AUDITING NOTES

Subject: AUDITING AND CORPORATE GOVERNANCE (BCH-6.1)

Study material for B. Com.(H)-Semester VI (Sec-3 & 4) for (week 1) March 30-April 5, 2020

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2.7-2 Scope of internal audit (on the basis of SA 610)

Scope of internal audit function	The internal audit function may be assigned specific responsibility for—
a. *Monitoring of internal control*	Reviewing controls, monitoring their operation and recommending improvements thereto.
b. *Examination of financial and operating information*	Reviewing the means used to identify measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.
c. *Review of operating activities*	Reviewing the economy, efficiency and effectiveness and operating activities, including non-financial activities of an entity.
d. *Review of compliance with laws and regulations*	Reviewing compliance with laws and regulations and other external requirements and with management policies and directives and other internal requirements.
e. *Risk management*	Identifying and evaluating significant exposures to risk and contributing to improvement of risk management and control systems.
f. *Governance*	Assessing the governance process in its accomplishment of objectives on ethics and values, performance management and accountability, communicating risk and control information to appropriate areas of the organisation and effectiveness of communication among those charged with governance.

Statutory status

2.7-3 Section 138 of the 2013 Act has made internal audit of the limited companies specified under rules made by the Central Government mandatory. In pursuance of powers given by this section, the Central Government has made the Companies (Accounts) Rules, 2014. Under these Rules, internal audit is compulsory for—

(*i*) every listed company;

(*ii*) every unlisted public company having—

(*a*) paid up share capital of fifty crore rupees or more during the preceding financial year; or

(*b*) turnover of two hundred crore rupees or more during the preceding financial year; or

(*c*) outstanding loans or borrowing from banks or public financial institutions exceeding one hundred crore rupees at any point of time during the preceding financial year; or

(*d*) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year.

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(*iii*) every private company having—

(*a*) turnover of two hundred crore rupees or more during the preceding financial year; or

(*b*) outstanding loans or borrowing from banks or public financial institutions exceeding one hundred crore rupees at any point of time during the preceding financial year.

Who can be appointed as internal auditor?

(*i*) An employee of the company; or

(*ii*) A Chartered Accountant or a Cost Accountant or any other professional as may be decided by the BOD.

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2.6-5 Internal check and the auditor

- The auditor should, first of all, *assess the reliability* of internal check system. In order to do so he should—
  - (*a*) Call for a brief statement from his client with regard to the system of internal check in operation.
  - (*b*) Examine the system in the light of the size and nature of the business to determine its adequacy.
  - (*c*) Evaluate the system to assess its capability in minimising and preventing errors.
- The auditor should *familiarise* himself completely *with the internal check system* after assessing its reliability. In the Canadian case of *Mc. Bride Ltd.* v. *Rooke and Thomas* [1941], the auditors took much for granted in familiarising themselves with the internal check system. They failed to make occasional inspection of original bank deposit slips and could not, thus, discover thefts by an employee of the company. The court held them liable for negligence and their plea that such inspection was not possible because they were working far from the place where deposit slips were kept, was rejected.
- If the auditor *decides to rely* on the internal check system, he *can reduce the extent of detail checking* of the transactions and can apply test checks on a relatively smaller sample for a particular class of transactions.

To conclude, one can say that an efficient internal check system helps an auditor to a great extent in the conduct of his work but it does not reduce his legal liability.

- The auditor should *assess the reliability* of internal check system. An efficient internal check system helps an auditor to a great extent in the conduct of his work but it does not reduce his legal liability.

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(ii) Difference between Internal Audit and Internal Check

Basis	Internal Audit	Internal Check
(i) **Meaning**	It is an *independent review* of operations and records.	It is an *arrangement of duties* allocated in such a manner that the work of one clerk is automatically checked by another.
(ii) **Object**	To *detect* frauds and errors.	To *prevent* frauds and errors.
(iii) **Staffing requirement**	It is carried out by *staff especially assigned* for it. At times, professional auditors are engaged to carry out internal audit in order to save cost.	No special staff is required to be engaged for internal check.
(iv) **Timing**	It is a *post-mortem analysis* and starts after the completion of recording of transactions.	It is *simultaneous i.e.* it starts to operate the moment a transaction is finalised and continues till all its aspects are recorded.
(v) **Submission of report**	Internal auditor submits his report to the management.	The statement relating to the transactions for the whole day is to be submitted by the clerk to the departmental heads.

