannot be achieved. Therefore, the auditor should take maximum care regarding verification and valuation of all type of assets.



KEY TERMS

- **Current Assets:** Current assets are those assets which can be easily converted into cash within a shorter period of time, normally not exceeding one year.
- **Verification of Cash:** It refers count the cash in one sitting and compared it with the cashbook balance.
- **Verification of Cash at Bank:** It means comparison of the balances between pass book and bank column of the cash book.
- **Examination of Stock Taking:** Stock taking refers to the physical count of stock-in-trade.
- **Loose Tools:** These are part of current assets and will be typically found on any Balance Sheet that may be produced for the business.
- **Stores and Spare Parts:** It refers to additional or extra item is kept ready for ordinary use, in case another item of the same type is lost, broken or worn out.
- **Raw Materials:** Raw materials form a major input into the production. They are required to carry out production. Example: Steel, copper, rubber, cotton, wool, timber, lime stone, coal etc.
- **Work-in-Progress:** The work in progress is that stage of stock which are in between raw materials and finished goods. It means the total value of unfinished production at the end of each financial period.
- **Finished Goods:** These are the goods which are ready for the consumers. The stock of finished goods provides a buffer between the production and the market.
- **Net Realisable Value:** It refers to the estimated price at which the stock of goods can be sold in the market. It is also known as price prevailing in the market.
- **Replacement Cost:** It represents the cost of replacing the stock of identical items at the date of Balance Sheet.
- **Individual or Pick and Choose Method:** The lower of cost or market price is the basis in respect of each individual item and the total of the same is the value of the inventory.
- **Global Method:** Under this method, the cost of all items is determined and aggregated.

- **Sundry Debtors:** It implies the amount receivable from customers. It falls under the category of current assets. It is also known as Book Debts. According to Companies Act 2013, the book debts of a company should be shown as three categories such as Good, Doubtful and Bad.
- **Intangible Asset:** An intangible asset is an asset, other than a financial asset without physical form.
- **Goodwill:** It is an intangible asset which represents the earning capacity of the business.
- **Patents:** A patent is an official document that guarantees to the inventor an exclusive right for a term of years to make, use or sell his invention.
- **Copy Right:** It is an exclusive right to produce or re-produce or authorise the doing of certain acts specified in the Copyright Act 1957.
- **Trade Marks:** A trademark is a distinctive mark attached to goods offered for sale in the market, to distinguish the same from similar goods and to identify them with a particular trader.



EVALUATION



DMJ449

I. Multiple Choice Questions:

1. Which one of the following is not an example of intangible assets?
 - a. Patents & Trademarks
 - b. Land
 - c. Slogan
 - d. Copy right
2. Inventory of a manufacturing enterprise includes:
 - a. Raw materials
 - b. Work-in-Progress
 - c. Finished Stock
 - d. All of these
3. In valuation of raw materials, the unit cost method is also called as:
 - a. FIFO
 - b. LIFO
 - c. Actual cost Method
 - d. HIFO
4. FIFO is advisable in case of
 - a. falling Prices
 - b. rising Prices
 - c. constant Prices
 - d. none of these

5. Under which method issue of materials is priced at the latest purchase price?
- FIFO
 - LIFO
 - Simple Average
 - Weighted Average
6. Book Debts should be verified by
- Balance sheet
 - Amount received from Debtors
 - Debtors Schedule
 - Certificate from Manager
7. Costs of intangible fixed assets are _____ over their useful life.
- Depreciated
 - Charged
 - Amortized
 - Allocated
8. An example of intangible asset is
- Furniture & Fixtures
 - Loose Tools
 - Store and Spare Parts
 - Patents, Copyrights & Goodwill
9. Goodwill is a _____.
- Intangible Asset
 - Current Asset
 - Fixed Asset
 - Fictitious Asset
10. Which one of the following does not call for physical verification?
- Plant
 - Goodwill
 - Loose Tools
 - Stamp
11. Goodwill is shown in Company's balance sheet under the head _____.
- Investments
 - Fixed Assets
 - Current Assets
 - Miscellaneous Expenses
12. The original fees paid to purchase the patent right should be treated as _____.
- Revenue Expenditure
 - Deferred Revenue Expenditure
 - Capital Expenditure
 - None of these
13. The renewal fee of patent right should be treated as a _____.
- Revenue Expenditure
 - Deferred Revenue Expenditure
 - Capital Expenditure
 - None of these
14. Which one of the following is the reason for charging depreciation on patent rights?
- Lapse of time
 - Obsolescence
 - Out of fashion
 - All of these
15. Patents and copyrights fall under the category of _____.
- Current Assets
 - Liquid Assets
 - Intangible Assets
 - Fixed Assets

16. Some kind of literary, dramatic, musical, cinematograph film, sound recording or artistic works etc are coming under which type of intangible asset?
- Goodwill
 - Patent rights
 - Trade Marks
 - Copyrights
17. In the balance sheet, generally copy right must be shown at _____.
- Cost Price
 - Market Price
 - Cost or Market Price whichever is less
 - Written down Value
18. A registered and legalized brand name or brand mark is what is known as _____.
- Brand Name
 - Trade Name
 - Trade Mark
 - Brand Mark
19. Stores and Spare Parts are shown in Company's balance sheet under the head _____.
- Current Assets
 - Fixed Assets
 - Intangible Assets
 - Fictitious Assets

**Answers 1.(b), 2.(d), 3.(c), 4.(a), 5.(b), 6.(c), 7.(c), 8.(d), 9.(a), 10.(b) 11.(b)
12.(c) 13.(a) 14.(d) 15.(c) 16.(d) 17.(d) 18.(c) 19.(a)**

II. Very Short Answer Questions

- How would you classify current assets?
- What is current asset? Give example.
- What is the general procedure for physical stock taking?
- What is an intangible asset? Give example.
- How should goodwill be valued?
- What is replacement cost?
- What is realisable value?
- How would you verify Copyrights?
- What is Pick and Choose method for valuing stock?
- Write short notes on the following:(i). Verification of Cash-in-hand.(ii). Verification of Book Debts.(iii). Verification of Stock-in-trade.
- What are Stores and Spare Parts?
- How would you verify Loose Tools?

III. Short Answer Questions

- State the auditor's duty as regards to verification of cash-in-hand and cash at bank.
- How an auditor is responsible for verification of stock-in-trade?
- What are the steps to be taken to verify sundry debtors of a limited company by the auditor?
- What is the general procedure of valuing the stock-in-trade?

5. What are the duties of an auditor regarding the valuation of Goodwill?
6. Explain the procedure of sending letters requesting confirmation from debtors.
7. Can an auditor afford to remain totally absent during the physical verification of inventories? Discuss and enumerate the methods of valuation of stock-in-trade.
9. Enumerate the important features of Goodwill.
10. State briefly, how the copyrights of a business are verified and valued for Balance Sheet purpose.

IV. Essay Type Questions

1. Explain the verification of current assets.
2. How would you verify the balance at bank to eliminate the risk of fraud?
3. Briefly explain the valuation of stock for Balance Sheet purpose and examine the Auditor's position in this respect.
4. Explain about the verification of intangible assets.
5. What is verification? How would you verify (a) Goodwill (b) Patents (c) Copyrights and (d) Trade Marks.
6. What is valuation? How would you value (a) Goodwill (b) Patents (c) Copyrights and (d) Trade Marks
7. What are the special considerations should be kept in mind while verifying and valuing Trade debtors?
8. Explain the special points to which an auditor should direct his attention for the adequacy of provision for bad and doubtful debts in the valuation of sundry debtors?

9. Discuss fully recognised accounting principles governing valuation of inventories.
10. State the steps to be taken to verify Goodwill by an auditor and his duties regarding these?

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Chapter

6

VERIFICATION OF LIABILITIES



Learning Objectives

- To understand the various forms of liabilities.
- To define the auditors duty with regard to verification of various liabilities.

POINTS TO RECALL

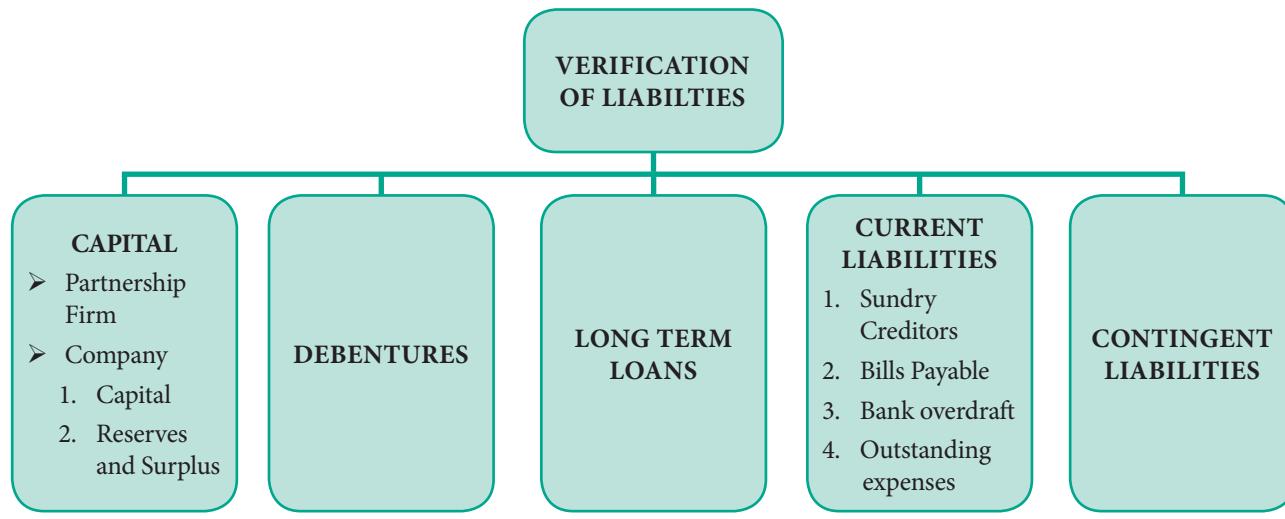
RECAP

From the previous chapter, we have studied the meaning and classification of assets and procedures for verification and valuation of fixed assets, investments, current assets and intangible assets.

6.1 Introduction

Liabilities are legal obligations of the organization to third parties. It is in the form of Capital, Debentures, Long term loans, payment to suppliers against goods and expenses, contingent liabilities etc. Verification of liabilities is as important as verification of assets. If liabilities are

not properly verified and valued, the Balance Sheet will not reveal a true and fair view of the state of affairs of a business concern. The main objective of verifying liabilities is to ensure that all the liabilities are properly disclosed, valued, classified and presented in the Balance Sheet. The diagram given below shows the various types and classifications of liabilities.





6.2 Verification of Capital

The amount invested by the owner in a business concern is called as Capital. The owner may be a sole proprietor or partner or shareholder. It is an internal liability of the business concern and the auditor is required to verify the genuineness and correctness of it in the Balance Sheet.

6.2.1 Verification of Capital in a Partnership Firm

The auditor should take into consideration the following while verifying capital of a partnership firm.

1. Verify Partnership Deed:

The auditor should verify the partnership deed to find out the original capital contributed by each partner and the rate of interest payable on capital.

2. Verify Capital Accounts:

He should verify all the transactions affecting the capital accounts of the partner.

3. Examine Books of Accounts:

He should examine the cash book, pass book and withdrawals of the partners.

6.2.2 Verification of Capital in a Company

While verifying the capital of a company, the auditor should verify the share capital

and the level of reserves and surplus maintained by the company.

Meaning of Share Capital

Share capital means the capital raised by issue of shares. It is the amount invested by shareholders towards the face value of shares are collectively known as Share Capital.

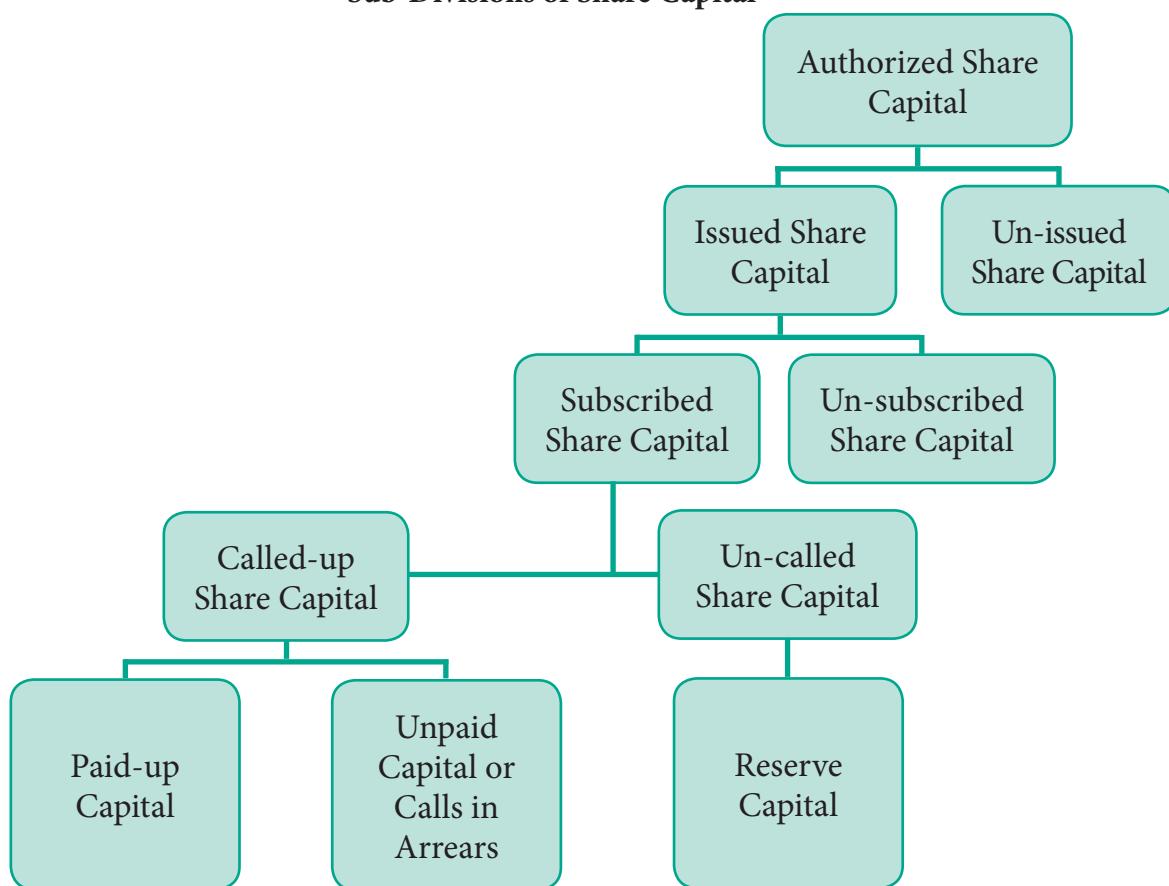
Sub-Divisions of Share Capital

- **Authorised Capital:** It is the maximum amount of capital which a company is authorised to raise and is stated in the Memorandum of Association. It can also be called as "Registered Capital" or "Nominal Capital".
- **Issued Capital:** This represents a part of the authorized capital, which is issued to the public for subscription.
- **Unissued Capital:** The difference between authorised capital and the issued capital represents unissued capital.
- **Subscribed Capital:** It refers to that part of the issued capital which has been subscribed by the public.
- **Unsubscribed Capital:** The difference between issued capital and subscribed capital represents unsubscribed capital.
- **Called-up Capital:** This refers to that part of the subscribed capital which has been called up by the company for payment.
- **Un-called Capital:** The difference between subscribed and called-up capital is called as un-called capital.
- **Paid-up Capital:** It is that part of called-up capital which has been actually paid-up by shareholders.
- **Unpaid Capital:** The un-paid balance in the called-up capital





Sub-Divisions of Share Capital



is known as “calls in arrears” or “un-paid capital”.

- **Reserve Capital:** A company can reserve part of its un-called capital and will be called only at the time of winding up. A special resolution has to be passed for this purpose. It is not disclosed in the company’s balance sheet.

Auditor's Duty in Verification of Share Capital

The auditor’s role in verifying the Share Capital is listed below:

1. **Verify Memorandum of Association and Register of Members:** In case of first audit, the auditor should check the Memorandum of Association, list of share holders and register of members for verification of share capital.
2. **Vouch Entries:** He should examine the pass book, cash book, and Minute book of directors in order to find out the number of shares issued, different types of shares issued and the amount received on each shares.
3. **Compliance with the Provisions of Companies Act:** In case of subsequent audits, the auditor should ensure that the share capital balance is the same as at the end of last year. If he finds that the capital stands altered by fresh issue of shares, the auditor should ensure that relevant provisions of the Companies Act have been complied with.
4. **Disclosure in Balance Sheet:** He should ensure that ‘authorised capital’ and each class of issued and subscribed capital has been shown separately in the Balance Sheet.
5. **Examine Rights of Shareholders:** He should examine the rights attached



to various shares in the Articles of the company.

6. **Issue at Premium:** Where the shares are issued at premium, he should verify that they are shown separately in the Balance Sheet.
7. **Issue of Shares for Consideration other than Cash:** Where the shares were allotted for consideration other than cash, he should examine the contract constituting with the vendor share and minutes book of the board.
8. **Verify RBI's Approval:** Where shares are allotted to foreign nationals, the auditor should verify RBI's permission in this regard.
9. **Forfeiture and Reissue of Shares:** The auditor should ensure that Articles of Association permit for forfeiture shares of and check the entries regarding forfeiture and reissue of shares.
10. **Transfer of Capital Profit:** He should verify that capital profit if any on reissue of forfeited shares has been transferred to Capital Reserve.



6.2.3 Verification of Reserves and Surplus Meaning

Reserves and Surplus is that portion of current profits or of accumulated profits which is not distributed as dividend, but is kept separate for purposes of meeting some known or unknown liabilities or for fulfillment of future needs.

Auditor's Duty

Reserves and surplus are appropriation out of profits. The auditor should verify that the reserves and surplus are

shown on the liability side of Balance Sheet with footnotes and verify entries in the Profit and Loss Appropriation Account.

6.3 Verification of Debentures

6.3.1 Debentures - Meaning

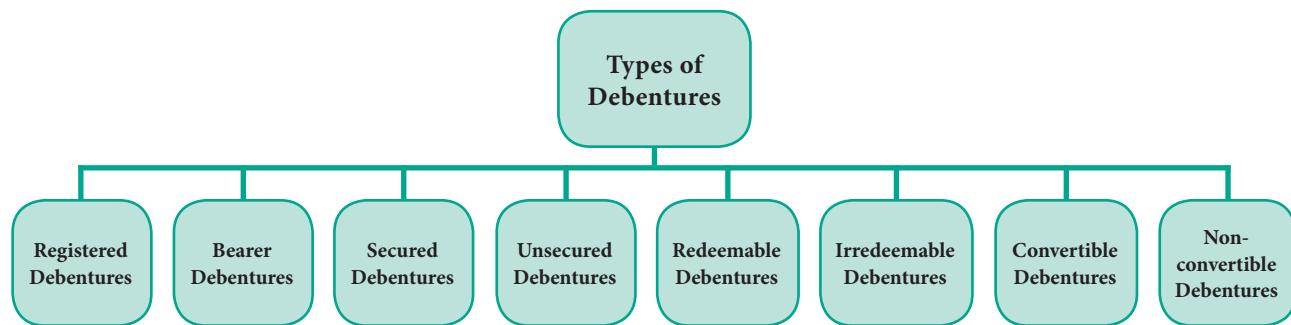
Debenture means a document issued by a company to raise finance. It is an acknowledgement of a debt which is given under the common seal of the company.



6.3.2 Types of Debentures

1. Registered Debentures: Registered Debentures are those which are transferable only by transfer deed names, address and particulars of the debentures possessed by holders are entered in the register. Interest is paid to one whose name appears in the register.

2. Bearer Debentures: Bearer Debentures are those which are transferred by mere delivery and company does not keep any record of debenture holders name and address. Payment of interest is made on submission on coupons attached to the debentures.



- 3. Secured Debentures or Mortgage Debentures:** Mortgage debentures are those debentures that are secured either on a particular asset called fixed charge or on general assets of the company called floating charge. Mortgage debentures are also called collateral debentures. In this case, debentures may also be issued to banks and financial institutions as addition or subsidiary security along with certain principal security. Lending institutions can exercise their right as debenture-holders, if the company does not pay its loan and the principal security falls short.
- 4. Un-secured or Naked Debentures:** Naked debentures are those which are not secured, companies of very good standing are able to issue Debentures of this type. They are not very common.
- 5. Redeemable Debentures:** Redeemable Debentures are those debentures which are redeemed or the payment of which is made after a specified Period. Debentures are redeemable in the following manner:
- (i) At the expiry of a specified period at par or at a premium.
 - (ii) Through purchase in the open market any time, at the price prevailing in the market.
 - (iii) By annual drawings.
- 6. Irredeemable Debentures:** Irredeemable Debentures are those for which the

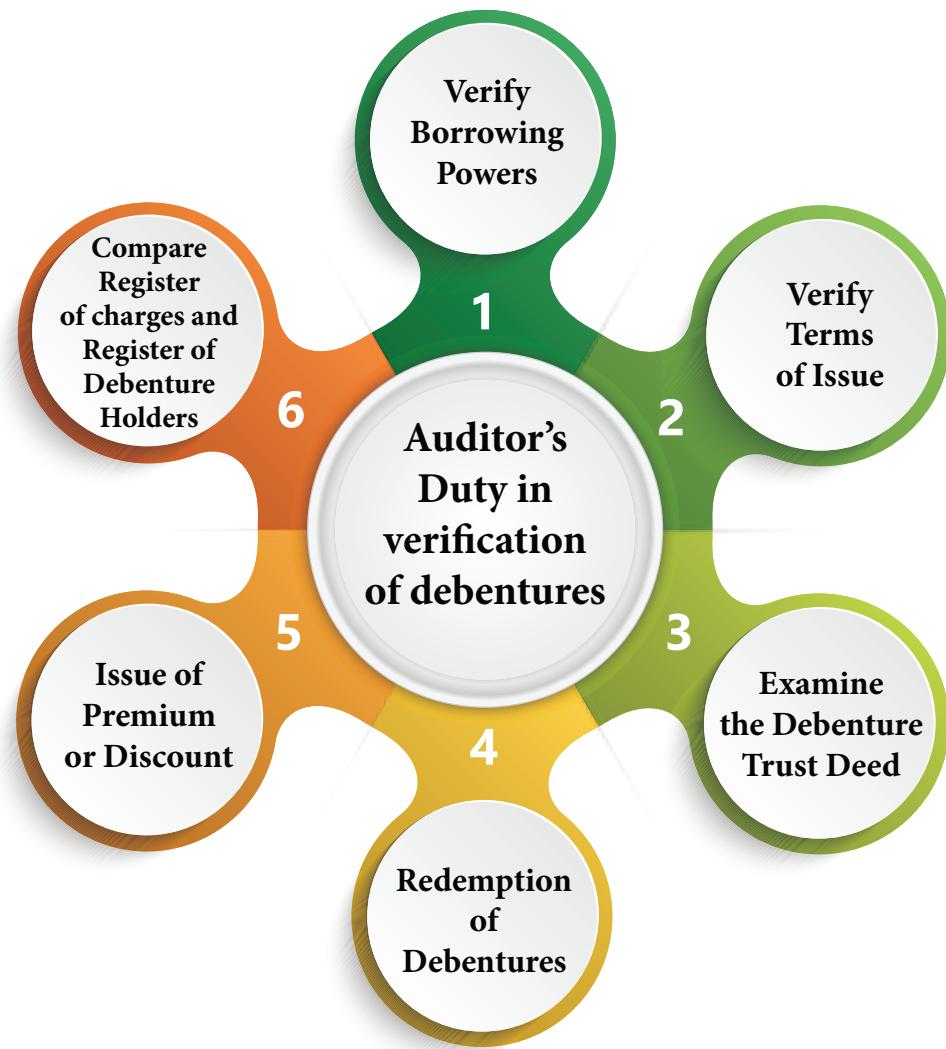
issuing company does not fix any date by when they should be redeemed and the holders of such Debentures cannot demand payment from the company so long as it is going concern. Usually such Debentures are repayable after a long period of time or when the company is winding up.