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Internal Controls: Defined

In accounting and auditing internal control is defined as:

A process designed, implemented & maintained by

Those charged with governance, Management, Other personnel

To provide ***reasonable assurance***

About achievement of entity's objectives with regard to.....

- Reliability of Financial Reporting
- Compliance with laws and regulations
- Effectiveness & Efficiency of operations
- Safeguarding of assets

Principles of Internal Controls

Component	Principles
Control Environment	1. Demonstrates commitment to integrity and ethical values 2. Exercises oversight responsibility 3. Establishes structure, authority and responsibility 4. Demonstrates commitment to competence 5. Enforces accountability
Risk Assessment	6. Specifies suitable objectives 7. Identifies and analyzes risk 8. Assesses fraud risk 9. Identifies and analyzes significant change
Control Activities	10. Selects and develops control activities 11. Selects and develops general controls over technology 12. Deploys through policies and procedures
Information & Communication	13. Uses relevant information 14. Communicates internally 15. Communicates externally
Monitoring Activities	16. Conducts ongoing and/or separate evaluations 17. Evaluates and communicates deficiencies

...ed by the BOD. ...or a Cost Accountant or any other professional

2.8 INTER-RELATIONSHIP OF INTERNAL CONTROL, INTERNAL CHECK AND INTERNAL AUDIT

(*i*) **Difference between Internal Control and Internal Check**

Basis	*Internal Control*	*Internal Check*
(*i*) **Meaning**	Comprises of *whole system of controls*, financial or otherwise, established by the management for the conduct of business.	Refer to a *system of allocating duties* among the staff in such a manner that every person records a different aspect of a transaction.
(*ii*) **Scope**	It is broader in scope as it includes internal check and internal audit, besides other controls.	It is narrower in scope.
(*iii*) **Objects**	It strives to achieve objectives such as adherence to policies and procedures laid down by the management, safeguarding of assets, prevention and detection of errors and frauds, accuracy and completeness of records and timely preparation of reliable financial information.	It is designed to prevent errors and frauds, fixing responsibility and Safeguarding assets. It is a part of internal control system.
(*iv*) **Flexibility**	It is *reviewed occasionally* by the management, in the light of changes within the organisation, both in the context of economic environment as well as suggestions of internal and/or external auditor.	Once an internal check is introduced in the business, it is generally stable for a certain period and, therefore, less flexible as compared to internal control system.

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TABLE 2.1 : INTERNAL CHECK WITH REGARD TO CREDIT SALES

Function	*Department or unit*	*Related activities*	*Documents or records*
1. Accepting customer order	Sales	Receives orders; fixes terms and conditions of sales; prepares sales order; and maintains unfilled order file.	Customer's purchase order; and sales order.
2. Credit approval	Credit	Determines creditworthiness of new and present customers; sets credit limits for customers and obtains references from banks, trade and credit agencies.	Sales order (for stamping approval) customer credit files.
3. Issue of Merchandise	Warehouse or production department's warehouse unit	Maintains custody over inventory and issues goods to despatch department.	Sales order (for stamping the issue of goods).
4. Despatch of Goods	Despatch	Undertakes packaging of the goods and arranges transportation for despatch.	Goods outward notes; acknowledgement issued by transporter; despatch register.
5. Billing Customer	Billing or billing unit of finance department	Matches despatch documents with sales order and customer's purchase order; prepares and sends sales invoices to customers and prepares daily summary of sales billed.	Sales invoice; sales journal; summary sales report.

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Function	Department or unit	Related activities	Documents or records
6. Recording the sales invoice and sending statements to customers.	Accounts receivable or accounts receivable unit of finance department.	Records sales invoices against debtors; records payments and sends statements to customers.	Cash receipts; monthly statements.
7. Granting of write offs and credits.	Depends upon the circumstances.	To write off receivables and approval of credit notes.	Goods return notes; write off authorisation.

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TABLE 2.2 : INTERNAL CHECK WITH REGARD TO PURCHASE TRANSACTIONS

Function	*Department/ unit*	*Related activities*	*Documents or records*
1. Requisitioning the goods.	Stores or production department's stores unit.	Prepares and approves purchase requisition.	Purchase requisition.
2. Ordering the goods requisitioned.	Purchase	Prepares, approves and issues purchase order.	Purchase order
3. Receiving the goods ordered.	Receiving	Inspects and counts the goods; prepares goods received notes/receiving report.	Goods received notes or receiving report.
4. Preparing the payment voucher.	Accounts payable or finance department's accounts payable unit	Receives vendor invoices; compare them with purchase requisition, purchase order and goods received notes; prepare vouchers for payment; prepare daily voucher summary.	Vouchers; daily voucher summary.

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businesses also there...

TABLE 2.3 : INTERNAL CHECK WITH REGARD TO PAYMENT OF WAGES AND SALARIES

Function	Department or unit	Related activities	Documents or records
1. Personal hiring.	Personnel	Hires, transfers, terminates the employees and maintains personnel records.	Office orders; personnel files.
2. Time-keeping.	Production	Determines the number of hours (or units of production) for which each employee is to be paid; compares time clock records with time reports prepared by supervisors.	Time cards; time reports.
3. Preparing the payroll.	Payroll	Computes employees' gross and net earnings; prepares payroll summary/wage sheets; prepares payroll cheques and envelopes for cash; makes salary statements; maintains wages and salaries records; prepares distribution schedule showing allocation of wage cost to various heads.	Wage sheets; cheques; salary statements; distribution schedule; wages and salaries records.
4. Distribution of wages & salaries.	Any person who has no role in payroll.	Disbursement of wages and salaries on fixed days and timings in the presence of section head/foreman concerned after ascertaining identity of the employee; obtaining thumb impressions or signatures of employees on wage sheets; depositing unclaimed wages and salaries in a bank or keeping it in custody with a responsible officer not connected with payroll and disbursement	Pay-in-slips; authorisation letters.

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Function	Department or unit	Related activities	Documents or records
		activities; seeking proper authorizations for paying wages and salaries to temporary, casual and contract workers.	
5. Preparation of Returns	Payroll or Finance	Preparation of statement of income-tax deducted at source; preparation of statement of provident fund contribution of employees and employers and other such statements; deposits dues with appropriate authorities within prescribed time limits, prepares and distributes.	Form 16A; provident fund statements; etc.

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MEANING OF VOUCHNG

- Vouching is defined as the verification of entries in the books of account by examination of documentary evidence or vouchers, such as invoices, debit and credit notes, statements, receipts, etc.
- It means to test the truth of items appearing in the books of original entry.

Importance of Vouching

- **Backbone of Auditing –** Vouching is the **only way of detecting all sorts of errors and planned frauds**. Hence it is the backbone of auditing.
- **Essence of Auditing –** Auditing checks **if transactions are related to business or not.** It checks for **fictitious transactions created for committing frauds**. All these facts can be found with the help of vouching. So, **vouching is essential** for auditing.
- **To check whether evidences are correct or not –** Frauds may be committed presenting duplicate vouchers. **Evidential documents or records are to be checked carefully** which is the scope of vouching.

Vouching

- Voucher Numbering – Ordering
- Attention to dates, names & amount
- Stamped, Initials etc
- Special Attention: Personal Name, Partner, Director
- Duly Signed, Authorized
- Duly Stamped
- Nature of Receipts & Payments
- Elucidation
- Scrutinize the Duplicate Vouchers
- Avoid involvement of Members of Client Staff
- Receipted Invoice
- Printed Receipts as Voucher
- Payments of Rent Rates & Taxes – Advances - Adjustments

Verification of assets and liabilities

Verification means procedures normally carried out at the year end, to confirm the ownership, valuation and existence of items at the balance date.

Difference between verification and Valuation

Verification	Valuation
1. Verification is a final work.	1. Valuation is the initial work and it need to verification.
2. Verification is the work of Auditor.	2. Valuation is the work of concerned authority or board (Company)
3. Verification is made at the end of the year.	3. Valuation is made throughout the year

Objectives of Verification

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

Verification of Assets

Verification is an important audit process of inspection and collection of information and examination of documentary evidence to confirm that

1. Assets were in existence on the balance sheet date.
2. Assets have been acquired for the purpose of the business and under a proper authority.
3. Right of ownership of the asset vested in or belonged to the undertaking.
4. Assets are free from any lien or charge not disclosed in the balance sheet.
5. Assets have been correctly valued having regard to their physical condition.
6. And assets values are correctly disclosed in the balance sheet.