- 7. Convertible Debentures:** Convertible Debentures are those whose holders are given the option to convert the debentures fully or partly into equity shares after a specified Period. Those which are fully convertible are called fully Convertible Debentures and those which are partly Convertible are called partly convertible debentures.
- 8. Non-convertible Debentures:** Non-convertible debentures are those whose holders have no right to convert them into equity shares.

6.3.3 Auditor's Duty in Verification of Debentures

The auditor should note the following points while verifying debentures:

- 1. Verify Borrowing Powers:** The auditor should verify the Memorandum and Articles of Association of the company and verify whether the company has got the power to issue debentures and ascertain the borrowing limits of the company.



2. **Verify Terms of Issue:** He should ensure that the terms of the issue have been complied with.
3. **Examine Debenture Trust Deed:** He should examine the Debentures Trust Deed to know the amount of debentures issued and securities offered and he should obtain a certificate from the debenture holder to confirm the debenture amount.
4. **Redemption of Debentures:** He should make an inquiry regarding Debenture redemption and verify the Articles of Association for the Debenture redemption fund.
5. **Issue at Premium or Discount:** He should examine whether premium or

discount on issue of Debentures are properly disclosed in the Balance Sheet.

6. **Compare Register of Charges and Register of Debenture Holders:** He should compare the register of charges and register of debenture holders and check whether it is recorded correctly and verify that the assets mortgaged or charged are clearly indicated in the Balance Sheet.

6.4 Verification of Long Term Loans

Loans or Borrowings of a concern may be either secured or unsecured or may be for a short or long period.



6.5 Verification of Current Liabilities



Auditor's Duty

The auditor while verifying loan in general has the following duties:

- 1. Verify Loan Agreement:** The auditor should verify the loan agreement and refer to the correspondences for getting the loan.
- 2. Enquire Purpose of Loan:** He should enquire the purpose or purposes for which loan has been raised and also confirm that the loan raised are being utilized for the specific purpose for which it is being obtained.
- 3. Examine Borrowing Powers:** He should examine the borrowing powers of the company by referring to the Memorandum and Articles of Association of the company.
- 4. Disclosure in Balance Sheet:** He should verify that secured loans are shown separately from unsecured loans and any interest due but not paid is treated as a current liability in the Balance Sheet.
- 5. Obtain Confirmation Letter:** He should obtain confirmation letter from the parties who have advanced loans and should verify the balances with the books.

Current liabilities are those liabilities which are payable within one year. This includes bank overdraft, sundry creditors, bills payable and outstanding expenses.

6.5.1 Sundry Creditors

MEANING

A person who gives a benefit without receiving money or money's worth immediately but to claim in future is a creditor. The creditors are shown as a current liability in the Balance Sheet.

AUDITOR'S DUTY

1. Verify Books of Prime Entry:

The postings in purchase ledger are to be checked by verifying the books of prime entry. The postings may be checked for part of a year.

2. Verify Statement of Accounts:

The balances shown in credit of suppliers account are to be verified with the statement of accounts obtained from the creditors.

3. Verify Credit Entries:

The credit entries relating to discounts, returns, rebates etc. made in the suppliers account are to be verified



with the statement of accounts obtained from them.

4. Accounting of Purchase Returns:

The return outwards book is to be compared with the ledger accounts and confirm that all the returns are supported by the credit notes of the suppliers.

5. Purchases of Subsequent Year:

The purchase invoices relating to the period immediately following the close of the year, are to be verified to ensure that they do not relate to the period under audit.

6. Obtain Reasons for Outstanding Balance

The balances outstanding for a long period is to be probed and reasons for the same are to be found out.

7. Comparison of Gross Profit:

Percentage of gross profits of the previous years is to be compared with the gross profits of the year under audit. Variation if any, found to be unreasonable or omission of purchase or inclusion of fictitious purchases are to be considered.

8. Confirmation from Management

The auditor shall obtain from the management a certificate that all liabilities that had accrued till the close of the accounting year are carefully accounted for.

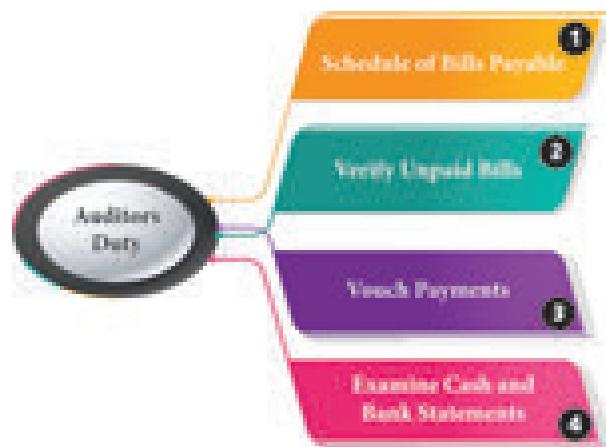
6.5.2 Bills Payable

MEANING

Bill refers to bill of exchange. Bills payable means bills accepted for the credit purchases made. The amounts on bills are payable at its due dates. It is a current liability.

AUDITOR'S DUTY

- Schedule of Bills Payable:** The auditor should get a schedule of bills payable and compare with the Bills Payable Book and Bills payable Account.
- Verify Unpaid bills:** He should verify unpaid bills and check the subsequent payments with the cash book.
- Vouch Payments:** He should vouch the payments made against bills payable.
- Examine Cash and Bank Statements:** He should examine cash and bank statements for the bills which are met after the date of Balance Sheet but before the date of audit.



6.5.3 Bank Overdraft

MEANING

It is a line of credit extended by a bank to its account holder to withdraw money in excess of the balance in his account up to a specified limit. It is a current liability as the business concern, being an account holder is liable to repay the amount to the bank.

AUDITOR'S DUTY

- Verify Borrowing Powers:** The auditor should examine the Memorandum and Articles of Association to know the borrowing powers of the company.



2. **Verify Details of Contract:** He should study the loan contract, terms and conditions of loan, rate of interest, nature of security, type of pledge etc.
3. **Proper Authorisation by Directors:** He should refer the minutes book of directors to know that bank overdraft is duly authorised.
4. **Confirm Overdraft Balance:** He should confirm the amount of overdraft from the bank at the close of the year.



6.5.4 Outstanding Expenses

MEANING

Expenses which have been incurred but not yet paid during the accounting period for which the final accounts are being prepared are called as Outstanding Expenses.

AUDITOR'S DUTY

1. Verify list of Outstanding Expenses:

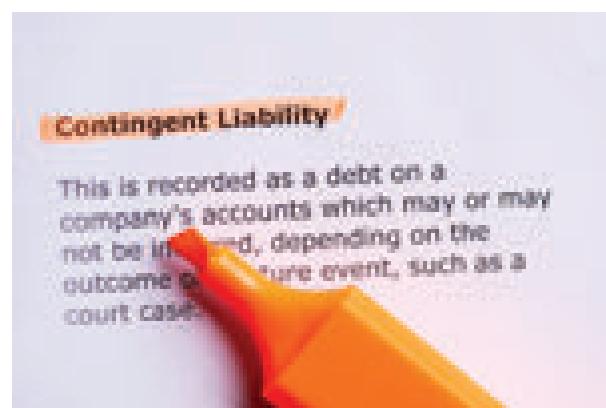
The auditor should ask for a list of outstanding expenses certified by a responsible officer from the client with classification as per the nature of expenses.

2. **Verify Cash Book:** He should check the next year cash book to confirm that they have been paid off by the time of audit.
3. **Compare Expenses with Previous year:** He should compare the list of outstanding expenses of the current year with that of the previous year to identify deviations, if any.
4. **Verify Provision Created:** He should see whether necessary provision for all outstanding expenses has been made by checking relevant receipts and vouchers.

6.6 Verification of Contingent Liabilities

6.6.1 Meaning

Contingent liabilities are those liabilities, which may or may not arise in the future for payment. The auditor should ensure that all known and unknown liabilities





have been accounted in the books of accounts and have been shown in the Balance Sheet.

The following are the examples of Contingent Liabilities:

1. Liabilities on Bills Receivable discounted and not matured.
2. Liability on account of partly paid calls.
3. Liability on arrears of dividend on Cumulative Preference Shares.
4. Liability under a guarantee.
5. Liability for penalties under forward contracts
6. Liability that arises on account of litigation in respect of labour suits, trademarks, copyrights etc.

6.6.2 Auditor's Duty in Verifying Contingent Liabilities

1. Ensure Creation of Adequate Provision:

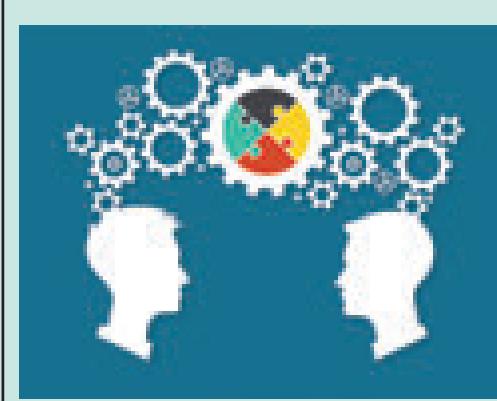
The auditor should ensure that proper provision has been made for certain liabilities, for example, liability which arise on account of litigation and if he is not satisfied, the fact should be stated in the report.

2. Disclosure in Balance Sheet:

In respect of certain liabilities for which no provision has been made in the books for example, Bills Receivable which has been discounted, arrears of accumulated fixed dividend etc. The auditor should verify that such liabilities are disclosed as foot note in the Balance Sheet.



STUDENTS ACTIVITY



1. Discuss long term liability, short term liability and current liability of an industry
2. Discuss the financial arrangements made to meet the unforeseen expenses in your institution

SUMMARY

- The auditor should take into consideration the following while verifying liabilities:
(1) whether proper records are maintained, (2) whether liabilities are actually payable and properly disclosed in balance sheet.
- Auditor should verify Share Capital with reference to the following - Memorandum of association and register of member, Vouch entries in cash and pass book,



Examine contracts with promoters and vendors, Properly disclosed in balance sheet and comply with provisions of Companies Act.

- Auditor should verify Reserves and Surplus with reference to the following - Creation of reserve, Utilisation of reserve, Disclosure in balance sheet, Confirm the rate of premium, Examine prospectus, articles of association and minutes of directors and Transfer of premium to securities premium account.
- Verification of debentures: Borrowing powers of the company, Terms of issue, Examine the debentures trust deed, Verify articles with regard to redemption of debentures and Compare register of charges and register of Debenture holders.
- Verification of Creditors: Schedule of creditors Vouch entries and postings, Verify goods inward register, Verify discounts and Verify hire purchase agreement.
- Verification of outstanding expenses: Verify statement of outstanding expenses, Provision for expenses, Compare balance with last year and Subsequent payment of expenses.
- Verification of contingent liabilities: Contingent liabilities are a liability which may or may not arise in the future for payment. The auditor has to check that all the known and unknown liabilities are shown in the balance sheet.



KEY TERMS

- **Shares:** It is a part of the share capital.
- **Debentures:** It is a credit bond issued by a company.
- **Share Capital:** A capital raised by the company by issue of shares.
- **Bearer Debenture:** A bearer debenture is an unregistered unsecured bond and are not recorded in the company's debenture-holders register with full details of every debenture holder.
- **Secured Debenture (or) Mortgage Debenture:** The debenture secured by a charge on the fixed asset of the issued company.
- **Un-secured (or) Naked Debentures:** Debentures that are not supported by a collateral security.
- **Contingent Liability:** A liability which may or may not occur in the future.



EVALUATION



I. Multiple Choice Questions:

1. The liability which may or may not arise in the future for payment is _____.
 - a. Certain liability
 - b. Contingent liability
 - c. Expenses
 - d. Revenues
2. While verifying the capital of a partnership firm, the important document to be verified is _____.
 - a. Memorandum of Association
 - b. Partnership Deed
 - c. Both
 - d. None of the above
3. While verifying the share capital of joint stock companies, the important document to be verified is _____.
 - a. Memorandum of Association
 - b. Partnership Deed
 - c. Both
 - d. None of the above
4. _____ denotes the verification made by the auditor to know whether the liabilities are properly valued.
 - a. Valuation
 - b. Assessment
 - c. Computation
 - d. None of the above
5. Creditors and Bank over draft are _____.
 - a. Current Assets
 - b. Fixed Assets
 - c. Current Liabilities
 - d. Fixed Liabilities
6. In _____ side of the balance sheet, outstanding wages, salaries, rent, tax and interest etc. have to be shown.
 - a. Assets
 - b. Liabilities
 - c. Both
 - d. None of the above
7. The difference between the subscribed capital and called-up capital is called _____.
 - a. Calls-in Arrears
 - b. Calls-in Advance
 - c. Paid-up Capital
 - d. Reserve Capital
8. _____ is created out of capital profits of the company.
 - a. Capital Reserve
 - b. Reserve Capital
 - c. Subscribed Capital
 - d. Calls-in Advance
9. _____ is an acknowledgement of a debt received by the company.
 - a. Shares
 - b. Debentures
 - c. Bonds
 - d. Fixed Deposits



10. _____ are those debentures for which repayment is made after a specified period.
- Redeemable Debenture
 - Irredeemable Debenture
 - Convertible Debenture
 - Secured Debenture

Answers: 1. (b), 2. (b), 3(a) 4(a), 5.(c), 6.(b), 7.(a), 8.(a), 9.(b), 10.(a)

II. Very short answer questions:

- What do you mean by verification of liabilities?
- What is calls-in advance?
- What is a debenture?
- What is calls-in arrears?
- What is Bank Overdraft?

III. Short answer questions:

- What do you mean by share capital?
- What is contingent liability?
- What do you understand by authorised capital?
- What is reserve capital?
- What are the kinds of Debentures?

IV. Essay type questions:

- Explain the types of share capital
- Explain the auditor's duty with regard to share capital
- Explain the auditor's duty in respect of capital reserve
- Explain the auditor's duty in relation to contingent liability?
- As an Auditor, how will you verify loans taken by a business concern?

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Chapter

7

DEPRECIATION



Learning Objectives

- To understand the meaning and definition of depreciation.
- To know the causes for depreciation.
- To understand the objectives and factors for providing depreciation.
- To understand different methods of calculating depreciation and auditor duties with regard to it.

POINTS TO RECALL

RECAP

In the previous lesson we have studied verification of various liabilities such as share capital, reserve and surplus, long term loan and current liabilities like trade creditors, outstanding expenses and contingent liabilities.

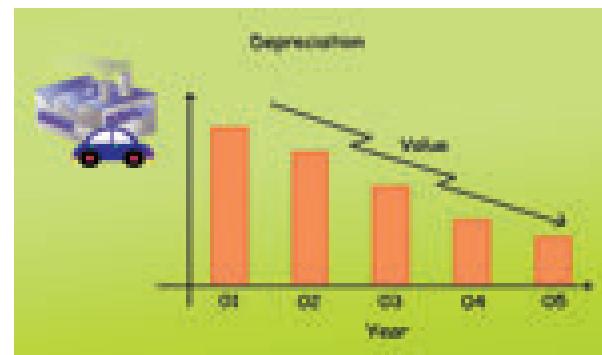
7.1 Depreciation – Meaning

The word depreciation has been derived from a Latin word 'Depretium'. The words 'De' means decline and 'pretium' means 'price'. Thus, the word 'Depretium' stands for decline in the value or price of an asset. The gradual diminution, loss or shrinkage in the utility value of an asset due to wear and tear in use, effluxion of time or obsolescence is called as depreciation.

Depreciation accounting is a system which aims at distributing the cost or basic value of tangible capital assets less salvage value over the estimated useful life of the asset in a systematic and rational manner.

Only assets like building, plant, machinery, furniture etc. are subject to depreciation. It refers to the gradual diminution or loss in the utility value of

an asset on account of wear and tear in use, efflux of time or obsolescence.





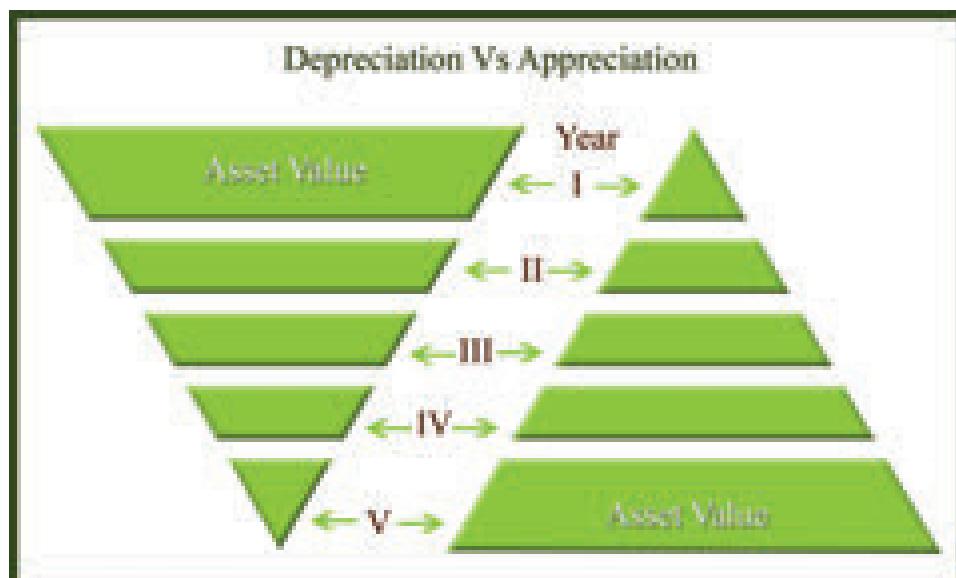
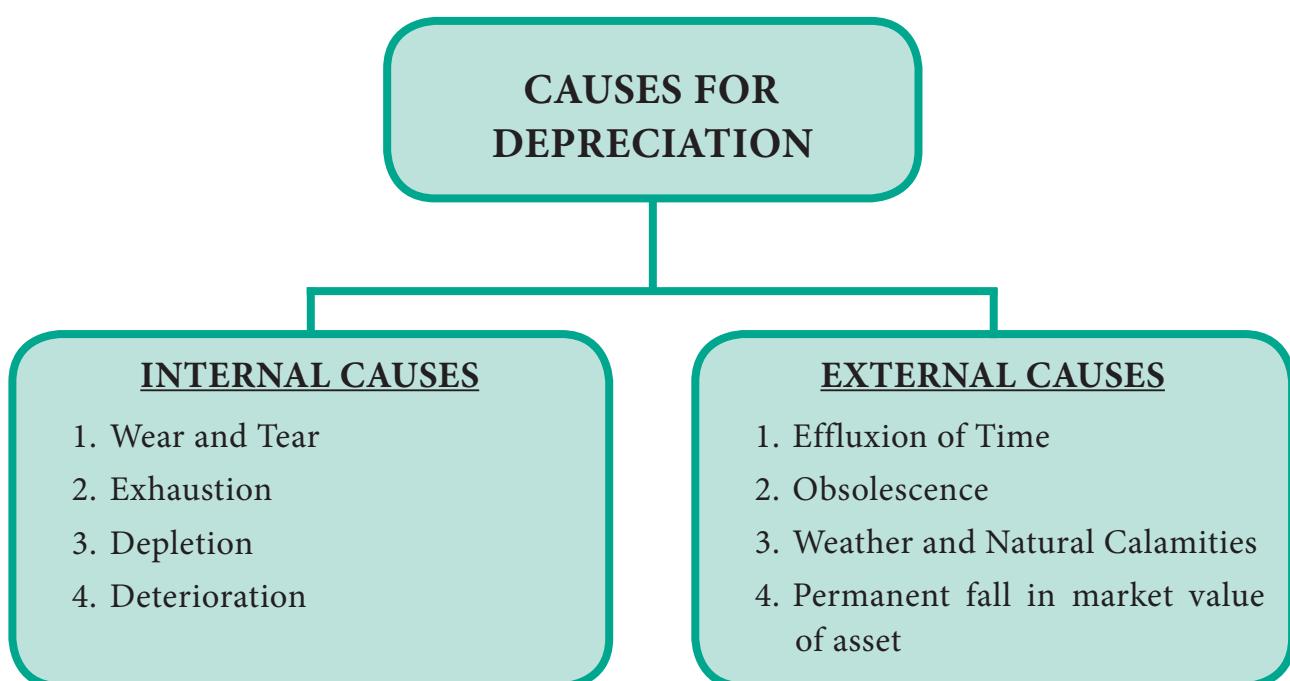
7.2 Definition

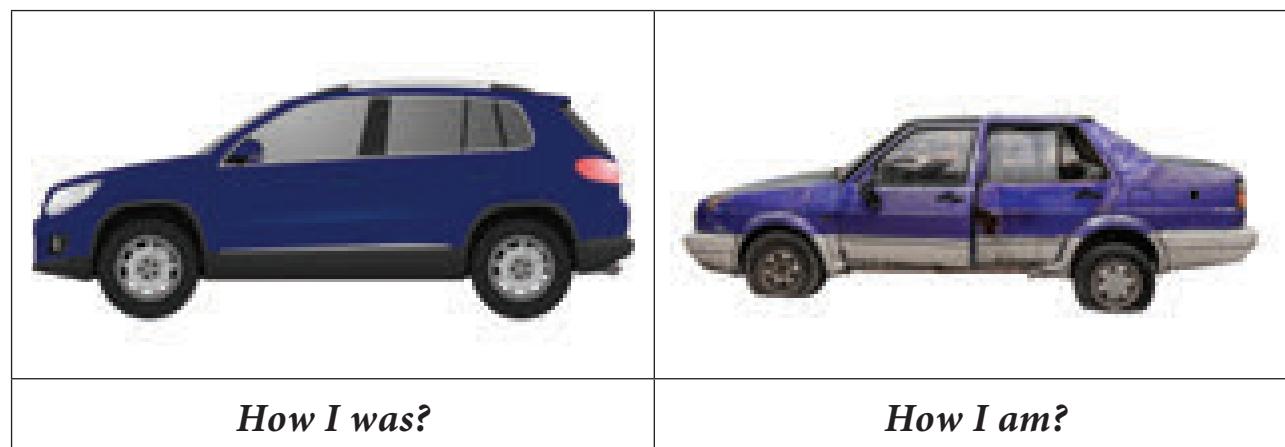
- **R.G.Williams**, “Depreciation may be defined as a gradual deterioration in value due to use”.
- **Spicer and Pegler**, “Depreciation may be defined as the measure of exhaustion of the effective life of an asset from any cause during a given period”.
- **The Institute of Chartered Accountants of India** defines it as, “depreciation is

a measure of wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes”.