Procedures - Verification of Liabilities

- Verify existence of liabilities shown in the balance sheet
- Verify the correctness of the money amount of such liabilities
- Verify the appropriateness of the description given in the accounts and the adequacy of disclosure
- Verify that all existing liabilities are actually included in the accounts

Verification of liabilities

If the liabilities are overstated or understated the balance sheet shall not represent a true and fair view of the state of affairs of the company. Similarly the profit and loss account will be incorrect.

1. **Capital:** Although capital is not the liability of a company, still it should be verified to enable an auditor to give a certificate in regard to the correctness of the balance sheet. The auditor should examine cash book, pass book and minute book to find out the number and different classes of share issued.
2. **Outstanding expenses:** The auditor should get a certificate from a responsible official to see that all expenses for the current year are included and that the payment for each expenses such as interest, discounts, salaries, wages, legal expenses, which have not been paid are included.

DIFFERENCE BETWEEN VOUCHING AND VERIFICATION

Basis	Vouching	Verification
(i) Meaning	Substantiating the occurrence of transactions	Substantiating the existence of assets and forming an opinion on different aspects.
(ii) Scope	Narrow	Wide
(iii) Object	Verify the authority, authenticity and genuineness of transactions	Satisfy as to existence, ownership, possession, valuation and disclosure of items.
(iv) Level of expertise	Done by junior level clerks	Done by senior clerks and auditor himself
(v) Relationship with financial statements	P&L A/c & some B/s items	Only B/s items

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the related credit notes ...

TABLE 3.1 : VOUCHING OF SALES ITEMS

Item	*Procedures for vouching*	*Relevant documentary evidence*
1. Credit sales	1. Examine sales book 2. Examine sales invoices 3. Examine numerical sequence of source documents generated within the organisation. Examine treatment of additional charges and trade discount 4. Routine checking 5. Examine cut-off points.	*a.* Sales book *b.* Sales invoices *c.* Goods outward notes *d.* Transporter's receipt *e.* Purchase order.
2. Sales return	1. Examine sales return book 2. Examine credit notes 3. Examine cut-off points.	*a.* Sales return book *b.* Credit notes *c.* Inward return notes *d.* Inspection reports.

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...turns of the period under audit.

TABLE 3.2 : VOUCHING OF PURCHASE TRANSACTIONS

Item	*Procedures for vouching*	*Relevant documentary evidence*
1. Credit purchases	1. Examine purchase book	*a.* Purchase book
	2. Examine purchase invoice	*b.* Purchase invoice
	3. Examine the numerical sequence of source documents	*c.* Purchase requisition *d.* Purchase order
	4. Examine cut-off points	*e.* Goods received notes.
2. Purchase returns	1. Examine purchase return book	*a.* Purchase return book
	2. Examine debit notes	*b.* Debit notes
	3. Examine cut-off points	*c.* Goods outward notes
		d. Advice note
		e. Original purchase invoice.

...account. ...amount collected as

TABLE 3.3 : VOUCHING OF CASH RECEIPTS

Item	*Procedures for vouching*	*Relevant documentary evidence*
1. Cash receipts	1. Examine cash book 2. Examine the counterfoils of pay-in slips 3. Examine the carbon copies of receipts 4. Routine checking	*a.* Cash Book *b.* Counterfoils of pay-in-slips *c.* Carbon copies of receipts *d.* Relevant documentary evidence
2. Cash sales	1. Examine cash book 2. Examine cash memos 3. Examine the counterfoil of pay-in-slips 4. Routine checking	*a.* Cash book *b.* Daily cash sales summary *c.* Cash memos *d.* Salesmen's summary *e.* Goods delivered summary *f.* Relevant accounting heads in ledger.

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... of pay-in-slip.