7.3 Causes For Depreciation

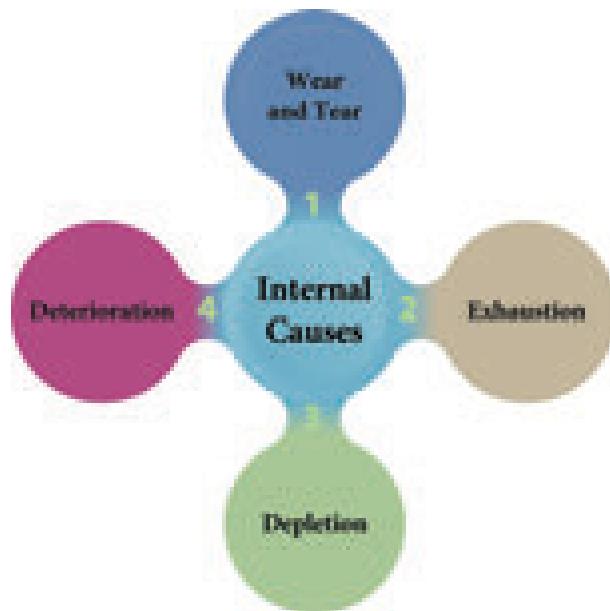
The causes of depreciation can be classified as – (1) Internal causes, and (2) External causes.





INTERNAL CAUSES

Wear and tear, exhaustion, depletion, deterioration etc., causes depreciation on assets which are internal in nature.



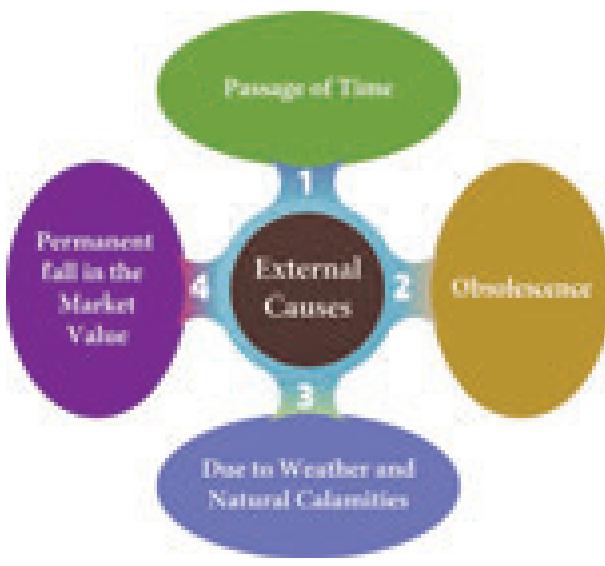
1. Wear and Tear: The value of capital assets like plant, machinery, building etc. decrease in value due to constant use. The wear and tear of an asset depends on the usage of asset. For example, when machinery is used for three shifts the wear and tear will be greater than the machinery which is used on a single shift. The difference between the value of an asset when it

was purchased and its value after being used for some time period represents wear and tear of the asset.

2. **Exhaustion:** Certain assets like plantations and livestock loose their value with lapse of time as they are being used or consumed. These assets have a definite period of life after which they exhaust in value and become useless.
3. **Depletion:** Natural resources such as mines, quarries and oil wells are of a wasting character and are called as wasting asset. These assets loose their value due to extraction of oil, depletion of minerals and metals. Thus, the value of wasting assets declines due to gradual exhaustion.
4. **Deterioration:** Deterioration means erosion in value of those assets which have a very short period of life. The fall in value of those assets refers to depreciation.

EXTERNAL CAUSES

External factors which cause depreciation include passage of time, obsolescence, permanent fall in market value and weather and accidental calamities. These factors are not connected to the inherent nature of the asset.



- 1. Effluxion or Passage of Time:** The utility of some fixed assets like patents, copyrights, trademarks, leasehold property etc., is confined to a time frame. The value of the asset decreases after a particular period of time. For example, assets like lease hold property becomes valueless after the expiry of the period of lease.
- 2. Obsolescence:** The value of an asset decreases due to (a) invention of new and improved techniques or production methods, for example, old machines become outdated with the introduction of new machines, (b) decline in market due to change in taste and fashions, or (c) change in market conditions, for example, the demand for a product or service falls to such a level that it is no longer viable to continue with that product or service, (d) legal restraints, etc. These factors make it economical to replace the assets though they are still usable.
- 3. Due to Weather and Natural Calamities:** Some assets lose in value when they are constantly exposed to rain, sun, wind etc. and certain assets decline in value

when they are affected by certain natural calamities like flood, earth quake, fire etc.

4. Permanent fall in the Market Value:

Assets like investments lose value due to permanent fall in market value of the asset. Such a fall in the price of an asset should be treated as depreciation. Temporary fall in the value of investments should be ignored for calculating depreciation.

7.4 Objectives of Providing Depreciation

The need for charging depreciation arises due to the following objectives:



- 1. To Ascertain the True Cost of Production:** Depreciation or decrease in the value of fixed asset arises when the asset is used in production of goods or services.



Hence the cost of utilizing the asset is an indirect cost and it is necessary to charge depreciation as an item of cost of production. If depreciation on fixed assets is not charged, the cost records will not present a true and fair view of the cost of production.

2. To Ascertain Correct Income:

Depreciation is a charge against the income or revenue in an accounting period and should be deducted from the income earned to ascertain correct income of the business. It is an invisible cost and is not paid to external persons. True and correct profit can be ascertained only when depreciation is charged against income. Otherwise, the Profit and Loss Account or Income Statement will not present a true and fair view of the business.

3. To Show a True and Fair View of Financial Position:

Balance Sheet reveals the financial position of the business. The value of fixed assets should be shown in Balance Sheet after deduction of depreciation. Otherwise, the value of fixed assets will be overstated and the Balance Sheet will not show a true and fair view of the financial position of the business.

4. To Comply with Legal Requirements:

Companies are formed and registered under the Companies Act. According to this, the Companies should compulsorily provide for depreciation before payment of dividend to shareholders.

5. To Accumulate Funds for Replacement of Asset:

A portion of profit is set aside every year in the form of depreciation for replacement of an asset. Depreciation which is accumulated over a period of time is used

for a specific purpose of replacement of the asset at the end of its useful life.



6. To Keep Capital Intact: Keeping the capital intact has always been the focal point in business. The amount of depreciation charged against every year's profit should be appropriated. Omission or understatement of depreciation will inflate profit. If any dividend is distributed out of inflated profit, it would be an incorrect return on capital and will decrease the value of the business.

7. To Plan Tax Liability:



Tax planning is the legitimate right of every assessee. Depreciation can be used as tax saving device. It is an admissible expense while computing income from business. Income tax liability is reduced by claiming depreciation. A suitable depreciation policy is always essential to minimize tax liability.



7.5 Factors (or) Basis of Providing Depreciation



- 1. Original Cost of the Asset:** Depreciation has to be provided on the original cost of the asset. Cost includes all expenses incurred like freight and installation charges up to the point at which the asset is ready for use.
- 2. Residual or Scrap Value:** The value which an asset brings when it is sold

as scrap should be considered before making provision for depreciation. Residual value is the estimated sale value of an asset at the end of its economic life to the business concern.

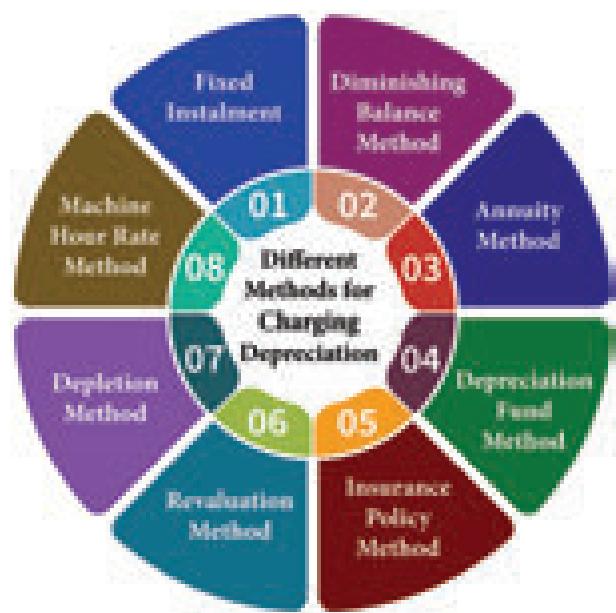
- 3. Estimated Working Life:** The working life of an asset differs, based on its nature, usage, conditions under which it is maintained and preserved in business. Hence the working life of an asset should be carefully determined to calculate the accurate amount of depreciation.
- 4. Additions and Extensions:** Additions and extensions are made whenever necessary throughout the life of an asset. Such expenditure is capital in nature. When additions are made on the asset, the working life is extended and depreciation is provided accordingly.
- 5. Repairs and Renewals:** In order to maintain an asset in good working condition, proper provision for repairs should be provided. By proper maintenance and repairs, the asset works well for the stipulated period otherwise it becomes useless after a few years. This should be considered before providing for depreciation.
- 6. Obsolescence:** Obsolescence is another factor to be considered for depreciation. The innovation and improvement in new technology make the existing asset valueless. Hence, it should be borne in mind before providing depreciation.
- 7. Interest on Capital Investment:** Interest could be earned if the capital involved in purchasing an asset would have been invested elsewhere. The loss of interest on that account should be



taken into account before providing for depreciation.

8. Legal Provisions: The provisions of Companies Act and Income Tax Act should be kept in mind before charging depreciation on an asset.

7.6 Different Methods of Charging Depreciation



1. Straight Line (Or) Fixed Instalment Method

This is the oldest and simplest method of charging depreciation. The life of

the asset is estimated and depreciation is written off equally over the life of an asset. The amount of depreciation is such that the book value of the asset is reduced to zero at the end of life of the asset. The amount of depreciation is calculated as follows:

$$\text{Amount of Depreciation (Rs.)} = \frac{\text{Original cost} - \text{Residual or Scrap value}}{\text{Estimated Useful life of the Asset}}$$

$$\text{Rate of Depreciation (\%)} = \frac{\text{Amount of Depreciation}}{\text{Original Cost}} \times 100$$

ADVANTAGES

- Simple to Understand:** This method of calculating depreciation is very simple to understand.
- Easy to Calculate:** It is easy to calculate the amount and rate of depreciation.
- Accuracy:** In this method, the book value of the asset, i.e., cost price of the asset less depreciation, becomes zero or equal to its scrap value of the expiry of its useful life.

SUITABILITY

- Straight line method of charging depreciation is suitable for assets when – (1) the possibility of obsolescence is less, and (2) when repair charges are less.
- This method is recommended in case of fixed assets such as buildings, plant and machinery and other assets which are subject to depreciation by reason of their employment in the business.
- It is also recommended in case of assets which become exhausted by the effluxion of time such as leasehold properties, patents etc.



DISADVANTAGES

- 1. Difficulty in Calculating Depreciation:** Calculation of depreciation is easy only when life of the original asset and its additions are similar. When both have varied life calculation becomes difficult and complicated.
- 2. No Provision for Replacement of Asset:** This method does not provide any provision for replacement of asset on the expiry of its useful life.
3. This method increases the charge to the Profit and Loss Account over the years because the repairs to an old asset increases.
4. This method increases the cost of the asset over the years as the amount of depreciation is fixed over the years.

2. Diminishing Balance or Written Down Value Method

In this method depreciation is charged at a fixed percentage on the reducing balance of the asset every year over the useful life of the asset. The amount of depreciation goes on decreasing every year. This method is very useful for plant and machinery where additions and extensions take place very often.

ADVANTAGES

1. It is a simple method of providing depreciation as fixed rate is applied on book value or written down value of assets.
2. This method is quite popular.
3. It provides uniform charge for services of the assets throughout the life.

DISADVANTAGES

1. The method is slightly complicated.
2. If the asset has no residual value it is very difficult to calculate the rate.

SUITABILITY

This method of charging depreciation is suitable when – (a) the possibility of obsolescence are more, and (b) the amount of repairs and renewals increases as the asset grows older.

3. ANNUITY METHOD

Annuity method considers both the value of asset and the amount of interest on the investment made in the fixed asset. Besides, interest, a fixed amount of depreciation is calculated on the basis of depreciation from Annuity Table and is charged to Profit and Loss Account every year. The method is precise and exact from the point of view of calculations, so it is called a scientific method.

ADVANTAGES

1. This method takes interest on capital invested in the asset into account.
2. It is regarded as most exact and precise from the point of view of calculations and is therefore most scientific.

DISADVANTAGES

1. The system is complicated and difficult to understand.
2. The ultimate consequences being that the net burden on profit and loss account grows heavier each year.

SUITABILITY

This method of calculating depreciation is suitable for those assets which require huge amount of capital, like, leasehold property.

4. DEPRECIATION FUND METHOD

This method provides funds for the replacement of the asset at the end of



its life. The amount of depreciation is credited to an account called Sinking Fund or Depreciation Fund account which is shown on the liabilities side of the balance sheet. This amount is invested in securities.

Every year the amount set aside for depreciation along with the interest is again invested. The amount so invested is debited to an account known as Sinking Fund Investment Account and these investments are shown as an asset in the Balance Sheet. The amount of depreciation remains the same for the year.

The rate of interest available from investments and the time required for replacement of the asset enables to determine the amount of depreciation. A reference to Sinking Fund Table gives the extra amount of depreciation to be charged every year. The investments are sold when the asset is due for replacement and the amount so received is used for purchasing the new asset.

The value of asset is shown at its original cost in all years. In the last year, the asset is written off by transferring it to Depreciation Fund Account.

This method is suitable where intention is not only to provide depreciation but also to provide for its replacement as happens in case of Plant and Machinery and many wasting assets.

ADVANTAGES

1. This method sets aside certain amount for replacement of asset by maintaining separate provision.
2. The sale proceeds of the investments are useful for replacement of the asset.
3. This method helps to strengthen financial position of a concern.

DISADVANTAGES

1. This method creates complication and burden on funds each year as they are invested outside.
2. Prices of securities may fall at the time when they are to be realized as a result of which loss may have to be suffered.

5. INSURANCE POLICY METHOD

In this method an insurance policy is purchased for the value of the asset. This policy is taken up for the life of the asset and it matures at a time when the asset is to be replaced. The amount provided for depreciation is paid towards insurance premium. The amount of premium remains the same in all the years. On maturity of the policy, insurance company will pay the amount and the amount will be used for replacing the asset.

ADVANTAGES

1. Funds are readily available for replacement of the asset.
2. Funds are not used for other purposes as they are invested outside.
3. There is no risk in getting back the money as the policy is taken with the insurance company.

DISADVANTAGES

The drawback of this method is that it creates an increasing burden on the funds of each year as they are invested outside.

6. REVALUATION METHOD

In this method the amount of depreciation is calculated by revaluing the asset at the end of each year. The difference between the value of the asset at the beginning and at the end of the period is taken as depreciation. There can be an appreciation in value too. The amount of appreciation is



debited to the asset and credited to profit and loss account.

ADVANTAGES

1. It is easy to understand and simple to implement.
2. Depreciation is calculated every year in the opening balance of asset.
3. This method equalizes the yearly burden on profit and loss account in respect of depreciation.

DISADVANTAGES

1. This method charges heavy amount of depreciation in earlier years.
2. It is difficult to assess the life of these assets, calculation of depreciation becomes complicated.
3. The formula to obtain rate of depreciation can be applied only when there is residual value of the asset.
4. This method has limited applicability.

SUITABILITY

This method can be used for specific assets like loose tools, copyrights, trademarks, etc.,

7. DEPLETION METHOD

This method is specially used for those assets which deplete with use. The cost of the assets is divided by total workable deposits. The depreciation rate is calculated by dividing the cost of the asset by the estimated quantity of product likely to be available. Annual depreciation will be the quantity extracted multiplied by the rate per unit.

For example, If a mine has 2 lakh tons of coal and the value of mine is ₹ 5 lakhs, each ton of coal will cost ₹ 2.50.

The quantity of coal taken out of the mine in a period will be multiplied by the rate per ton, i.e., ₹ 2.50 and the resultant figure will be the amount of depreciation.

ADVANTAGES

1. It provides a method to charge amortization or depreciation for the companies dealing in resources, as these assets are different in nature and consumption, from other fixed assets like car, building etc.
2. The method is easy to understand.

DISADVANTAGES

1. The method is simply used for a periodic reduction in the cost of the asset.
2. The method is highly subjective especially the number of units to be extracted is difficult to estimate.

SUITABILITY

This method is suitable for mines, quarries, sandpits, etc.

8. MACHINE HOUR RATE METHOD

Under this method, the life of a machine is estimated in terms of its working hours instead of years. The total number of hours in which a particular machine will work efficiently is estimated. The estimated number of hours is then divided by the cost of the machinery less residual value to ascertain the hourly rate of depreciation.

This method is considered more scientific and precise than either the fixed instalment method or the diminishing balance method.



ADVANTAGES

1. It helps to compare the relative efficiencies and cost of operating different machines.
2. It is most scientific, practical and accurate method of recovery of manufacturing overheads.
3. It provides ready method for measuring the cost of idle machines.

DISADVANTAGES

1. It involves additional work in assessing the working hours of machines and thus it is a costly method.
2. It gives inaccurate results if manual labour is also used.

Rates of Depreciation (for Income-Tax) Specified in Finance Act, 2018

Block of Asset	Depreciation Allowances as % on WDV
PART-A (Tangible Assets)	
1. Building (Residential, Hotel, Boarding Houses)	5%
2. Building (Commercial – Other than residential)	10%
3. Furniture & Fittings	10%
4. Plant & Machinery	
➤ Machinery & Plant (General)	15%
➤ Vehicles (Non-commercial)	15%
➤ Vehicles (Commercial) - Motor car, Lorry, Trucks	30%
5. Ships	20%
PART-B (Intangible Assets)	
I. Know - how patents, copy rights, trade marks, licences, franchises or any other business or commercial rights of similar nature.	25%
Plant & Machinery	
1. Motor Car	15%
2. Aeroplane	40%
3. Motor Bus, Lorry	30%
4. Life Saving – Medical Equipment	30%
5. Surgical / Medical Equipment	40%
6. Computer / Computer Software	40%
7. Books – Annual publication, library	40%

To Think:

- Depreciation is not provided on Land why? But appreciated.....
- Depreciation is not provided on Gold, Silver and Diamond why? But appreciated



7.7 Auditor's Duties with Regard to Depreciation

An auditor is not a valuer to determine the value of assets held by the company. He has to depend on the suggestions and advice given by professionals or experts in determining the value and estimated life of the asset. However, the following are the duties of an auditor in this regard.

- 1. Verify Depreciation Rates:** The auditor should ensure that depreciation has been provided as per the rates prescribed by the Companies Act.
- 2. Disclosure in Financial Statement:** He should ensure that adequate depreciation is charged and properly disclosed in the Profit and Loss Account and Balance Sheet.
- 3. Compliance with Accounting Principles:** He should ensure that relevant accounting principles have been followed while providing for depreciation.
- 4. Depreciation on Purchase or Sale:** When assets are purchased or sold during the year, auditor should ensure that depreciation is charged on pro-rata basis

taking into account the date of purchase or sale and the accounting period.

- 5. Certification from Experts:** In case the depreciation charged is more than the rates prescribed, he should examine whether same are based on professional and technical advice.
- 6. Consistency:** Where difference rates are used for different assets, the same should be consistently applied over the years.
- 7. Change in Method of Depreciation:** In case of a change in the method of accounting for depreciation it is recalculated from the date on which asset came into use and deficiency, if any, should be charged to Profit and Loss Account.
- 8. Adequacy of Capital Employed:** Auditor should check whether the capital employed in the assets is being kept intact.
- 9. Revaluation of Assets:** In case of revaluation of asset during the year he should ensure that depreciation is charged on revalued amounts.





STUDENTS ACTIVITY



1. Discuss the process for depreciation for the assets in your institution and calculate the book value as on date.
2. Discuss the suitable method of depreciation for your computer and its accessories.
3. Refer the depreciation rates prescribed by the finance act for income tax purpose.

SUMMARY

10. **Procedure of Computation:** He should ensure that the procedure for calculating depreciation complies with the provisions of Companies Act and Income tax Act.

Depreciation is the gradual diminution, loss or shrinkage in the utility value of an asset due to wear and tear in use, effluxion of time or obsolescence. It is caused due to wear and tear, exhaustion, depletion, deterioration, effluxion of time, obsolescence, permanent fall in market value of an asset etc. The main objectives of providing depreciation is to ascertain correct profit or loss and to show true and fair view of the financial position and to ensure the compliance of legal provisions of the Companies and Income Tax Act. The method of providing depreciation varies according to the nature of the asset and business. Some of the principal methods of providing depreciation are: Fixed Instalment method, Written down value method, Depreciation or Sinking Fund method, Insurance policy method, Depletion method, Machine hour rate method. In depreciation audit, it is the duty of an auditor to verify the cost of the asset, scrap or residual value, useful life of the asset, depreciation amount, rate of providing depreciation, additions or deletions to the asset, provision for depreciation and proper disclosure in the financial statements.



KEY TERMS

- **Depreciation** is the decrease or reduction in the value of fixed assets.
- **Obsolescence** is the loss arising on account of new invention, technological changes and legal restraints.
- **Effluxion:** Fall in the value of asset over passage of time, like leasehold property, patents, trademarks, copyrights etc.



- **Amortization:** It is an accounting term that refers to the process of allocating the cost of an intangible asset over a period of time. It also refers to the repayment of loan principal over time.
- **Exhaustion:** Assets like plantation, livestock loose their value with lapse of time as they are being used or consumed. These assets have a definite period of life after which they exhaust in value and become useless.
- **Depletion:** Assets like oil wells, mines, quarries etc. loose their value on extraction of oil, mineral and metals.
- **Deterioration:** Depreciation by deterioration is found in case of those assets which have a temporary or short period of life like food articles.
- **Assets Replacement** is the replacement of existing assets at a future date.
- **Residual or Scrap Value:** Residual or scrap value is an estimated sale value of the asset at the end of its economic life.



EVALUATION



HVZZCJ

Multiple Choice Questions:

1. Depreciation is charged on _____
 - a. Fixed Asset
 - b. Current Asset
 - c. Contingent Asset
 - d. All of the above
2. Which one of the following is not external cause of depreciation?
 - a. Effluxion of time
 - b. Obsolescence
 - c. Permanent fall in market value
 - d. Wear and tear
3. Which one of the following is not an internal cause of depreciation?
 - a. Exhaustion
 - b. Depletion
4. In case any addition is made to any asset during the financial year, depreciation should be calculated
 - a. On a pro-rata basis
 - b. For full year
 - c. At a higher rate
 - d. At a lower rate
5. Depletion method is used in respect of _____.
 - a. Wasting assets
 - b. Fixed assets
 - c. Premises
 - d. Patents



6. This method is suitable for assets such as bottles, loose tools, livestock etc.
 - a. Depletion method
 - b. Production unit method
 - c. Revaluation method
 - d. Sum of the year's digits method
7. This method is suitable for fixed assets like tunnels, bridges, railway lines etc.
 - a. Production unit method
 - b. Annuity method
 - c. Depreciation fund method
 - d. Renewals method
8. Obsolescence means decline in value of asset due to _____.
 - a. Wear and tear
 - b. Fall in market value
9. The term used to depreciate intangible asset is _____.
 - a. Obsolescence
 - b. Replacement
 - c. Amortisation
 - d. Depletion
10. Rate of depreciation is same but the amount of depreciation is diminishing under _____.
 - a. Fixed Installment Method
 - b. Diminishing Balance Method
 - c. Both
 - d. None of the above

Answers: 1.(a), 2.(d), 3.(d), 4.(a), 5.(a), 6.(c), 7.(a), 8.(c), 9.(c), 10.(b)

II Very Short Questions

1. Define depreciation?
2. What is Depletion?
3. What is obsolescence?
4. Write short notes on Revaluation method?
5. What is meant by Amortization?
6. Explain the term “Wear and Tear”

III Short Questions

1. Describe the causes of depreciation?
2. What are the different methods of providing depreciation?
3. Write a short note on – (a) Fixed Instalment Method (b) Written Down Value Method.
4. Explain the method of charging depreciation for Wasting Assets.



Essay Type Questions

1. Explain the causes of depreciation.
2. State the objectives of providing depreciation.
3. What are the factors for providing depreciation?
4. Explain the different methods of charging depreciation.
5. Discuss the duties of an auditor in verifying depreciation

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4. Auditing Practical – Dr. Radha, Prasanna Publishers and Distributors.
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Learning Objectives



- To understand the meaning, definition, classification and auditors duties with regard to reserves and provisions.
- To identify the differences between reserves and provisions.

POINTS TO RECALL

RECAP

In the previous Chapter, we have studied the meaning and definition of depreciation, causes of depreciation, objectives and different methods of calculating depreciation, auditors duties with regard to verify depreciation.

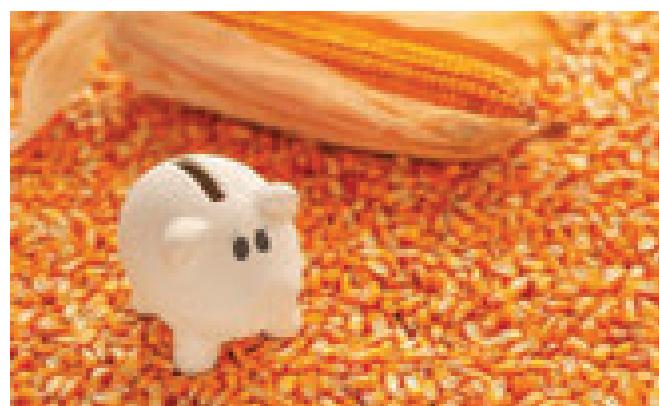
8.1 Reserves

8.1.1 Meaning

Reserve is a part of the profits which are set aside for any known or unknown contingency, liability or diminution in the value of an asset etc. It is that portion of the current profits or of accumulated profits which is not distributed as dividend, but is kept separate for the purpose of meeting some known or unknown liabilities which might arise in the future.

8.1.2 Definition

- **Companies Act** defines Reserve as, “shall not include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability”.
- **The American Institute of Accountant** defines a reserve as, “the use of the term be limited to indicate that an undivided portion of the assets is being held or retained for general or specific purpose.”



8.1.3 Classification of Reserves



1. GENERAL RESERVE

A reserve which is created out of the profits or surplus of a business for meeting any unknown liability is called as 'General Reserve' or 'Free Reserve' or 'Revenue Reserve.' It is an appropriation of profit. According to Companies Act, creation of general reserve is not compulsory, it is to be created only when the company has sufficient profit. However, if the Articles of Association of the company state that a specific amount is to be set aside out of profit before distribution of dividend, then the amount should be transferred to General Reserve account.

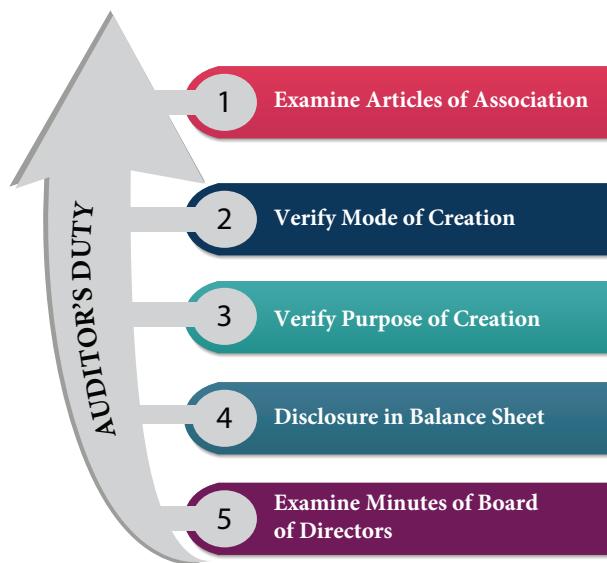
Objects of creating General Reserve

It is created with an object to

- Provide additional working capital,
- Strengthen the liquid resources of the business,
- Meet any unknown contingency or liability,
- Equalize dividend in the years in which profits are inadequate and
- Expand business etc.



AUDITOR'S DUTY



- 1. Examine Articles of Association:** The auditor should examine the Articles of Association to see whether provision regarding creation of general reserve has been complied with.
- 2. Verify Mode of Creation:** It is the duty of the auditor to ensure that reserve is created only out of profits of the company.
- 3. Verify Purpose of Creation:** Auditor should ensure that general reserve is created for the best interest of the company.
- 4. Disclosure in Balance Sheet:** He should examine that reserve amount is properly shown in the Balance Sheet. When reserve amount is invested in securities, he should verify that investments are shown on the assets side of the Balance Sheet.

5. Examine Minutes of Board of Directors:

Auditor should examine Minutes of the Board of Directors meeting to verify directors approval for utilizing the reserve amount.

2. SPECIFIC RESERVE



A reserve which is created for the purpose of providing for losses and contingencies which are known or expected to occur at a future date is called as a Specific Reserve. In simple words, it is a reserve created out of profit or loss of a company for a specific purpose. For example, Dividend Equalization Reserve, Investment Fluctuation Reserve, Reserve for redemption of Debentures, Plant Replacement Reserve etc.

Specific Reserve is not represented by any asset and therefore it is not available for distribution amongst the shareholders. The reserve must be created irrespective of profit or loss involved in the business.

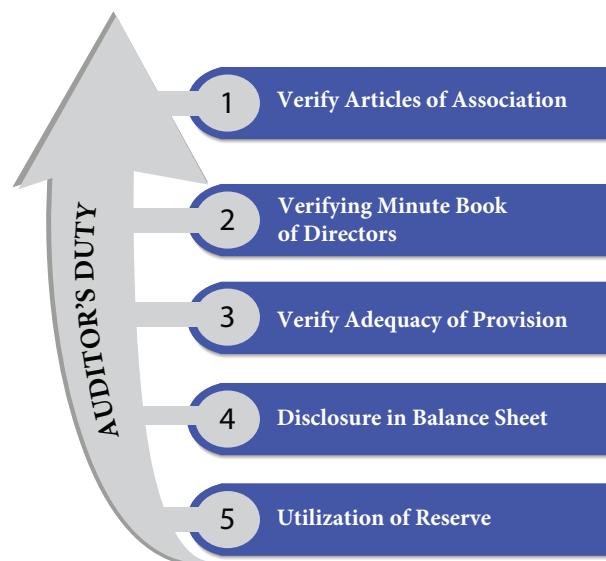
Objects of creating Specific Reserve

The reserve is created with a definite object to:

- Meet a known loss, such as depreciation, heavy repairs and renewals etc.
- Meet an expected contingency such as, doubtful debts, discount on debtors, liability for a disputed claim, contingency under Workmen's Compensation Act, etc.

- Meet an outstanding liability for expenses already incurred such as, salaries and wages, commission, income tax and other outstanding expenses.

AUDITOR'S DUTY



1. Verify Articles of Association: It is the duty of the auditor to verify the Articles of Association to check whether the amount appropriated from profit to specific reserve is duly complied.

2. Verifying Minute Book of Board meeting: The auditor should ensure that profits are appropriated according to the board of directors decision by verifying the Minutes book of the Board meeting.

3. Verify Adequacy of Provision: Auditor should ensure that adequate provision has been created. In case, the amount created is not adequate, he should insist the management to increase the provision. Otherwise, he should disclose the same in the audit report.

4. Disclosure in Balance Sheet: The auditor should see whether provisions are properly shown on the liabilities side of the Balance Sheet.

5. Utilization of Reserve: Lastly, the auditor has to ensure that reserve is utilized for the special purpose for which they are created.

3. CAPITAL RESERVE



A reserve which is created out of capital profits of a company is called as a Capital Reserve. It is defined in Part III of Schedule VI of the Companies Act as, "any reserve which cannot legally be distributed amongst the shareholders". Capital profit refers to the following:

- Profits on sale of fixed assets
- Profits on revaluation of fixed assets and liabilities
- Profits earned prior to incorporation of a company
- Profits made in purchasing a business
- Profits on redemption of debentures at a discount
- Premium received on issue of shares or debentures
- Profits earned from forfeited shares and re-issue of forfeited shares
- Exceptional profits not earned during regular course of business.

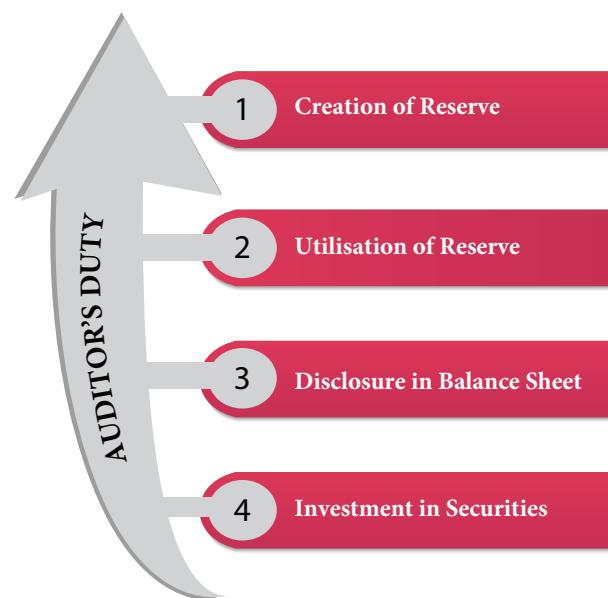
Capital profits should not be utilized in distributing dividend to the shareholders but should be kept aside to strengthen the financial position of the company and to meet capital or abnormal revenue losses.

Objects of creating Capital Reserve

Capital Reserves are utilised for the following purposes:

1. To issue bonus shares to the shareholders subject to the Articles of Association of the company.
2. To write off intangible assets of the company like goodwill, preliminary expenses etc.
3. To provide for premium payable on the redemption of debentures or redeemable preference shares.
4. To write off discount allowed, commission paid or expenses incurred on the issue of shares and debentures of the company.

AUDITOR'S DUTY



1. **Creation of Reserve:** The auditor should ensure that the reserve is created only out of the capital profits of the company.
2. **Utilisation of Reserve:** He should verify that the reserve is utilized according to the provisions of the Companies Act and the Articles of Association of the company.
3. **Disclosure in Balance Sheet:** Auditor should examine whether capital reserve has been shown separately from the revenue reserve in the Balance Sheet.

Any addition or deduction from the previous year balance sheet should be clearly shown.

4. **Investment in Securities:** The auditor should check whether capital reserve is invested in easily realizable securities or may be invested in the business itself.

4. SECRET RESERVE



It is a reserve, the existence of which is not apparent on the face of the Balance Sheet. It is also called as "Hidden Reserve" or "Internal Reserve" or "Inner Reserve". The reserve represents the surplus of assets over liabilities and capital. Secret Reserves are usually created by banking companies, insurance companies and electricity supply companies. When secret reserve exist, the financial position of the company is better than what it would appear from the balance sheet. However, the existence of such a reserve is found only by a close and intelligent scrutiny of the account of the company.



Objects of creating Secret Reserve

Secret Reserve is created for the following purpose:

1. To meet any extraordinary loss without disclosing the fact to the shareholders or outsiders.
2. To increase the working capital and to strengthen the financial position of the company.
3. To withhold information of the progress of the company from trade competitors.
4. To equalize the payment of dividend during the period of loss.
5. To meet unexpected financial losses in future.

Methods of Creating Secret Reserve

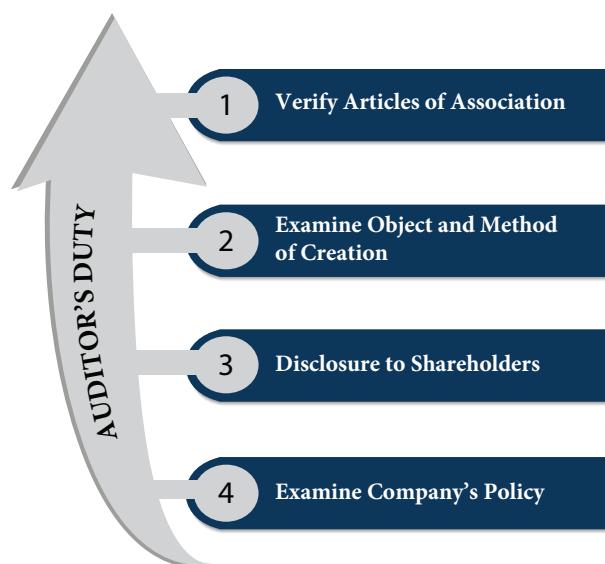
- Undervaluing the assets below cost or market value.
- Not recording the appreciated value of an asset.
- Providing excess reserve for bad and doubtful debts or discount on debtors.
- Providing excess depreciation on fixed assets.
- Writing down goodwill to a nominal value
- Omitting some of the assets in the Balance Sheet.
- Undervaluing the assets by charging capital expenditure to revenue account.
- Overvaluing the liabilities.
- Inclusion of fictitious liabilities
- Showing contingent liabilities as real liabilities.
- Grouping dissimilar items on the liabilities side of the Balance Sheet.

AUDITOR'S DUTIES

1. **Verify Articles of Association:** The auditor should study the Articles of Association of the company to ascertain the legal implications of creating the reserve.
2. **Examine Object and Method of Creation:** Auditor should examine carefully the

object and method of creating a secret reserve if he is fully satisfied, he should disclose the facts in his report.

3. **Disclosure to Shareholders:** It is the duty of the auditor to disclose the fact to the shareholders that secret reserve has been created. If he fails to do so, he will certify a false statement which will not exhibit a true and fair view of the state of affairs of the company.
4. **Examine Company's Policy:** When secret reserve is created by undervaluing the assets or overvaluing the liabilities, the auditor should make a detailed enquiry with the directors and examine the company's policy.



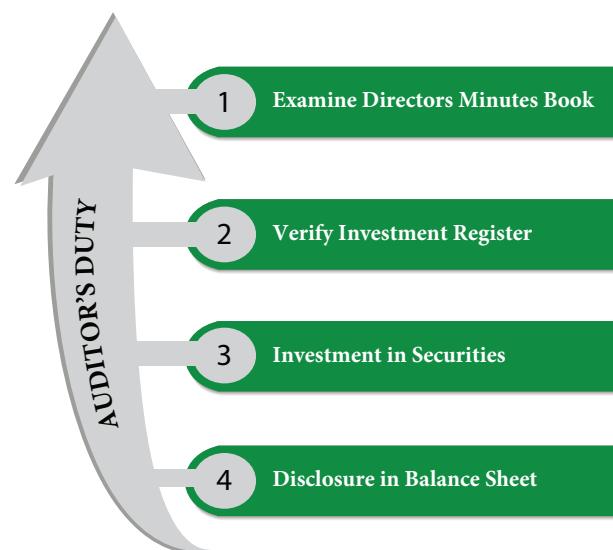
5. RESERVE FUND

It is a reserve created out of the surplus of the company and is invested in outside securities. It is similar to general reserve, which is created out of surplus but is retained in the business. In other words, reserve fund is appropriations of profits which is invested in safe securities and are easily realizable.

AUDITOR'S DUTY

1. **Examine Directors meeting Minutes Book:** Auditor should examine the Minutes of Board of Directors meeting to verify that all investments are made with the consent of the Board.

2. **Verify Investment Register:** The auditor should physically verify the securities with the Investment Register.
3. **Investment in Securities:** The auditor should ensure that the reserve fund is invested in easily realizable securities.
4. **Disclosure in Balance Sheet:** He should verify that the reserve fund is shown distinctly on the liabilities side of the Balance Sheet.



6. SINKING FUND

The fund which is created to have a certain sum of money accumulated for a future date by setting aside a certain sum of money every year is called as Sinking Fund. It is defined as, "a form of specific reserve set aside for redemption of a long debt or replacement of a wasting or a depreciable asset".



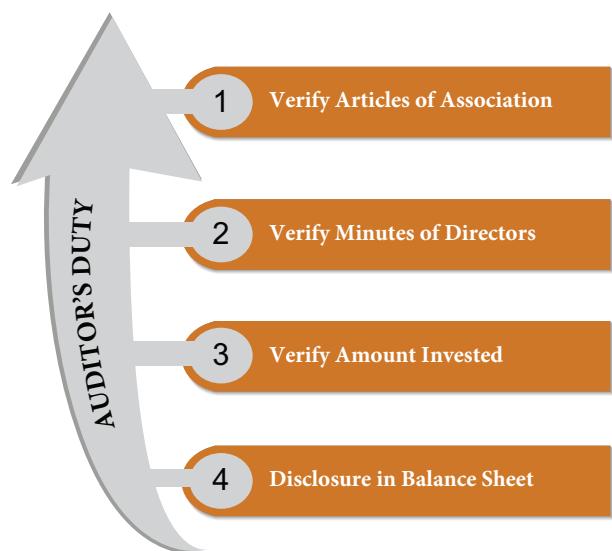
Objects of Creating Sinking Fund

The objects of creating Sinking Fund are as follows:

- To reduce a liability for example, redemption of debentures or repayment of a loan.
- To replace a wasting asset.
- To replace a depreciating asset.
- To renew a lease.



AUDITOR'S DUTY



1. Verify Articles of Association: Auditor should verify Articles of Association and examine the creation and utilisation of the fund.

2. Verify Minutes of Directors: He should verify the Minutes of the Board of Directors to ensure the correctness of the amount transferred to Sinking Fund.

3. Verify amount Invested: He should ensure that the amount set aside is invested in guilt-edged securities known as Sinking Fund Investment which earns a reasonable rate of return.

4. Disclosure in Balance Sheet: The auditor should verify that sinking fund and Sinking Fund Investment is separately and properly disclosed in the Balance Sheet.

8.2 Provisions

8.2.1 Meaning

Provision is an amount which is set aside as a charge against earnings to meet a loss which may arise on the sale or realization of certain asset or diminution in the value of an asset or to meet heavy depreciation, repairs and renewals or to meet a known liability. Provisions are created for a specific known liability or contingency and they can be used to meet only the specific liability for which they are created.