TABLE 3.4 : VOUCHING OF CASH PAYMENTS

Items	*Procedures for vouching*	*Relevant documentary evidence*
1. General approach	1. Examine the payment in the cash book 2. Examine the bank statement 3. Routine checking	*a.* Cash book *b.* Relevant documents *c.* Bank statement
2. Cash purchases	1. Examine the payment in the cash book 2. Examine stock ledger 3. Routine checking.	*a.* Cash book *b.* Cash memos *c.* Stock ledger
3. Wages and salaries	1. Examine the payments in the cash book 2. Examine the pay-roll summary 3. Examine unclaimed wages carefully	*a.* Cash book *b.* Pay-roll summary *c.* Job cards *d.* Returns submitted to various authorities *e.* Relevant registers *f.* Authority letters *g.* Schedule of unclaimed wages *h.* Ledger (Commission A/c) *i.* Bank statement

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a. **Freehold land**

The auditor should follow the audit procedures mentioned below to achieve the objects of verification of freehold land.

Objective	*Audit Procedure*
(i) Existence and ownership	♦ Inspect original title deeds and conveyance or purchase deed which should be in the name of the client. ♦ Vouch payments in case new land has been purchased during the year.
(ii) Possession and determine liens, if any	♦ Title deed should be in custody of owners. ♦ In the case of mortgage, obtain a certificate from mortgagee or his lawyer confirming the possession of the title deed. ♦ If any charge or encumbrances exist on land, the auditor should ensure they have been properly disclosed.
(iii) Valuation and disclosure	♦ Land is a non-depreciable asset. It is, generally, shown in the balance sheet at historical cost which includes purchase price, broker's commission, stamp duties, registration fees, legal charges and also levelling, clearing and draining charges.

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The audit procedures for ...

BUILDING

Objective	Audit Procedure
(*i*) Existence, ownership, possession and determine liens, if any	◆ The audit procedures followed for ascertaining the existence, ownership and possession are similar to those of freehold land. ◆ The extent of liens against building can be determined by examining records and obtaining proofs similar to freehold land.
(*ii*) Valuation and disclosure	◆ Buildings should be valued at cost less depreciation. ◆ In case land and building have been purchased together, ensure that cost has been segregated for depreciation purposes on a reasonable basis.

Documents to be inspected : Title deeds; conveyance/purchase deed; certificate from mortgagee or his lawyer; minutes book or resolutions.

c. **Plant and machinery**

The audit procedures to verify plant and machinery are given below :

PLANT AND MACHINERY

Objective	Audit Procedure
(*i*) Existence and ownership	◆ Inspect Plant Register which contains detailed particulars relating to various machines and equipment alongwith their original cost, rate and amount of depreciation, accumulated depreciation, additions and sales from time to time. ◆ Ensure physical verification of plant and machinery was done by the management. ◆ Vouch new purchases and sales with relevant documentary evidence.
(*ii*) Possession and liens, if any	◆ Confirm the existence of lien or floating charge, if any, by inspecting register of charges, approval by appropriate authority, certificate from client's legal adviser and confirmation from mortgagee.
(*iii*) Valuation and disclosure	◆ Plant should be valued at cost of acquisition *less* depreciation.

Documents/Book to be inspected : Plant register; minutes book; BOD's resolution; purchase invoices; register of charges.

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VERIFICATION OF

INVESTMENTS

Objective	*Audit Procedure*
(*i*) Existence, ownership possession	◆ Inspect whether the investments made are within the authority of the entity. ◆ Inspect the investment register with reference to relevant documentary evidence such as allotment letters, brokers' notes, statements issued by depository, etc. ◆ Check the adjustment made in the cost of acquisition or sales value of the security in case of ex-dividend/interest/right/bonus or in case of cum-dividend/interest/right/bonus purchase or sales. ◆ Carry out physical examination of securities on the last day of balance-sheet or a date close to it. ◆ Examine statements and certificates issued by the depository or custodian for the scrips held by them. ◆ Obtain certificates from third parties in case they hold investments owned by the client. In such cases he should insist on physical inspection of securities. He should not rely on the certificates issued by such third parties if in his opinion the investments are not in the custody of a proper person or company. In such cases, he should insist on physical inspection of securities. This principle has been laid down by the judgment in *City Equitable Fire Insurance Co. Ltd.'s (1924)* case. In this case, a large number of investments appearing in the balance sheet of the company were held by the company's stock brokers for safe-custody and they, in turn, pledged these investments. The auditor relied on the 'false certificate' issued by the brokers for the purpose of verifying investments. If the auditor would have insisted upon the physical inspection of the underlying investments, he could have easily discovered the fraud. The judge held the auditor guilty of negligence. He remarked, "*an auditor is not ever justified in omitting a personal inspection of securities that are in the custody of a person or company with whom it is not proper that they should be left. A company's brokers are not the proper persons with whom the securities are, lodged for safe custody, however respectable those brokers may be.*" ◆ Examine justification for keeping investments with third parties other than banks. ◆ Ascertain the reasons for holding investment otherwise than in the name of the entity.
(*ii*) Valuation and disclosure	◆ Compare valuation practices against those prescribed by recognised accounting principles, specially with regard to determination of cost of investments, classification of investments, into long term investments (to be valued at cost) and current investments (to be valued at lower of cost or fair value).