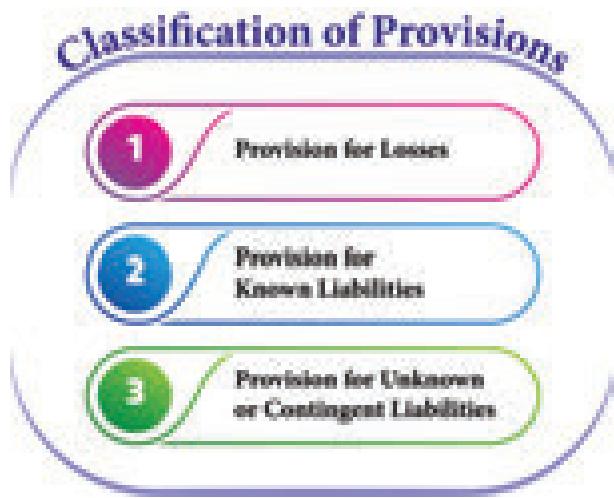
Examples of Provisions: (1) Provision for Depreciation (2) Provision for Taxation (3) Provision for Doubtful Debts (4) Provision for discount on Debtors (5) Provision for Repairs and Renewals.

8.2.2 Definition

- **Companies Act** defines the term Provision as, “any amount written off or retained by way of providing for depreciation, renewal or diminution in the value of assets or retain by way of providing for any known liability of which the amount cannot be determined with substantial accuracy”.

8.2.3 Classification of Provisions

Provisions can be broadly classified as follows:



- 1. Provision for Losses:** An amount which is set aside out of the earnings of the company to meet losses, for example, (1) loss on account of depreciation on fixed assets (2) loss on account of repairs and renewals etc.

2. Provision for Known Liabilities:

Provision which is created for known liabilities or expenses which arise in future, for example, (1) Provision for Income Tax, (2) Provision for Dividend, (3) Provision for discount on Debtors and Creditors, (4) Provision for outstanding expenses such as outstanding salaries and wages, payment on retirement such as pension, provident fund, gratuity etc.

3. Provision for Unknown or Contingent Liabilities

Provision created for unknown or contingent liabilities, for example, (1) Provision for bad and doubtful debts, (2) Provision against disputed claims, (3) Provision against guarantee, (4) Provision against compensation, (5) Provision against payment of arrears of dividend.

Provision for Repairs and Renewals: Provision created to equalize the charge of repairs and renewals over the life of the asset.

Provision for discount on debtors and creditors: Provision is created when a debtor makes payment within the prescribed period or when a certain amount of discount is allowed. Similarly, a business concern earns discount on making payment to suppliers.

Provision for Bad and Doubtful Debts: Provision for bad debts is created when a debtor fails to pay the whole or a part of the debt owing by them. The expected loss on account of bad debts should be charged to current year's profit.

8.2.4 Auditor's Duties

- 1. Examine Articles of Association:** The auditor should examine the provisions of the Articles of Association to confirm the appropriations created for a specific purpose.
- 2. Examine Directors Meeting Minute Books:** Auditor should examine the Minute Book of the Board of Directors to verify the provisions to be made.

3. Disclosure in Financial Statements:

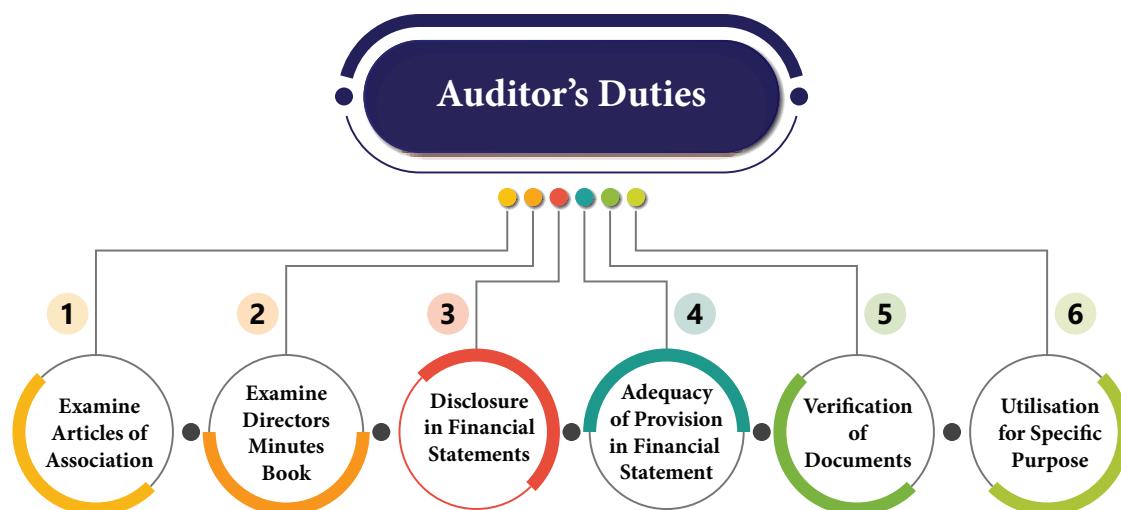
He should ensure that all provisions are properly disclosed in the Profit and Loss Account and Balance Sheet.

4. Adequacy of Provision in Financial Statement:

He should ensure that adequate provision has been shown in the financial statement. If in case, the provision created is not adequate, the auditor should mention the fact in the report.

5. Verification of Documents: The auditor should examine all the documents and ensure that the amount to be created as provision is adequate and sufficient to meet the loss or liability.

6. Utilisation for Specific Purpose: He has to ensure that the provisions created are utilized for the specific purpose for which they are created.



8.3 Differences Between Reserves and Provisions

Generally the term 'Reserves' and 'Provisions' are used together, giving

an impression that both are one and the same thing. However, it is desirable to understand the differences between the two terms.

S.No.	Basis	Reserves	Provision
1.	Meaning	Reserve is that portion of current or accumulated profits which is kept aside for meeting some known or unknown liabilities. It is an appropriation of profit.	Provision is a charge against the profit to meet known or unknown liabilities or losses.
2.	Creation	A Reserve is created by debiting Profit and Loss Appropriation Account.	A Provision is debited to Profit and Loss Account.
3.	Nature	A reserve is created for unknown liabilities.	A provision is made for a known liabilities.
4.	Purpose	The main object of creation of reserve is a matter of financial policy of a business concern. It is created without taking into account the actual amount required except in the case of redemption of debentures.	Provision is created as a legal necessity.

S.No.	Basis	Reserves	Provision
5.	Disclosure	It is shown on the liabilities side of the Balance Sheet.	It is shown on the assets side of the Balance Sheet by way of deduction from the concerned asset. For example Reserve for bad and doubtful debts is deducted from the balance of Sundry Debtors.
5.	Charge Against Profit	Reserves depend upon the profit position of the company, when a company suffers a loss no reserve is created.	Provisions do not depend upon the profit position of the company, hence they are created even when company suffers a loss.
6.	Payment to Shareholders	Reserves represent undistributed profit, hence it can be distributed amongst shareholders as dividend.	Provisions are not distributed to shareholders as dividend.
7.	Auditors Duty	An auditor need not interfere on creation of reserve except when Articles of Association specifically provide for creation of a reserve.	The auditor should carefully examine whether adequate provision has been created to meet the loss or liability.



STUDENTS ACTIVITY



1. Visit a industry and discuss with its owner's about the reserves they made.
2. Estimate total income of your parents. Discuss about creating reserves for unforeseen expenses of your family.
3. Discuss with your parents for making provision for meeting expected losses.
4. How would you create reserve funds from your students consumer club for meeting any emergency for your students.

SUMMARY

Reserve is that portion of current or accumulated profits which is kept aside for meeting some known or unknown liabilities or contingencies which might arise in future. It is classified as, (1) General Reserve, (2) Specific Reserve, (3) Capital Reserve, (5) Secret Reserve, (6) Reserve Fund, and (7) Sinking Fund.

Provision is a charge against profit created for a specific known or unknown liability or contingencies. It is classified as, (1) Provision for losses, (2) Provision for known liabilities, and (3) Provision for unknown liabilities. It is the duty of an auditor to carefully examine whether adequate provision has been created to meet the loss or liability.



KEY TERMS

- **Reserve** – It is an amount which has been set aside for future use or for emergency.
- **General Reserve** – It is a reserve created to provide additional working capital created from profit.
- **Sinking Fund** – It is a form of specific reserve set aside for the redemption of a long term debt.
- **Capital Reserve** – It is created out of profits of a capital nature.
- **Secret Reserve** – Any reserve which is not apparent on the face of the balance sheet.
- **Provisions** – It is an amount set aside as a charge against earnings created for a specific known liability.



EVALUATION

I. Multiple Choice Questions:

1. Reserve means _____
 - a) Use for future emergency
 - b) Meet contingency
 - c) Meet Liability
 - d) All the above
2. _____ is to provide additional working capital.
 - a) General Reserve
3. The reserve which is a charge against reserve for the purpose of providing for losses and contingencies which may result in losses and which are known or expected is known as _____



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- a) Specific Reserve
b) General Reserve
c) Provision
d) Sinking Fund
4. _____ fund is a form of specific reserve set aside for the redemption of a long term debt or the replacement of a wasting or a depreciating asset.
a) General
b) Special
c) Redemption
d) Sinking
5. _____ cannot be utilized for payment of dividend as a reserve can be, because it has been created for a specific purpose.
a) Development Fund
b) Special Fund
c) General Fund
d) Sinking Fund
6. _____ is created out of profits of a capital nature.
a) Capital Reserve
b) General Reserve
c) Specific Reserve
d) None of the above
7. Any reserve which is not apparent on the face of the balance sheet is known as _____
a) Secret Reserve
b) General Reserve
c) Specific Reserve
d) Sinking Reserve
8. Secret reserve is created for the purpose of _____
a) To avoid competition
b) To regulate dividend
c) To meet unforeseen emergencies
d) All the above
9. It is created as a charge on profits for some specific purposes in order to meet specific losses and certain but un-estimated liabilities
a) General Reserve
b) Specific Reserve
c) Capital Reserve
d) Reserve Fund
10. In which side of the balance sheet, the reserve fund and sinking fund are to be shown?
a) Assets
b) Liabilities
c) Both
d) None of these

Answers: 1.(d), 2.(a), 3.(a), 4.(b), 5.(a), 6.(a), 7.(a), 8.(d), 9.(b), 10.(b)

II. Very Short Answer Question:

1. What is Reserve?
2. Define a “Reserve”.
3. What are the types of Reserves?
4. What is capital reserve?
5. What is secret reserve?
6. Write a note on sinking fund.
7. What is meant by provision?
8. Define a Provision.

III. Short Answer Questions:

1. What is general reserve? How it is created?
2. Differentiate reserves and provisions.
3. How can capital reserve be created?
4. How secret reserve is created?
5. Explain the duties of an auditor with capital reserve.
6. What are the duties of an auditor with regard to sinking fund?
7. What are the duties of an auditor with regard to secret reserves?
8. Briefly explain various types of provisions.

IV. Essay Type Questions:

1. Discuss the classifications of reserves.
2. What are the dangers of creating secret reserve?
3. Explain the auditor’s duty with regard to provisions
4. Discuss the auditor’s duty with regard to reserves.
5. Differentiate Reserves and Provisions.

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(As per Provisions of the Companies Act, 2013)



Learning Objectives

- To have a brief view of the provisions of the Companies Act, 2013 regarding the functions of an Auditor.
- To understand the qualifications and disqualifications of an auditor
- To analyse the procedure for appointment and removal of auditors
- To discuss the rights, duties and liabilities of an auditor

POINTS TO RECALL

RECAP

From the previous Chapter, the students understood the meaning, definition, classification and auditors duties with regard to reserves and provisions and able to identify the differences between reserves and provisions.

9.1 Introduction

The fundamental aspects of auditing are objectives, techniques and principles of auditing, preparation for an audit, internal audit and internal check, vouching,

verification and valuation of assets and liabilities etc., These aspects are applicable to the audit of all types of business entities. However audit of business concerns other than corporate entity is not mandatory. But



in the case of a joint stock company, the audit is a statutory requirement under the Companies Act, 2013. Therefore, provisions regarding appointment of a company auditor, his qualifications, disqualifications, powers, duties etc., are also governed by the Act.

As per the Indian Companies Act, 2013, it is compulsory for every company whether public or private limited, to get its accounts audited by a qualified auditor. Therefore, it is essential that the auditor of a company should be familiar with the provisions of the Companies Act relating to his appointment, duties and rights.

9.2 Qualifications of a Company Auditor [Sec.141 (1) & (2)]

Section 141 (1) & (2) of the Companies Act, 2013 prescribed the following eligibility and qualifications of auditor which are as follows:

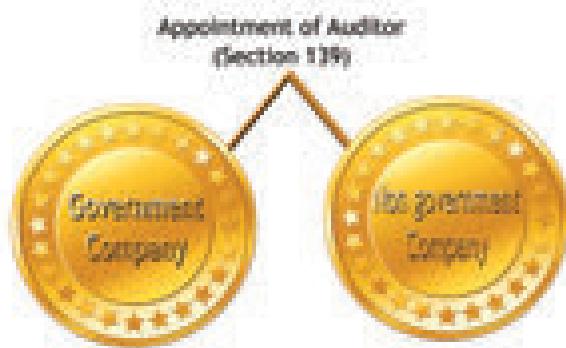
1. A person, who is a chartered accountant and holds a certificate of practice, shall be qualified to be appointed as an auditor of a company.
2. The partners who are chartered accountants of a firm alone shall be authorized to act and sign on behalf of the firm.

9.3 Disqualifications of a Company Auditor [Sec.141 (3)]

The following persons shall not be eligible for appointment as an auditor of a company.

1. A body corporate, except Limited Liability Partnership.
2. An officer or employee of the company
3. A person who is a partner or an officier or employee of the company.
4. A person who is a relative or his partner of a company or holding or subsidiary company or associate company is disqualified in the following circumstances:
 - a. When he is holding any security, or
 - b. When he is indebted in excess of Rs.5,00,000, or
 - c. When he is given a guarantee or provided any security in connection with indebtedness in excess of Rs.1,00,000.
5. A person or a firm has business relationship of such nature with a company or holding or subsidiary company or associate company.
6. A person whose relative is a director or is in employment of the company as director or key managerial personnel.
7. A person holding more than 20 company audit (20 company audit shall exclude one person company, small company, dormant company, private company with paid up capital less than Rs.100 Crore).
8. A person who has been convicted by a court of an offence involving fraud and a period of 10 years has not elapsed from the date of such conviction.
9. Any person who is engaged in consulting and specialized services.

9.4 Appointment of Auditor [Sec. 139]



9.4.1 Appointment of Auditor in Government Company

Companies Act, 2013 defines a Government Company [Section 2 (45)], "as a company in which not less than 51% of the paid up share capital is held by the Central or State Government or Governments or partly by the Central government and partly by one or more State governments."



1. Appointment of First Auditor [Section 139 (7)]

- The first auditor of Government company shall be appointed by the Comptroller and Auditor General of India within 60 days from the date of registration of the company.
- In case the Comptroller and Auditor General of India does not appoint such auditor within 60 days, the Board of Directors of the company shall appoint first auditor within next 30 days.
- In case of failure of the Board to appoint the first auditor, it shall inform Members of the company who shall appoint first auditor within 60 days at an Extraordinary General Meeting.
- First Auditor shall hold office till the conclusion of the first Annual General Meeting.

AGM – Annual General Meeting

BOD – Board of Directors

C&AG – Comptroller and Auditor General of India

DOOR – Date of Registration

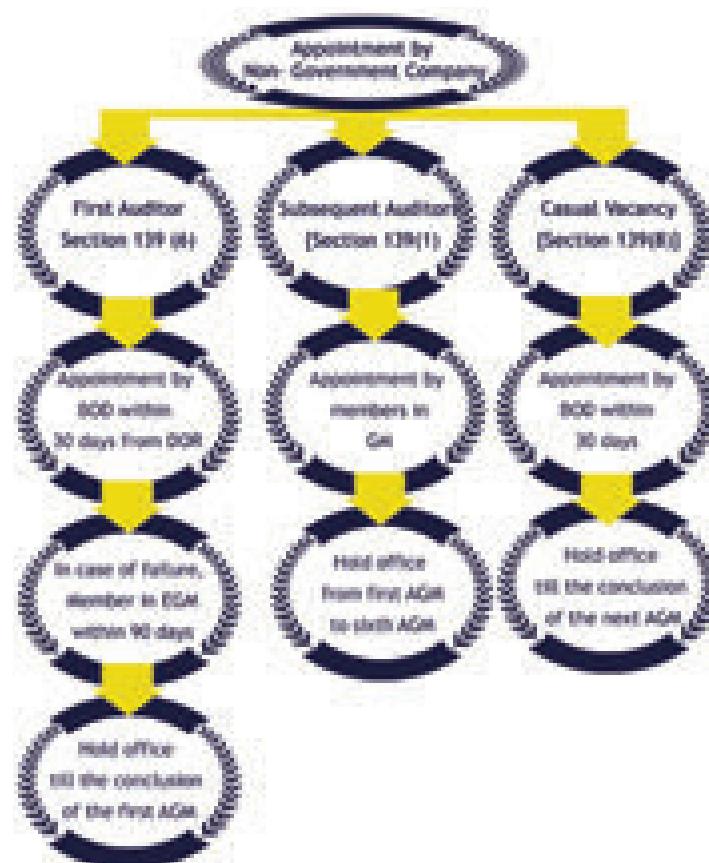
EGM – Extraordinary General Meeting

days from the commencement of the financial year and who shall hold office till the conclusion of the Annual General Meeting.

3. Appointment in case of Casual Vacancy [Section 139 (8)]

Appointment of auditor due to casual vacancy in Government Company is filled by the Comptroller and Auditor General of India within 30 days. If he fails to do so, the Board of Directors shall fill within next 30 days.

9.4.2 Appointment of Auditor in Non-Government Company



2. Appointment of Subsequent Auditor [Section 139 (5)]

The Comptroller and Auditor General of India shall appoint subsequent auditor of Government companies within 180

1. Appointment of First Auditor [Section 139 (6)]

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.

In case of failure of the Board to appoint the auditor, it shall inform the members of the company. The Members shall appoint the auditor within 90 days at an Extraordinary General Meeting.

Appointed First Auditor shall hold office till the conclusion of the first Annual General Meeting.

2. Appointment of Subsequent Auditor's [Section 139 (1)]

Every company shall appoint an individual or a firm as auditor of the company at the first Annual General Meeting.

The appointed auditor shall hold the office till the conclusion of sixth Annual General Meeting and thereafter till the conclusion of every sixth meeting.

The Company shall place the matter relating to such appointment of ratification by member at every Annual General Meeting.

Before such appointment is made, the written consent of the auditor to such appointment and also a certificate from the auditor that he is eligible for appointment shall be obtained from the auditor.

The company shall inform the appointed auditor and also file a notice of such appointment with the Registrar within 15 days of the meeting in which the auditor is appointed.

3. Appointment in case of Casual Vacancy [Section 139 (8)]

Causal vacancy arise due to death or insanity or insolvency of an auditor. If an auditor is disqualified after his appointment, he shall vacate his office as auditor. Such vacation shall be deemed to be a casual vacancy in the office of the auditor.

Appointment of auditor's in case of casual vacancy shall be done by the Board of Directors within a period of 30 days.

If vacancy is due to resignation of an auditor, such appointment shall also be approved by the company at a General Meeting convened within 3 months of the recommendation of the Board.

The auditor shall hold office till the conclusion of the next Annual General Meeting.

9.5 Removal and Resignation of Auditor

9.5.1 Removal of Auditor [Sec.140 (1)]

- i. An auditor can be removed before the expiry of the term by obtaining the prior approval of the Central Government by filling an application.
- ii. The Company shall hold the general meeting within 60 days of receipt of approval of the Central Government for passing the special resolution.
- iii. The auditor concerned shall be given a reasonable opportunity of being heard.

9.5.2 Resignation of Auditor [Sec.140 (2) & (3)]

1. The auditor who has resigned from the Company shall file a statement in the prescribed form stating the reasons for his resignation to the Comptroller and Auditor General of India in case of a Government Company and to the Registrar of Companies in case of Non-Government Companies.
2. While filing the statement, reasons for resignation and other facts as may be relevant with regard to his resignation shall also be indicated.
3. In case of non-compliance, he shall be punishable with fine ranging from ₹.50,000 to ₹.5,00,000.

9.6 Powers (or) Rights of an Auditor [Sec.143]

The Companies Act has conferred certain rights on auditor's so as to enable them to discharge their duties smoothly.

1. **Right to Access Books and Vouchers:**
Every auditor of a company has a right to access book of accounts and vouchers of the company at all times. Vouchers include all documents, correspondence, agreements, etc. Books include financial, accounting, statutory and statistical books of the company. The term all times means only during the normal business hours.
2. **Right to Obtain Information and Explanation:**
An auditor has the right to seek information and explanation from the

directors and officers of the company. That will enable him to perform his duties successfully. Every officer of the company must furnish the necessary information to the auditor. If the officer refuses to do so, the auditor may report to the members of the company.



3. Right to Sign Audit Report [Sec.145]:

The auditor has the right to sign the auditor's report. The auditor can also sign or authenticate any document which the law requires to furnish.

4. Right to receive Notices and attend General Meeting [Sec.146]:

The company must send all notices and communications to the auditor relating to any general meeting. The auditor may attend the meeting either through himself or through his representative, who shall be an auditor. The auditor in general meeting must be given reasonable opportunity to speak on any part of the business, which concerns him as the auditor.

5. Right to visit Branches:

The auditor has the right to access all books and vouchers kept at the head office or at any branches of the company. In case the accounts of branches are audited by a person other than the company's auditor, he shall be entitled to visit the branch office. The company auditor can get copies of accounts certified by the branch auditor.

6. Right to get Remuneration:

The remuneration of the auditor of a company shall be fixed in its general meeting for auditing the books of accounts of the company. The auditor can claim remuneration from the appointing authority. At the time of winding up of the company, he can claim remuneration as creditor of the company.

7. Right to Report to Members:

The auditor has the right and duty to report to the members of the company regarding the accounts examined by him. He is also required to give his opinion about whether the financial statements give a true and fair picture of the state of affairs of the company.

8. Right to seek Legal and Technical Advice:

The auditor has the right to seek expert advice in respect of legal or technical matters at the expense of the company.

9. Right to give Suggestions to the Board:

The auditor has the right to suggest some modifications in the books of accounts to the Board. The Board should comply with the suggestions made by the company auditor. If not, the auditor should report the same to the members. But the auditor cannot make changes in the books of accounts of his own.

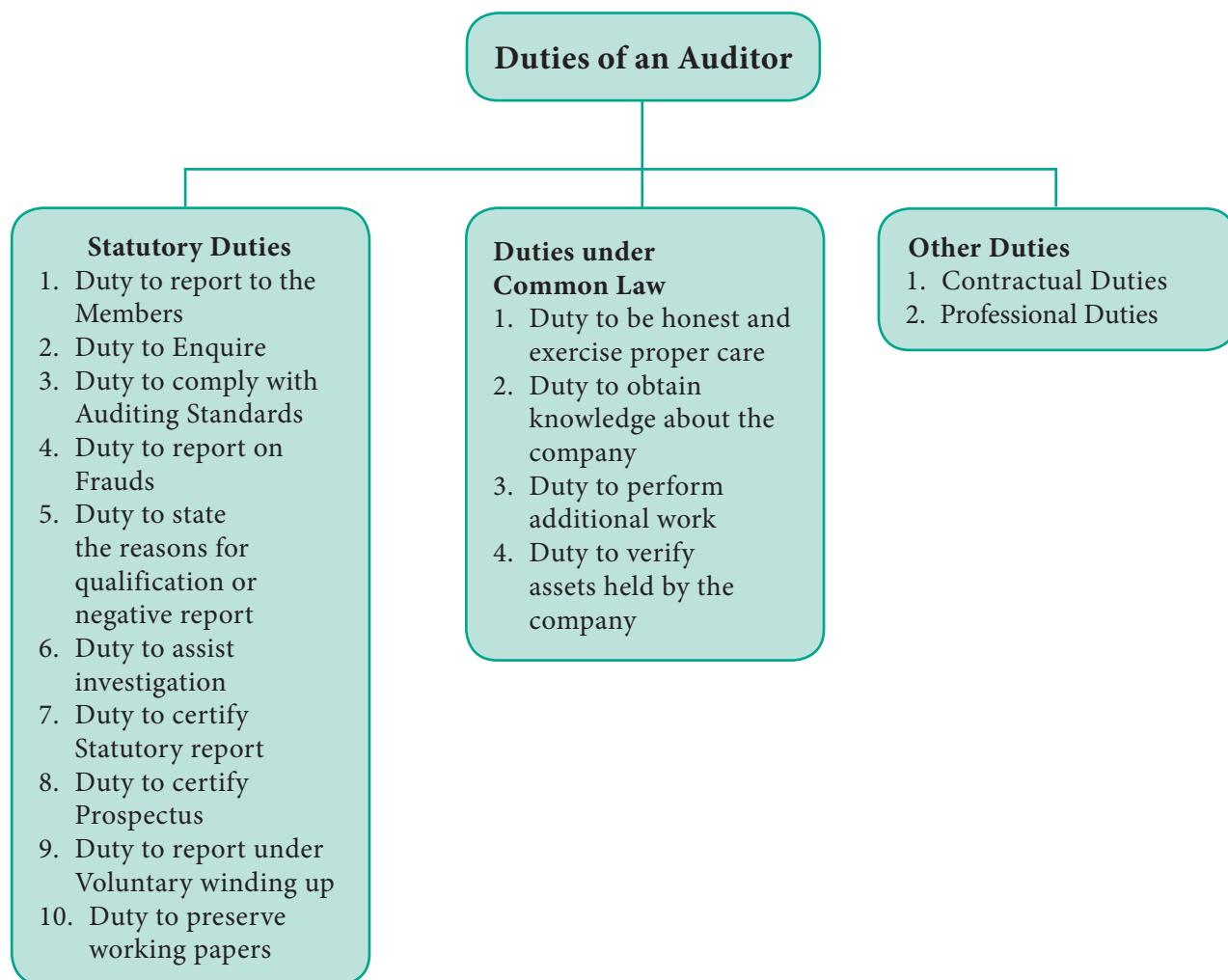
10. Right to Correct Wrong Statements:

The auditor has the right to correct wrong statements made by the directors relating to the accounts. But it should be remembered that any statement by him to this effect will not relieve himself for any omission or incompleteness in his report.

11. Right to be Indemnified:

The auditor has the right to be indemnified out of the assets of the company against any liability incurred by him in defending himself against the civil or criminal proceedings by the company if it is proved that the auditor has acted honestly.

9.7 Duties of an Auditor [Sec.143]



9.7.1 Statutory Duties

1. Duty to report to the Members [Sec.143 (3)]:

The auditor shall make a report to the members of the company on accounts and financial statements examined by him.

The report shall state:

- a. Whether he has sought and obtained all necessary information and explanations.
- b. Whether proper books of accounts has been kept.

c. Whether company's Balance Sheet and Profit and Loss account are in agreement with books of accounts and returns.

2. Duty to Enquire [Sec.143 (1)]:

It is the duty to inquire into the following matters:

- Whether loans and advances made by the company based on security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members.

- Whether transactions of the company, which are represented merely by book entries, are prejudicial to the interests of the company.
- Whether loans and advances made by the company have been shown as deposits.
- Whether personal expenses have been charged to revenue account.
- Whether it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

3. Duty to comply with Auditing Standards [Sec.143 (9)]:

- Every auditor shall comply with the auditing standards.
- The Central Government shall notify standards in consultation with National Financial Reporting Authority, (NFRA).
- The government shall also notify that auditor's report shall include a statement on such matters as notified.

4. Duty to report on Frauds [Sec. 143 (12)]:

When an auditor suspects an offence involving fraud is being committed by officers or employees of the company, he shall immediately report the matter to the Central Government in such manner as may be prescribed.

5. Duty to state the reasons for qualified or negative report [Sec.143 (4)]:

In case of negative or qualified report, the reasons must be stated in the report.

6. Duty to assist investigation:

It is the important duty of the auditor to assist the investigator to investigate the affairs of the company. Further, it is the duty of the auditor,

- To provide and preserve the necessary documents which are in his custody to the investigator, and
- To assist the investigator by providing all assistance in connection with the investigation.

7. Duty to certify Statutory Report:

The auditor has to certify statutory report as correct to the extent of –

- Shares allotted by the company,
- Cash received in respect of such shares, and
- An abstract of receipts and payments of the company.

8. Duty to certify Prospectus:

It is the duty of auditor to certify a report showing statement of profits or losses and assets and liabilities of the company and its subsidiaries. The report shall also include rates of dividend paid by the company for each of five financial years preceding the issue of prospectus.

9. Duty to report under Voluntary winding up:

When the company proposes for voluntary winding up, directors of the company have to make a declaration of solvency. The auditor has to certify a report upon the solvency based on the Profit and Loss Account and Balance Sheet.

- 10. Duty to preserve Working Papers:**
It is the duty of an auditor to preserve and produce all books and papers relating to the company which are in his custody and to assist the inspector appointed by the government for investigation.

9.7.2 Duties under Common Law

- 1. Duty to be honest and exercise proper care:**
The auditor should be straightforward, honest and tactful and must not be influenced by others in discharge of his duties. He should be careful and cautious in performing his duties.
- 2. Duty to obtain knowledge about the company:**
He should obtain detailed knowledge about the activities and affairs of the company.
- 3. Duty to perform additional work:**
The auditor besides performing the statutory duties is bound to perform additional work by passing a resolution in the general meeting or making a provision in the Articles of Association of the company.

- 4. Duty to verify assets held by the company:**
It is the duty of the auditor to verify assets of the company.

9.7.3 Other Duties

1. Contractual Duties:

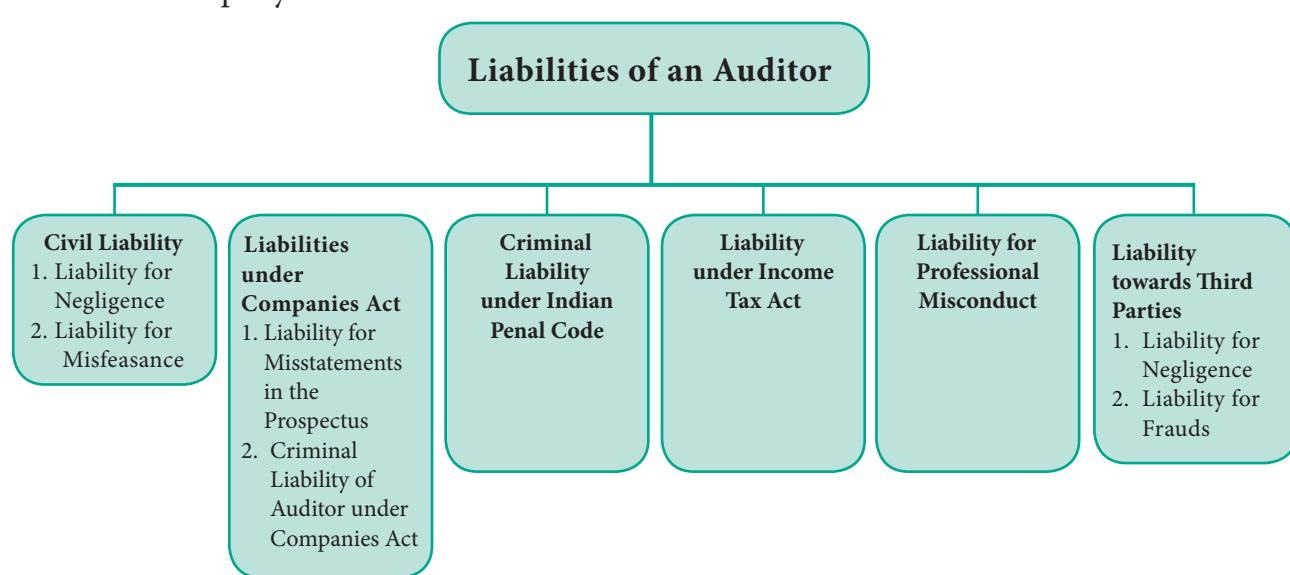
The auditor's duty will depend upon the terms and conditions of his appointment between him and the party who appointed him.

2. Professional Duties:

The auditor has to observe the ethics given by the Institute of Chartered Accountants of India. He should correspond with the previous auditor before accepting the assignment.

9.8 Liabilities of an Auditor:

A Chartered Accountant is associated with the valuable profession. His primary duty is to present a report on the accounts and statements submitted by him to members of the company. He is responsible not only to the members of the company but also to the third parties of the company, i.e., creditors, bankers etc.



Normally the liability of auditor based on the work done by him as professional accountant and carry out his work with due care, caution and diligence. The nature of liabilities of an auditor is discussed below:

9.8.1 Civil Liability:

1. Liability for Negligence:

Negligence means breach of duty. An auditor is an agent of the shareholders. He has to perform his professional duties. He should take reasonable care and skill in the performance of his duties. If he fails to do so, liability for negligence arises. An auditor will be held liable if the client has suffered loss due to his negligence. It should be noted that an auditor will not be liable to compensate the loss or damage if his negligence is not proved.

2. Liability for Misfeasance:

Misfeasance means breach of trust. If an auditor does something wrongfully in the performance of his duties resulting in a financial loss to the company, he is guilty of misfeasance. In such a case, the company can recover damages from the auditor or from any officer for breach of trust or misfeasance of the company. Misfeasance proceedings can be initiated against the auditor for any untrue statement in the prospectus or in the event of winding up of the company.

9.8.2 Liabilities under Companies Act

The following are the liabilities of an auditor under the provisions of the Companies Act.

[I] Liability for Misstatements in the Prospectus [Sec.35]:

An auditor shall be held liable to compensate every person who subscribes for any shares or debentures of a company on the faith of the prospectus containing an untrue statement made by him as an expert. The auditor shall be liable to compensate him for any loss or damages sustained by him by reason of any untrue statement included therein. The auditor may escape from liability if he proves that:

- The prospectus is issued without his knowledge or consent.
- He withdrew his consent, in writing before delivery of the prospectus for registration.
- He should have withdrawn his consent after issue of prospectus but before allotment of shares and reasonable public notice has given by him regarding this.

II. Criminal Liability of Auditor under Companies Act:

Criminal Liability of Auditor under Companies Act	1	Untrue statement in Prospectus [Sec.34]
	2	Non-compliance by auditor [Sec. 143 and 143]
	3	Failure to assist investigation [Sec. 217 (6)]
	4	Failure to assist prosecution of guilty officers [Sec. 234]
	5	Failure to return property, books or papers [Sec. 299]
	6	Penalty for falsification of books [Sec.336]
	7	Prescription of auditor [Sec.342]
	8	Penalty for deliberate act of commission or omission [Sec. 418]

1. Untrue statement in Prospectus [Sec.34]

The auditor is liable when he authorizes a false or untrue prospectus. When a prospectus includes any untrue statement, every person who authorizes the issue of prospectus shall be imprisoned for a period of six months to ten years or with a fine, which may be three times the amount involved in the fraud or with both.

2. Non compliance by auditor [Sec. 143 and 145]:

If the auditor does not comply regarding making his report or signing or authorization of any document and makes willful neglect on his part he shall be punishable with imprisonment upto one year or with fine not less than ₹. 25,000 extendable to ₹. 5,00,000.

3. Failure to assist investigation [Sec.217 (6)]:

When Central Government appoints an Inspector to investigate the affairs of the company, it is the duty of the auditor to produce all books, documents and to provide assistance to the inspectors. If the auditor fails to do so he shall be punishable with imprisonment upto one year and with fine up to ₹.1,00,000.

4. Failure to assist prosecution of guilty officers [Sec.224]:

An auditor is required to assist prosecution when Central Government takes any action against the report submitted by the Inspector. If he fails

to do so, he is found guilty and is punishable.

5. Failure to return property, books or papers [Sec.299]:

When a company is wound up the auditor is supposed to be present and subject himself to a private examination by the court and is also liable to return to the court any property, books or papers relating to the company. If the auditor does not comply, he may be imprisoned.

6. Penalty for falsification of books [Sec.336]:

An auditor when destroys, mutilates, alters or falsifies or secrets any books of account or document belonging to the company. He shall be punishable with imprisonment and also be liable to fine.

7. Prosecution of auditor [Sec.342]:

In the course of winding up of a company by the Tribunal, if it appears to the Tribunal that an auditor of the company has been guilty of an offence, it shall be the duty of the auditor to give all assistance in connection with the prosecution. If he fails to give assistance he shall be liable to fine not less than ₹ 25,000 extendable upto ₹1,00,000.

8. Penalty for deliberate act of commission or omission [Sec.448]:

If an auditor deliberately makes a statement in any report, certificate, balance sheet, prospectus, etc which is false or which contains omission of material facts, he shall

be punishable with imprisonment for a period of six months to ten years and fine not less than amount involved in fraud extendable to three times of such amount.

9.8.3 Criminal Liability under Indian Penal Code

If any person issues or signs any certificate relating to any fact which such certificate is false, he is punishable as if he gave false evidence. According to Sec.197 of the Indian Penal Code, the auditor is similarly liable for falsification of any books, materials, papers that belongs to the company.

9.8.4 Liability under Income Tax Act [Sec.278]

- For tax evasion exceeds ₹1,00,000, rigorous imprisonment of six months to seven years.
- A person who induces another person to make and deliver to the Income Tax authorities a false account, statement or declaration relating to any income chargeable to tax which he knows to be false, he shall be liable to fine and imprisonment of three months to three years. An auditor may also be charged in case of wrong certification of account.
- A Chartered Accountant can represent his clients before the Income Tax Authorities. However, if he is guilty of misconduct he can be disqualified from practicing.
- An auditor can face imprisonment upto two years for furnishing false information.

9.8.5 Liability for Professional Misconduct

The Chartered Accountant Act, 1949 mentions number of acts and omissions that comprise professional misconduct in relation to audit practice. The council of ICAI may remove the auditor's name for five years or more, if he is found guilty of professional misconduct.

ICAI – The Institute of Chartered Accountants of India.

9.8.6 Liability towards Third Parties

There are number of persons who rely upon the financial statements audited by the auditor and enter into transactions with the company without further enquiry viz. creditors, bankers, tax authorities, prospective shareholders, etc.

1. Liability for Negligence:

It has been held in the court that auditor is not liable to third parties, as there is no contract between auditor and third parties. He owes no duty towards them.

2. Liability for Frauds:

The third parties can hold the auditor liable, if there is fraud on the part of auditor even if there is no contractual relationship between auditor and third parties. In certain cases negligence of auditor may amount to fraud for which he may be held liable to third parties. But it must be proved that auditor did not act honestly and he knew about it.

1. What is ATC? (Accounting Technician Course)

A candidate may opt for Accounting Technician Course. Such a candidate has to undergo a study course of nine months, 35 hours Orientation Programme and 100 hours Information Technology Training before appearing in Accounting Technician Examination (ATE). It is to be noted that Group I of IPCC is equivalent to ATC. After passing ATE, he will also be required to complete 12 months of work experience and on production of a certificate to this effect he will be issued Accounting Technician Certificate. A candidate who does not wish to complete erstwhile Intermediate/PE-II/PCC/IPCC can opt for ATC.

2. What is FCA and ACA?

FCA stands for Fellow Chartered Accountant which one becomes after holding COP (Certificate of Practice) for more than 5 years. Whereas, ACA stands for Associate Chartered Accountant who holds Certificate of Practice for less than 5 years.

CERTIFICATE COURSES FOR MEMBERS

- Certificate Course on Enterprise Risk Management
- Certificate Course on Master in Business Finance
- Certificate Course on Corporate Governance
- Certificate Course on International Taxation
- Certificate Course on Forensic Accounting & Fraud Detection using IT & CAATs
- Certificate Course on International Financial Reporting Standards
- Certificate Course on Forex and Treasury Management
- Certificate Course on Derivatives
- Certificate Course on Valuation
- Certificate Course on Arbitration



STUDENTS ACTIVITY



1. Conduct a model Annual general meeting with proper agenda for appointing the auditor of a company and fixing his remuneration by passing an ordinary resolution by the shareholders.
2. Visit an auditor's office and discuss with the auditor regarding his professional services.
3. Discuss with an auditor regarding the scope of his work and liabilities of an auditor.

SUMMARY

- In case of a joint stock company, the audit is a statutory requirement under the Companies Act, 2013. A person will be qualified to be appointed as an auditor of a company, only if he is a Chartered Accountant. The following persons shall not be eligible for appointment as an auditor of a company (i) A body corporate, (ii) An officer or employee of the company, (iii) Any partner, (iv) A person indebted in excess of Rs.5,00,000, (v) A person whose relative is a director or key managerial personnel (vi) A person holding more than 20 company audit.
- An auditor shall be appointed as first auditor or subsequent auditor or in casual vacancy in case of Government Company and Non-Government Company in different ways.
- An auditor can be removed from the company before the expiry of the term only by obtaining the prior approval of the Central Government. The auditor who has resigned from the company shall file a statement with the company and the Registrar, in case of Non-Government Company. In case of Government Company with the Comptroller and Auditor General of India (C & AG).
- A company auditor has the right to access books and vouchers, right to obtain information and explanation, right to sign audit report, right to receive notices and attend general meeting, right to visit branches, right to get remuneration, right to report to members, right to seek legal and technical advice, right to give suggestions to the board, right to correct wrong statements and right to be indemnified.

- Duties of a Company Auditor may broadly classified into Statutory Duties, Duties under Common Law and Other Duties like Contractual Duties and Professional Duties.
- The nature of Liabilities of an Auditor are: (1) Civil Liability, (2) Liabilities under Companies Act, (3) Criminal Liability under Indian Penal Code, (4) Liability under Income Tax Act, (5) Liability for Professional Misconduct and (6) Liability towards Third Parties.



KEY TERMS

- **Government Company:** A 'Government Company' is a company in which not less than 51% of the paid up share capital is held by the Central or State Government or Governments or partly by the Central government and partly by one or more State governments.
- **Casual Vacancy:** Causal vacancy arises due to death, insanity, insolvency or due to any other disqualification of the auditor.
- **Negligence:** Negligence means breach of duty. An auditor should take reasonable care and skill in the performance of his duties. If he fails to do so, liability for negligence arises.
- **Misfeasance:** Misfeasance means breach of trust. If an auditor does something wrongfully in the performance of his duties resulting in a financial loss to the company, he is guilty of misfeasance.

Important Sections in Companies Act, 2013:

- Section 139 – Appointment of Auditors
- Section 140 – Removal and Resignation of Auditor
- Section 141 – Eligibility, Qualifications and Disqualifications of Auditors
- Section 142 – Remuneration of Auditor
- Section 143 – Powers and Duties of Auditor
- Section 144 – Auditor not to render certain services
- Section 145 – Auditor to sign Audit reports
- Section 146 – Auditor to attend General meeting
- Section 147 – Punishment for contravention



EVALUATION



I. Multiple Choice Questions:

1. Section 139 of the Companies Act, 2013 deals with
 - a. Appointment of auditors
 - b. Eligibility and qualifications of auditors
 - c. Removal of auditor
 - d. Remuneration of auditor
2. The subsequent auditors of a company are appointed by the
 - a. Board of Directors
 - b. Shareholders
 - c. Central Government
 - d. Company promoters
3. A company auditor on being an individual cannot be an auditor of more than the following number of companies at one time
 - a. 2
 - b. 5
6. Match list I (Items) with list II (Section of the Companies Act, 2013) and select the correct answer using the codes given below the lists:

List I

- A. Appointment of auditors by the CAG
- B. Qualifications and disqualifications of auditors
- C. Powers and duties of auditors
- D. Remuneration of auditors

List II

- 1. Section 139(5)
- 2. Section 141
- 3. Section 142
- 4. Section 143

Answer Codes:

- | | | | |
|-------|----|----|----|
| A. | B. | C. | D. |
| a. 1. | 2. | 3. | 4. |
| b. 4. | 3. | 2. | 1. |
| c. 1. | 2. | 4. | 3. |
| d. 2. | 3. | 1. | 4. |

7. A Company audit can be done by _____
- Chartered Accountant
 - Cost Accountant
 - Company Secretary
 - Auditor
8. An auditor is a professional that accumulates and evaluates evidence to report whether the company complies with the _____
- Accounting policies
 - Accounting standards
 - Government policies
 - Established set of procedures or standards
9. An auditor may function as _____
- An employee
 - Independent professional
 - An employee or an independent professional
 - An external professional
10. The first auditor so appointed shall hold office till the conclusion of _____
- First accounting year
 - Next accounting year
 - First Annual General Meeting
 - First statutory meeting
11. In case the Board of Directors fails to appoint the first auditors within one month of its incorporation the _____ may appoint the first auditors.
- Chairman of the company
 - Managing directors
 - Company in general meeting
 - Central Government
12. Casual vacancy of auditor in case of company other than Government Company may be filled by the _____
- Board of directors
 - Shareholders
 - Central Government
 - Comptroller & Auditor General
13. Where the vacancy is caused by resignation of auditor of a company, such vacancy shall only be filled by the _____
- Comptroller & Auditor General
 - Central Government
 - Company in general meeting
 - Board of directors
14. Examples of casual vacancy are vacancy arising due to _____
- Resignation of the auditor
 - Death of the audit
 - Disqualification of the auditor
 - All of the above
15. The auditor of a Government Company is appointed by the _____
- Comptroller and Auditor General of India
 - The shareholder in a general meeting
 - The shareholder at an extraordinary general meeting
 - The Board of directors

16. Section 141 contains provision as regards
- First appointment of auditors
 - Subsequent appointment of auditors
 - Qualifications and disqualifications of auditors
 - All of the above
17. Who of the following can be appointed auditors of a limited company?
- A chartered accountant
 - A cost accountant
 - A company secretary
 - All of the above
18. The auditors have the right to attend
- Board meeting
 - Annual general meeting
 - Extraordinary general meeting
19. The auditor shall have the right to receive _____ for auditing the accounts of the company.
- Remuneration
 - Commission
 - Reward
 - Award
20. A company auditor has the following rights
- Right to receive notice of general meeting
 - Right of access to the books of account
 - Right to seek from the officers of the company any information related to auditing
 - All of the above

[Answers: 1.(a), 2.(b), 3.(d), 4.(c), 5.(c), 6.(c), 7.(a), 8.(d), 9.(c), 10.(c), 11.(c), 12.(a), 13.(c), 14.(d), 15.(a), 16.(c), 17.(a), 18.(d), 19.(a), 20.(d)]

II. Very short answer questions

- Who can be appointed as an auditor of a company?
- What is meant by casual vacancy?
- What is the procedure for removal of an auditor?
- What is meant by misfeasance?
- Who cannot become auditor of a company?
- Who appoints the first auditor of a Company?
- What is statutory duty?
- What do you mean by negligence?
- State any three liabilities of a company auditor.
- Define 'Government company'.

III. Short answer questions.

- What are the qualifications of an auditor?
- What are the disqualifications of an auditor of a company?

3. What are the circumstances in which an auditor can be removed?
4. State the duties of an auditor of a limited company.
5. Explain the civil liability of an auditor.
6. What are the criminal liabilities of an auditor?

IV. Essay type questions.

1. State the qualifications and disqualifications of the auditor of a company.
2. State the provisions of the Companies Act, 2013 regarding appointment of auditor in Government Company.
3. Explain in detail about the appointment of auditors in Non-Government Company.
4. Explain in brief the powers of a company auditor.
5. What are the statutory duties of a company auditor? Discuss.
6. Discuss the rights of a company auditor.
7. Write a note on civil and criminal liabilities of an auditor.
8. Discuss the liabilities of a company auditor under the Companies Act.

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Learning Objectives

- To understand the meaning, elements and types of audit report.
- To analyse the procedure for conducting share capital audit.
- To discuss duties of an auditor regarding issue of initial public offer (IPO)
- To discuss duties of an auditor regarding issue of shares for other than cash consideration.
- To review the duties of an auditor when shares issued at premium or sweat equity.

POINTS TO RECALL

RECAP

From the previous chapter we have studied the qualifications and disqualifications of an auditor, removal and resignation of an auditor, rights and powers of an auditor, duties of auditor, and liabilities of auditor.

10.1 Audit Report

Audit report is the final stage of audit process. The results of the audit are communicated through audit report. Audit report is the written opinion of an auditor regarding companies financial statements. Audit report is a document prepared by an auditor to certify the financial position and accounting records of a firm.

truth and fairness of financial statements. Thus, the auditor protects the interest of shareholders through audit report.

10.1.1 Meaning of Audit Report

Audit report is the statement included in the financial statements. It contains the opinion of the auditor in financial statements. The auditor reports to the shareholders who have appointed him. He has to provide his opinion on the

10.1.2 Definition of Audit Report

- **Lancaster** has defined a report as “a report is a statement of collected and considered facts, so drawn up as to give clear and concise information to persons who are not already in possession of the full facts of subject matter of the report.”
- According to Cambridge Business English Dictionary, Audit report is defined as a formal document that states an auditor’s judgment of a company’s accounts.

Under Sec. 143(3), auditor of a company must report to its members.

- (a) The accounts examined by him;
- (b) Balance Sheet, Profit and Loss Account, and Cash Flow statement, which are

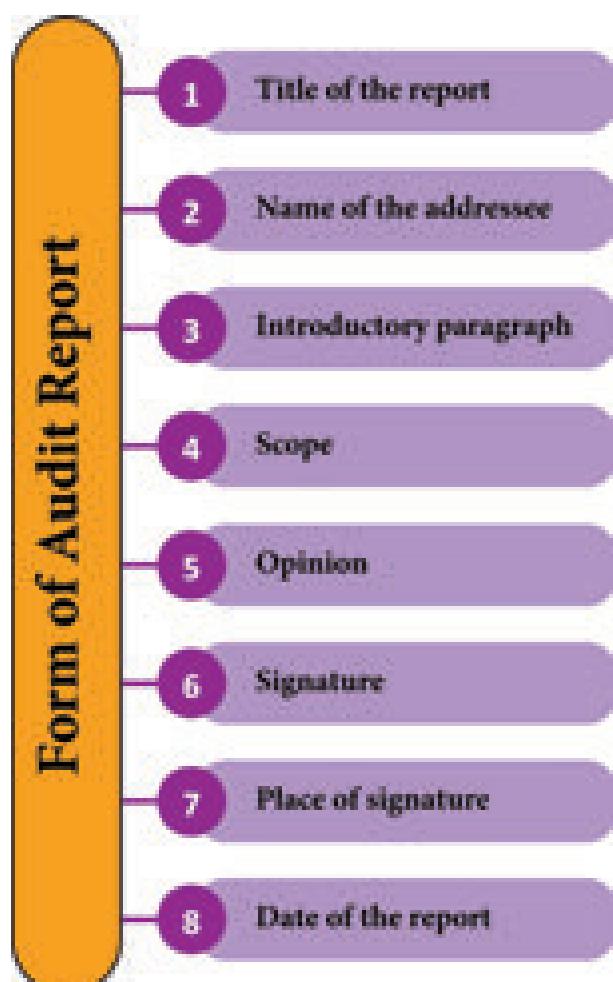
laid in general meeting of a company during his tenure of office; and

- (c) The document declared to be attached to the Balance Sheet and Profit and Loss Account.

Audit Certificate

- Audit Certificate vouches the truth of the statement.
- Audit Certificate is the guarantee for accuracy of statement.
- Audit Certificate ascertains the correctness of tangible facts after verification.
- If the audit certificate is with wrong details, the auditor is responsible.
- Audit certificate does not have the scope for suggestion or opinion.

10.1.3 Form of Audit Report



1. Title of the report

The title of audit report should help the reader to identify the report. It should disclose the

name of the client. The title distinguishes the audit report from other reports.

2. Name of the Addressee

The addressee normally refers to the person who appoints the auditor. If a company appoints the auditor, the addressee should be shareholders. As per law, the complete address of the addressee is required. Addressee for the statutory audit shall be shareholders and in case of Special Audit, it is Central Government.

3. Introductory Paragraph

The introductory paragraph should specify that it is the auditor's opinion on financial statements audited by him. The period covered by financial statements should be stated with exact dates.

4. Scope

This part should include the matter-of-fact relating to the manner in which audit examination was made. The audit examination should cover company's accounts, Profit and Loss Account, Balance Sheet and Cash Flow Statements. The examination should be as per the

relevant law. The auditor should not curtail or limit any examination task.

5. Opinion

The auditor's opinion on the books of account and financial statements examined by him is based on the information and free from bias. The auditor has to give his opinion as follows:

- i. Whether the financial statements are arithmetically correct and correspond to the figures recorded in the books of accounts.
- ii. In case of unqualified opinion, whether the financial statements represent a true and fair view of the state of affairs and the results of operations.
- iii. In case of qualified opinion, if the Balance Sheet and Profit and Loss account do not present a true and fair view, the reasons for qualification (what and where is wrong).

6. Signature

The signature part should include the manual signature of the auditor. The personal name and signature of the auditor should be given. If the auditor is a firm, the signature of the partner and firm name should be given.

7. Place of Signature

This should include the location of the auditor or the auditor firm, which is ordinarily their city.

8. Date of the Report

The date of completion of the audit work should be mentioned in this section.

10.1.4 Contents of Audit Report

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

- a. whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;
- b. whether, in his opinion, proper books of account as required by law have been kept by the company so far as it appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;
- c. whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company's auditor has been sent to him and the manner in which he has dealt with it in preparing his report;
- d. whether the company's Balance Sheet and Profit and Loss account dealt with in the report are in agreement with the books of account and returns;
- e. whether, in his opinion, the financial statements comply with the Accounting Standards;
- f. the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;
- g. whether any director is disqualified from being appointed as a director under sub-section (2) of section 164;
- h. any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;
- i. whether the company has adequate internal financial control system in

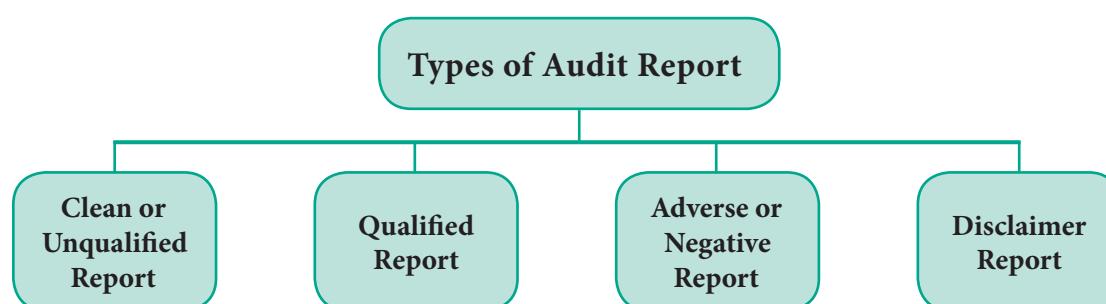
- place and the operating effectiveness of such controls;
- j. such other matters as may be prescribed.

10.1.5. Types of Audit Report

The audit report may be of the following types:

1. Clean or Unqualified Report

Clean or Unqualified report will be given by the auditor if the auditor is satisfied that the accounts, Balance Sheet, Profit and Loss Account and Cash Flow statement do represent a true and fair view and they are prepared in conformity with the accounting principles and statutory requirements.



Specimen of Clean on Unqualified Report

To

The Shareholders
ABC Ltd. Chennai

We have audited the attached Balance Sheet of ABC Ltd....as at..... and the profit and Loss Account of the company for the year ended on that date and we report that:

1. We have obtained all the information and explanations which are necessary for the purpose of audit.
2. In our opinion, proper books of accounts have been maintained in accordance with the standard accounting practices.
3. The Balance Sheet and Profit and Loss Account are in agreement with the books of accounts and returns.
4. In our opinion, and to the best of our information, the said accounts give the information required and give a true and fair view:
 - In the case of Balance Sheet of the company as at....; and
 - In the case of Profit and Loss Account of the company for the year ended on that date.

Signatures:

For X,Y&Co
Chartered Accountants Partner

2. Qualified Report

In qualified report the auditor believes that overall financial statements are not fairly stated. The reasons for giving Qualified Report are be as follows:

i. The books of accounts, Profit and Loss Account and the Balance Sheet do not represent the true and fair view of the state of affairs and results of the operations, due to lack of conformity

- with the accounting principles and statutory requirements,
- ii. The auditor is not able to verify the value and existence of certain assets,
 - iii. The information requested by the auditor is not furnished,
 - iv. Proper books of account are not maintained as required by law,
 - v. Part of audit examination done by other auditors.

Specimen of Qualified Report

To

The Shareholders
ABC Ltd.
Chennai

We have audited the attached Balance Sheet of XYZ Ltd., as at..... and also the Profit and Loss account for the year ended on that date. We report that:

We have received all the information and explanations which are necessary for the purpose of audit.

We conducted our audit in accordance with the auditing standards generally accepted in India.

In our opinion, proper books of accounts as per law have been maintained by the company with the accounting standards and the Balance Sheet and Profit and Loss account gives a true and fair view and subject to the comments given hereunder:

- The stock in trade has been valued at market price, which is higher than the cost by ₹ 50,000.
- The provision for depreciation is not sufficient.
- Amount spent for the repairs of machinery ₹ 2000 has been capitalized and added to the cost of machinery.

Signatures:

For X,Y&Co
Chartered Accountants Partner

3. Adverse or Negative Report

When there is sufficient basis for the auditor to form an opinion that the whole accounts and financial statements, do not present a true and fair view of the financial condition and results of operation, the adverse or negative opinion will be given. The adverse or negative report will be given on the following grounds:

- i. When the auditor is not satisfied with the truth and fairness of financial statements,
- ii. Non conformity with the Generally Accepted Accounting Principles,
- iii. Mistakes, discrepancies and material misstatement in the financial statements,
- iv. Omission of a material disclosure.

4. 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 base his opinion. In the scope and opinion paragraph, the auditor should give disclaimer information. This may happen on the following grounds:

- i. The auditor has not been able to obtain sufficient information to form his opinion,
- ii. The audit examination is not adequate to form an opinion,
- iii. There are some material undetermined item in audit examination.

10.1.6 Differences between Unqualified, Qualified and Adverse Audit Report

Basis	Unqualified Audit Report	Qualified Audit Report	Adverse Audit Report
Meaning	Auditor issues a unqualified report where the auditor is fully satisfied with the work of client.	Auditor issues a qualified report where the auditor is not fully satisfied with the work of client.	Auditor issues an adverse report when he does not agree with the affirmation made in the financial statements i.e., accounts disclose a serious distortion.
True and Fair View	The auditor is satisfied that the accounts, Balance Sheet, Profit and Loss Account and Cash Flow statement do represent a true and fair view.	The books of account, Profit and Loss Account and the Balance Sheet do not represent the true and fair view of the state of affairs.	When there is sufficient basis for the auditor to form an opinion that the whole accounts and financial statements, do not present a true and fair view of the financial condition.
Opinion	The auditor gives clean opinion without any reservation.	The auditor gives an opinion subject to certain reservation.	The auditor concludes that based on his examination, he is not satisfied with the affirmation made in the financial statements.

10.2 Audit Of Share Capital

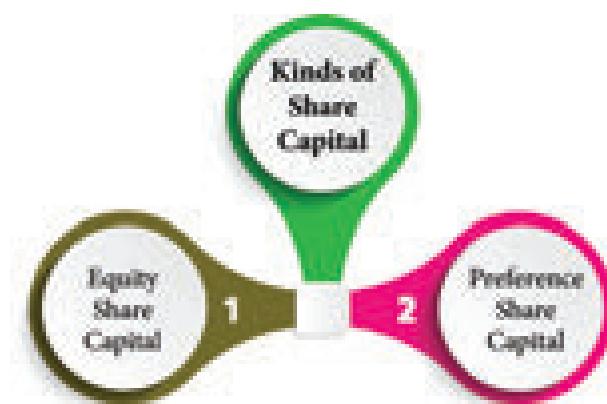
Share capital means capital raised by the company by issue of shares. This issue of share capital should be audited to verify the compliance of requirements and provisions of Companies Act.

10.2.1. Meaning of Share Capital

A company may meet its fund requirements either through raising share capital or through borrowings. The company does a proper financial analysis before taking such a decision. The funds raised through issue of shares is termed as share capital.

10.2.2. Kinds of Share Capital

The share capital of the company is of two kinds, namely Equity share capital and Preference share capital.



1. Equity Share Capital

Equity share capital means all share capital, which is not preference share capital and called as the ordinary share capital of the company.

2. Preference Share Capital

Preference share capital means that part of the issued share capital of the company which either carries or would carry a preferential right with respect to payment of dividend and a preferential right of

repayment in case of winding up or repayment of capital. Apart from these two preferential rights, preference shares can be of participating or non-participating type depending upon their right to participate in dividend payment with capital.

10.3 Audit of Share Capital of a New Company (or) Fresh Issue of Shares

The first function of the Company after incorporation was to raise funds. The funds can be raised either by issue of securities or by loan or borrowings. Section 23 of Companies Act, 2013 makes a distinction between public and private company as far as raising funds is concerned.

Section 23 of Companies act, 2013 provides that:

Public company may raise a fund or issue securities, by:

1. Issue of prospectus to public either by Initial Public Offering (**IPO**) or Follow on Public Offer (**FPO**), or
2. Private placement, or
3. Right issue
4. Bonus issue.

Private companies may raise fund or issue securities, by:

1. Right issue
2. Bonus issue
3. Private placement.

10.3.1. Meaning of Fresh Issue of Shares

Fresh issue of shares refers to the shares issued through Initial Public Offering (**IPO**).

It means when an unlisted company makes either a fresh issue of securities or an offer for sale of its existing securities or both for first time to public. Unlisted company is one whose security is not listed on any of the recognized stock exchange.

The underwriter serves as the intermediary between the company seeking to issue shares in an initial public offering (IPO) and investors. The underwriter helps the company to prepare for the IPO, considering issues such as the amount of money sought to be raised, the type of securities to be issued, and the agreement between the underwriter and the company. Syndicate Underwriting is one in which, two or more agencies or underwriters jointly underwrite an issue of securities. Such an arrangement is entered into when the total issue is beyond the resources of one underwriter or when he does not want to block up large amount of funds in one issue. Sub-Underwriting is one in which an underwriter gets a part of the issue further underwritten by another agency. This is done to diffuse the risk involved in underwriting. The name of every under-writer is mentioned in the prospectus along with the amount of securities underwritten by him. Firm Underwriting is one in which the underwriters apply for a block of securities. Under it, the underwriters agree to take up and pay for this block of securities as ordinary subscribers in addition to their commitment as underwriters.

This Initial Public Offering can be made through the fixed price method, book-building method or a combination of both. Under fixed price method, the investors know

the price at which the securities are offered and allotted in advance. Book Building is a process used by companies to raise raising capital through Public Offerings-both Initial Public Offers (IPOs) and Follow-on Public Offers (FPOs) to aid price and demand discovery.

Private Placement is issuing share capital to a select group of people, including or not the existing shareholders, like friends, family members, Angel investors, Venture Capitalists etc.

Rights issue is the pro-rata issuance of equity to existing equity shareholders in the company. This results in the advantages such as control in the hands of existing shareholders, prevention of dilution of control and less costly.

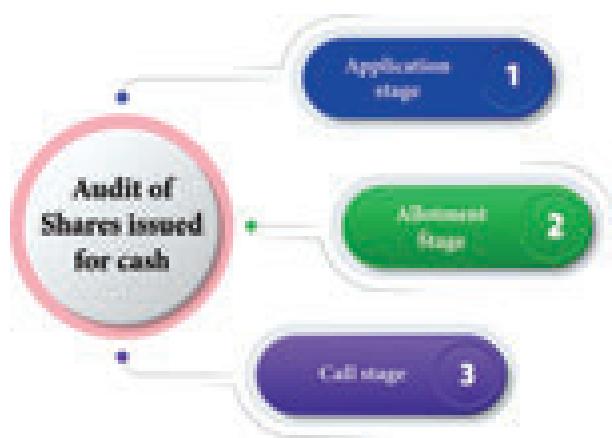
10.3.2. Auditors Duties

The issue of share capital should be audited by the auditor. He should study the conditions relating to the issue of share capital in the Memorandum, Articles of Association, as well as Prospectus and see that these have been duly complied with. A company cannot issue share capital exceeding the amount prescribed in its memorandum though, if its Articles permit, it may increase its authorized capital by altering its Memorandum in a general meeting. Every issue of capital should be properly authorized.

10.4 Audit of Shares issued for Cash

Shares issued for cash can be done in three stages as: (a) Application Stage, where applications were received along with application money; (b) Allotment

Stage, where allotment takes place and allotment money is received subject to the receipt of minimum subscription; (c) Calls stage, where calls are made on shares and the amount due is received.



a. APPLICATION STAGE

1. The auditor should check the original share application. He should check the entries in Application and Allotment Book.
2. He should vouch the application money received with Application and Allotment Book and the corresponding entries in cash book. He should ensure that application money received was deposited in a scheduled bank until the certificate of commencement of business is obtained. He should verify whether application money received is not less than 5% of the nominal value of shares issued.
3. He should vouch the money refunded to unsuccessful applicants with Application and Allotment Book, copies of letters of regret and bank book.
4. He should check the total columns of Application and Allotment Book and

see that proper journal entries have been passed in the books.

b. ALLOTMENT STAGE

1. The auditor should see that allotment begins only after the receipt of minimum subscription.
2. He should examine the Directors' Minute Book to see that all the allotments have been approved by the Board.
3. He should compare the copies of Letters of Allotment and Letters of Regret with entries made in the Application and Allotment Book.
4. He should check the amount received on allotment, by comparing Application and Allotment Book with Cash Book.
5. He should check the postings in Share Register of the amount received on application and allotment.
6. He should see that the relevant RBI and FEMA requirements, in case of allotment to non-residents.
7. He should see that appropriate journal entry debiting Share Allotment and crediting Share Capital Account has been duly made.

c. CALL STAGE

1. The auditor should examine the board of director's resolution in the Directors' Minute Book for making calls.
2. He should verify the amount received with the counterfoil of receipts.
3. He should compare the total amount due on calls with the amount collected and entered in the cash book. He should trace out the figures of call-in-arrears by comparing

the ‘Schedule of Calls in Arrears with Application and Allotment Book, and check the accuracy of the amount.

- He should see that appropriate journal entry debiting Calls Account and crediting Share Capital Account has been duly made.

10.5 Audit of shares issued for consideration other than cash

Shares may also be issued for consideration other than cash. Vendors, promoters, underwriters, etc. may be allotted shares instead of making payments to them. The audit procedure followed in this regard involves examining the contract, board of director's resolution, checking the journal entries and examining the prospectus.

10.5.1. Meaning

Shares issued for consideration other than cash may arise where a company issues shares to vendors of business against purchase consideration; or to promoter's who have borne preliminary expenses, or to underwriters against settlement of under-writing commission, etc.

10.5.2. Auditors Duties

1. Examination of Contracts

Copy of contracts entered into with vendors, promoters, underwriters, etc. should be examined by the auditor to ensure that the allotment is made as per the agreements. The amount of purchase consideration for the vendors,

nature and amount of consideration for the promoters, remuneration to underwriters would be mentioned in their respective agreements.

2. Examination of Prospectus

He should examine the Prospectus to ensure that conditions lay down such as details of the amount payable to the vendors, promoters, and underwriters and the mode of payment.

Section 2(70) of the Companies Act, 2013 defines a Prospectus as “any document described or issued as a prospectus and includes a red herring prospectus referred to in section 32 or shelf prospectus referred to in section 31 or any notice, circular, advertisement or other document inviting others from the public for the subscription or purchase of any securities of a body corporate.”

“**SHELF PROSPECTUS**” means a prospectus in respect of which the securities or class of securities included therein issued for subscription in one or more issues over a certain period without the issue of a further prospectus.

“**RED HERRING PROSPECTUS**” means a prospectus, which does not include complete particulars of the quantum or price of the securities included therein.

3. Verify Directors Minute Book

The auditor should examine the Minutes of the Board of Directors to ensure that the allotment is authorized by the Board.

4. Verify Entries in Books

The auditor should see that the journal entry is in order. He should verify Share capital account as shown in the ledger to ascertain that share allotments are posted in the ledger accounts.

e. Compliance with Legal Provisions

The auditor should verify the return filed with the Registrar of Companies to ensure that return is filed in accordance with the provisions of the Act.

10.6 Audit of Shares Issued at Premium

Share premium can be defined as the excess amount received by the company over and above the face value of shares. All types of companies can issue shares at premium. The auditor should examine the Prospectus, the Articles and the Minutes of the Directors to see whether the issue of shares at a premium is duly authorized or not. He should see that the sum available has been utilized in the manner as laid down by the Articles.

| 10.6.1. Meaning of Shares Issued at Premium

Share premium means the shares are issued at an amount in excess of the nominal value of the shares. Section

52, of the Companies Act, 2013 states that, if a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium received on those shares shall be transferred to a Share Premium Account. The auditor should examine the Articles, Minutes of Board meetings to see whether issue of shares at a premium is duly authorized.

| 10.6.2. Auditors Duties for Issue of Shares at Premium

The auditor should see that the amount of share premium is utilized in the manner laid down in Section 52. The share premium account may be used by the company only for –

1. Issuing fully paid bonus shares to the members of the company.
2. Writing off preliminary expenses or commission paid or discount allowed on any issue of shares or debentures of the company.
3. Providing for the premium payable on the redemption of any redeemable preference shares of the company.
4. Buying back own shares, if Articles permits it and authorized by special resolution passed in general meeting.

Audit of Sweat Equity Shares

Shares issued at a discount means the issue of shares at the price less than its face value. The auditor should verify whether the issue of shares at discount is as per the Section 53 and 54, of the Companies Act, 2013.

10.7 Audit of Sweat Equity Shares (Issue at Discount)

| 10.7.1 Meaning

According to Section 53, a company shall not issue shares at a discount, except in the case of an issue of sweat equity shares given under Section 54, of the Companies Act, 2013. Sweat Equity share means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called. If a company contravenes the provisions of this section, it shall be punishable with a fine not less than one lakh rupees but it may extend upto five lakhs. Moreover, the official in default shall be punishable with imprisonment for a term which may extend

to six months or with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees, or with both.

| 10.7.2. Auditors Duties

The auditor should see whether the following conditions are fulfilled in case of Sweat Equity Shares:

1. The issue should be authorized by a special resolution. The number of shares, current market price, consideration to be received, if any, and the class of directors, employees to whom the shares will be issued should be specified in the special resolution.
2. Only after expiry of at least one year from the date of commencement of company's business, these shares can be issued.
3. If shares of the company are listed on the stock exchange, issue of sweat equity shares should be in accordance with regulations made by SEBI.



STUDENTS ACTIVITY



1. Collect and go through the Audit Report of Public Sector Undertakings of Government of Tamil Nadu from the website of Comptroller and Auditor General of India. (www.cag.gov.in)
2. Collect the information relating to IPO by HDFC AMC.
3. Collect a prospectus of a company and refer issue of shares and discuss.
4. Collect a memorandum of association and discuss the share capital clause.
5. Collect articles of association and refer the mode of issue of share capital and discuss.

Find out the total equity capital of Reliance Industries Limited for the year 2017-18 by going through its annual report for the year 2017-18. (Visit the website for collecting the annual report: <http://www.ril.com/InvestorRelations/FinancialReporting.aspx>)

SUMMARY

- Audit report is the statement containing the opinion of the auditor on the representations made by company management in financial statements and matters relevant to them.
- Title of the report, name of the addressee, introductory paragraph, scope, opinion, signature, place of signature and date of the report are the elements of Audit report.
- Clean report or unqualified report, Qualified report, Adverse or negative report and Disclaimer are the types of audit report.
- The auditor should study the conditions relating to issue of share capital in the Memorandum, Articles of Association, as well as Prospectus and see that these have been duly complied with.
- In case of shares issued for cash, there are three stages (a) Application Stage, where applications were received along with application money; (b) Allotment Stage, where allotment takes place subject to the receipt of minimum subscription; (c) Calls stage, where calls are made on shares and the amount due is received.
- Shares may also be issued for consideration other than cash. Vendors, promoters, underwriters, etc may be allotted shares instead of making payments to them.
- Share premium means the shares are issued at an amount in excess of the nominal value of shares. The auditor should see that the amount of share premium is utilized in the manner laid down in Section 52.
- According to section 53, a company shall not issue shares at a discount, except in the case of an issue of sweat equity shares given under section 54, of the Companies Act, 2013.

KEY TERMS

- **Public Company:** According to the Companies Act, 2013 “A Public company is a company which is not a private company and has a minimum paid up capital of 5 lakh rupees and have the right to transfer of shares of a company”. The Public Limited company has “Ltd” at the end of its name.
- **Private Company:** According to the Companies Act, 2013 “A Private company is a company which has a minimum paid-up capital of 1 lakh rupees and which is restricted to have the right to transfer of share”.The Private Limited company has “Pvt.Ltd” at the end of its name.
- **Authorised Capital:** The authorised capital of a company is the maximum amount of share capital for which shares can be issued by a company.

- **Minimum Subscription:** The minimum shares the company needs to get from the public out of the total issue by the date of closure. (Presently every company need to raise 90% of the issued amount).
- **Promoters:** A promoter conceives an idea for setting-up a particular business at a given place and performs various formalities required for starting a company.
- **Underwriters:** A syndicate of banks (the lead managers) underwrites the transaction, which means they have taken on the risk of distributing the securities.
- **Sweat Equity:** Sweat share means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions.
- **Prospectus:** A prospectus is a legal document issued by companies that are offering securities for sale, including the details of the company and the issue.
- **Memorandum of Association:** A Memorandum of Association (MOA) is a legal document prepared in the formation and registration process of a limited liability company to define its relationship with shareholders.
- **Articles of Association:** is a document which states the rules and regulations of the internal affairs of the company. It is the by-laws of the company.
- **Preliminary Expenses:** Preliminary expenses are those expenses which are incurred in business before incorporation and commencement of business. Example : statuary fees ,company logo, survey report, Charges paid to charter accounting firm before forming a company.



EVALUATION



I. Multiple Choice Questions

1. The report given by the auditor reveals a true and fair view of a company is _____
 - a. Unqualified report
 - b. Qualified report
 - c. Interim report
 - d. Final report
2. Where an auditor gives an opinion on the various matters without any reservations, it is known as
 - a. Clean report
 - b. Qualified report
 - c. Adverse report
 - d. Negative report

3. If auditor gives a qualified report, following consequences will result:
- Board of Directors have to resign.
 - Central Government may impose a fine on directors
 - The recognised stock exchange on which company's shares are listed would revoke listing.
 - The Board of directors has to give reply to such qualifications in its Board's report.
4. The company auditors present the audit report to :
- Board of director
 - Company registrar
 - Central Government
 - Shareholders
5. A good audit report must at least meet one of the following qualifications _____.
- it should offer constructive and timely suggestions to the management.
 - it should not point out mistakes.
 - it should not be based on factual information.
 - it should not be based on Balance Sheet.
6. Who is responsible for the appointment of statutory auditor of a limited company?
- Directors of the company
 - Members of the company
 - The Central Government
 - All of the above
7. When restrictions that significantly affect the scope of the audit are imposed by the client, the auditor generally should issue which of the following opinion?
- Qualified opinion
 - Disclaimer of opinion
 - Adverse opinion
 - Unqualified report with 'an emphasis of matter' paragraph;
 - All of the above
8. In case the auditor gives a disclaimer of opinion in the audit report which of the following paragraph(s) of a standard unqualified audit report are modified?
- Scope paragraph
 - Opinion paragraph
 - Scope and opinion paragraphs
 - introductory, scope and opinion paragraph
9. Ordinary shares are also called:
- Equity Shares
 - Founder's Shares
 - Deferred Shares
 - Preference Shares
10. Share may be issued _____
- at par
 - at premium
 - at discount
 - all the above.
11. A copy of the _____ must accompany each from of application for shares offered to the public.
- Memorandum of Association
 - Prospectus
 - Articles of Association
 - All of the above

12. The persons who take the risk of issuing shares are known as:
- Directors
 - Promoters
 - Shareholders
 - Underwriters
13. Which of the following is the modern approach of fixation of issue price of shares?
- Fixed price method.
 - Mark-to-Market method.
 - Book Building method.
 - None of the above
14. Which of the following is/ are advantage(s) of Rights issue?
- Control in the hands of existing shareholders.
 - Less costly
 - No dilution in existing value of shares.
 - All of the above.
15. Which of the following is a feature of sweat equity shares?
- These are only to its directors or employees.
 - They are issued only for acquisition of tangible assets.
 - They are by nature of debentures.
 - All of the above
16. Which of the following is **not** included in the provisions for issue of shares at a premium?
- Special resolution must be passed in General meeting of the company.
 - Premium received must be transferred to "Securities Premium Account"
 - Amount of share premium can be utilized for issuing fully paid bonus shares.
 - Amount of share premium can be utilized for writing off preliminary expenses.
17. _____ means the total amount of called up share capital which is actually paid to the company by the members.
- Authorised Capital
 - Issued Capital
 - Called up Capital
 - Paid up Capital
18. _____ means the amount that is stated in the memorandum of a company to be the maximum amount of share capital of the company.
- Authorised Capital
 - Issued Capital
 - Called up Capital
 - Paid up Capital

Answer: 1.(a), 2.(a), 3.(d), 4.(d), 5.(a), 6.(b), 7.(a), 8.(c), 9.(a), 10.(d), 11.(a), 12.(d), 13.(c), 14.(d), 15.(a), 16.(a), 17.(d), 18.(a)

II. Very Short Answer Questions

1. What do you mean by audit report?
2. What is clean report?
3. What is qualified report?
4. Mention the purposes for which securities premium account can be utilised.
5. Mention any two duties of auditor regarding issue of sweat equity shares.

III. Short Answer Questions

1. When can a qualified audit report be given?
2. What are the kinds of share capital?
3. Discuss the auditors' duty with regard to issue of shares at a premium.
4. Under what circumstances the shares can be issued for the consideration other than cash?
5. State the various stages in which shares can be issued.

IV. Essay Type Questions

1. What are the basic elements of an auditor's report? Explain.
2. Explain the types of audit report.
3. Discuss the procedure for the audit of shares issued for cash.
4. As an Auditor, how will you verify shares issued for consideration other than cash.
5. Discuss the procedure for audit of shares issued for consideration other than cash.
6. What is meant by Sweat Equity Shares. Discuss the duties of an Auditor.

References

1. Auditing Practical – Dr. G. Anitha & Dr. J. Sankari, Sai Selva Publishers Distributors.
2. Principles and Practice of Auditing, Dinkar Pagare, Sultan Chand & Sons.
3. Auditing Practical (As per Companies Act, 2013), L. Natarajan, Margham Publications.

Glossary

Adverse or Negative Report	எதிர்மறை அறிக்கை
Adverse Report	எதிர்மறை அறிக்கை
Annuity method	ஆண்டுத்தொகைமுறை
Appointment	நியமனம்
Articles of Association	செயல்முறை விதிகள்
Assurance	உத்தரவாதம்
Audit Report	தணிக்கை அறிக்கை
Auditing Standards	தணிக்கை தரம்
Auditor	தணிக்கையாளர்
Auditors Duty	தணிக்கையாளர் கடமை
Authority and Responsibility	ஆணையுரிமை மற்றும் பொறுப்பாண்மை
Authorized share capital	அங்கீகரிக்கப்பட்ட பங்கு முதல்
Balance sheet	இருப்புநிலைக் குறிப்பு
Balance Sheet	இருப்புநிலைக் குறிப்பு
Bank over draft	வங்கி மேல்வரை பற்று
Bearer Debentures	கொணர்பவர் கடனீட்டுப் பத்திரங்கள்
Bills payable	செலுத்தற்குரிய மாற்றுச் சீட்டு
Bonus Issue	ஊக்கப் பங்கு
Book value	எட்டு மதிப்பு
Called-up share capital	அழைக்கப்பட்ட பங்கு முதல்
Calls in Arrears	அழைப்பு நிலுவை
Capital	முதல் (அ) மூலதனம்
Capital Reserve	முதலினக்காப்பு
Cash Book	ரொக்க ஏடு
Cash flow statements	ரொக்க நடமாட்ட அறிக்கை
Cash payment	ரொக்க செலுத்துதல்கள்
Cash Receipt	ரொக்கப் பெறுதல்கள்
Casual Vacancy	தற்செயல் காலியிடம்

Catalyst	வினையுக்கி
Check list	சாரிபார்ப்பு பட்டியல்
Civil Liabilities	உரிமையியல் பொறுப்புகள்
Clean Audit Report	தூய தணிக்கை அறிக்கை
Company	நிறுமம்
Company Auditor	நிறும தணிக்கையாளர்
Confirmation letter	உறுதிப்பாடு கடிதம்
Consumption	நுகர்வு
Contingent Liabilities	நிகழ்வடையாப் பொறுப்புகள்
Contractual Duties	ஒப்பந்த பணிகள்
Convertible Debentures	மாற்றத்தகு கடனீட்டுப் பத்திரங்கள்
Cost Price method	அடக்கவிலைமுறை
Credit Note	வரவு குறிப்பு
Criminal Liabilities	குற்றவியல் பொறுப்புகள்
Current Liabilities	நடப்பு பொறுப்புகள்
Debenture	கடனீட்டுப் பத்திரம்
Debit Note	பற்று குறிப்பு
Depletion	சிதைவு / காலியாதல்
Depletion	குறைதல்
Depreciation	தேய்மானம்
Detective control	புலனாய்வு கட்டுப்பாடு
Disclaimer	ஸ்ருதலிப்பு
Dispatch memo	சரக்கு அனுப்புகை குறிப்பு
Disqualifications	தகுதியின்மை
Division Work	வேலைப்பகிர்வு
Effluxion of time	காலப்போக்கு
Equity Share Capital	நேர்மை பங்கு முதல்
Erosion	அரித்தல் / தேய்மான அழிவு
Estimated Useful life	எதிர்பார்க்கும் பயன்பாட்டுக் காலம்
Exhaustion	சோர்வு (அ) வெறுமையாதல்
External causes	புறக்காரணங்கள்
Financial Statements	நிதி அறிக்கை
Fixed Assets	நிலைச் சொத்துகள்

Frauds	மோசடி
General Meeting	பொது கூட்டம்
General Reserve	பொதுக்காப்பு
Goods inward Book	சரக்கு உள் வரு ஏடு
Goods outward Book	சரக்கு வெளி செல்லேடு
Governance	ஆளுகை
Government Company	அரசு நிறுமம்
Gradual Deterioration	படிப்படியாக மதிப்பு குறைதல்
Indemnify	இழப்பை ஈடுகட்டுதல்
Initial Public Offering	ஆரம்ப பொது விடுப்புகள்
Internal audit	அகத்தனிக்கை
Internal Audit Report	அகத்தனிக்கை அறிக்கை
Internal auditor	அகத்தனிக்கையாளர்
Internal causes	அகக்காரணங்கள்
Internal Check	அகச்சீராய்வு / அகச்சோதனை
Internal control	அகக்கட்டுப்பாடு
Inventions	புதிய கண்டுபிடிப்புகள்
Investigating	புலனாய்வு
Investments	முதலீடுகள்
Invoice	இடாப்பு
Irredeemable Debentures	மீன்தகா கடனீட்டுப் பத்திரங்கள்
Issued share capital	வெளியிட்ட பங்கு முதல்
Legitimate right	சட்டப்படியான உரிமை
Liabilities	பொறுப்புகள்
Long Term Loans	நீண்ட கால கடன்கள்
Management Controls	நிர்வாக கட்டுப்பாடுகள்
Market value method	சந்தை மதிப்பு முறை
Memorandum of Association	அமைப்பு முறையேடு
Minimum Subscription	குறுமப் பங்கு ஒப்பம்
Minute Book	நிகழ்ச்சி குறிப்பு
Misfeasance	அதிகாரத்தை தவறாக பயன்படுத்துதல்
Mortgage Debentures	அடமான கடனீட்டுப் பத்திரங்கள்
Naked Debentures	வெற்று கடனீட்டுப் பத்திரங்கள்

Narrative record	விரிவான பதிவேடு
Natural calamities	இயற்கை சீற்றங்கள்
Negligence	கவனமின்மை
Net Realizable value	நிகர மெய் மதிப்பு
Non-Convertible Debentures	மாற்றத்தகா கடனீட்டுப் பத்திரங்கள்
Obsolescence	வழக்கொழிவு
Organisation	அமைப்பு
Outstanding Expenses	கொடுப்பா செலவுகள்
Over stated	மிகைப்படுத்தி எழுதுதல்
Over time records	மிகை நேர பதிவேடு
Paid-up share capital	செலுத்திய பங்கு முதல்
Partnership	கூட்டாண்மை
Partnership Deed	கூட்டாண்மை ஒப்பாவணம்
Pass Book	செல்லேடு
Piece work records	அலகு வீத பதிவேடு
Powers	அதிகாரங்கள்
Preference Share Capital	முன்னுரிமை பங்கு முதல்
Preventive control	தடுப்புக்கட்டுப்பாடு
Private Company	தனியார் நிறுமம்
Private Placement	தனி ஒதுக்கீடு
Professional Duties	தொழிற்சார்ந்த பணிகள்
Professional misconduct	தொழிற்சார்ந்த தவறான பணிகள்
Profit & Loss Appropriation Account	இலாப நட்ட பகிரவு கணக்கு
Profit and Loss Account	இலாப நட்டக் கணக்கு
Promoters	தோற்றுவிப்பாளர்கள்
Prospectus	தகவல் அறிக்கை
Public Company	பொது நிறுமம்
Qualifications	தகுதிகள்
Qualified Audit Report	தகுதியான தணிக்கை அறிக்கை
Qualified Report	தகுதியான அறிக்கை
Questionnaire	வினா வரிசை
Redeemable Debentures	மீளதகு கடனீட்டுப் பத்திரங்கள்

Registered Debentures	பதிவு செய்யப்பட்ட கடனீட்டுப் பத்திரங்கள்
Removal	நீக்கம்
Remuneration	ஊதியம்
Remuneration	ஊதியம்
Replacement value method	மாற்று மதிப்பு முறை
Reserve	காப்பு
Reserve Bank of India	இந்திய மைய வங்கி
Reserve capital	காப்பு முதல்
Reserve fund	காப்புநிதி
Reserves and Surplus	காப்பும் மிகுதியும்
Residual value / scrap value	இறுதி மதிப்பு
Resignation	பணி துறப்பு
Return from investments	முதலீடுகள் மீதான வருமானம்
Revaluation Method	மறுமதிப்பீட்டுமுறை
Rights	உரிமைகள்
Rights Issue	உரிமை பங்கு
Risk Management	இடர் மேலாண்மை
Salvage	அழிவுமீட்பு
Secret Reserve	இரகசியக்காப்பு / மறைக்காப்பு
Share allotment	பங்கு ஒதுக்கீடு
Share application	பங்கு விண்ணப்பம்
Share Capital	பங்கு முதல்
Share discount	பங்கு வட்டம்
Share forfeiture	பங்கு ஒறுப்பிழப்பு
Share holder	பங்குதாரர்
Share Premium	பங்கு முனைமம்
Sinking fund	கழிவுநிதி / ஒதுக்கீட்டு சேமவைப்பு நிதி / சீர்மைநிதி
Specific Reserve	குறிப்பிட்டக்காப்பு
Standard cost method	தர அடக்க மதிப்பு
Statutory auditor	சட்டமுறை தனிக்கையாளர்
Statutory Duty	சட்டமுறை கடமைகள்
Statutory Report	சட்டமுறை அறிக்கை

Subscribed share capital	ஓப்பிய பங்கு முதல்
Sundry Creditors	பற்பல கடனீந்தோர்
Sweat Equity	பணியாளர் பங்கு
Tangible asset	புலனாகும் சொத்து
Time Records	நேர வீத பதிவேடு
Trading transactions	வியாபார நடவடிக்கைகள்
Un-called share capital	அழைக்கப்படாத பங்கு முதல்
Under stated	குறைத்து எழுதுதல்
Un-issued share capital	வெளியிடா பங்கு முதல்
Unqualified Report	வரையறையற்ற அறிக்கை
Un-subscribed share capital	ஓப்பாத பங்கு முதல்
Verification	சரிபார்த்தல்
Wage sheet	கூலி பட்டியல்
WDV method	குறைந்த செல் இருப்பு முறை
Wear and Tear	தேய்வு மற்றும் உராய்வு
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