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e. **Debtors**

Objective	*Audit Procedure*
(i) Existence, ownership and possession	◆ Obtain a schedule of debtors duly signed by a responsible officer and examine it with reference to individual debtors' accounts. ◆ Inspect underlying documents (such as invoice, transporter's receipt, credit memos and so on) for each debtor. ◆ Vouch collection of accounts receivable subsequent to balance sheet date. ◆ The auditor may also *communicate directly* with the debtors so as to obtain confirmation of the amount due from them on the date of the balance sheet. The debtors to be confirmed will be chosen either by using judgment or statistical sampling. The latter procedure has been theoretically recognised as the best method for verifying the debtors. Such confirmation requests should be sent with the consent of the client. To maintain dependability of these requests, the mailing should be carefully supervised by the auditor and all responses to confirmation requests should come directly to the auditor. ◆ Examine reliability of debts as at the date of balance sheet. ◆ Recompute the provision for bad and doubtful debts and compare it with past periods. ◆ Inspect relevant correspondence such as court order declaring insolvency of a debtor, correspondence between the client and his lawyer for bad debts written off. ◆ Inspect memorandum record for subsequent recovery of debts declared bad.
(ii) Valuation and disclosure	◆ Examine to ascertain whether debtors have been properly classified and disclosed in balance-sheet in accordance with recognised accounting principles and statutory requirements, if any.

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f. **Cash-in-hand**

Objective	*Audit Procedure*
(*i*) Existence, ownership and possession	◆ Physically count the cash at the close of business on the last day of the fiscal period under audit or a date close to it. ◆ The year end verification should be supplemented by surprise checks of cash during the year. ◆ If possible, all cash balances such as petty cash, balance of staff societies, etc. should be verified simultaneously and count should always be made in the presence of the custodian of each of the funds. ◆ Do not include IOUs in cash-in-hand. ◆ Carryout surprise verification of cash during the year, particularly, when the entity is consistently maintaining unduly large cash balances. ◆ Ensure that there is no difference between actual cash-in-hand and balance as per books. If it exists, call for an explanation from the management.
(*ii*) Valuation and disclosure	◆ Ascertain whether cash has been disclosed in the financial statements in accordance with recognised accounting policies and practices and relevant statutory requirements, if any. ◆ Ensure that temporary advances are not included in cash-in-hand and if postage and revenue stamps exist in a substantial number, they should be shown separately and not included in cash-in-hand.

g. **Cash at bank**

Objective	*Audit Procedure*
(*i*) Verify existence, ownership and possession	◆ The auditor should confirm cash at bank lying in all types of accounts *directly* with the bank. The confirmation request must be signed by an appropriate representative of the client. ◆ Examine the *bank reconciliation statement* prepared as on the last day of the year. The auditor should, particularly, examine those items in the reconciliation statement which have been outstanding for an unduly long period. ◆ While examining the bank statements, care should be taken to ensure that the post dated cheques issued/received have not been accounted for as payments/receipts of the period under audit. ◆ Inspect *fixed deposits receipts* and *bank advices* for verifying fixed deposits. ◆ *Remittances-in-transit* should be verified with reference to their credit in the bank account in the subsequent period.

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Objective	Audit Procedure
	◆ In case of *stale cheques*, the auditor should ensure suitable adjustments have been made in books of account. ◆ Examine that suitable adjustments have also been made in respect of *funds* lying in the bank accounts in *foreign countries*, which are subject to foreign exchange restrictions and get affected by exchange rate fluctuations. ◆ Review the total number of bank accounts maintained by the entity to ensure that there are no *inoperative accounts* through which fraud is possible.
(*ii*) Verify valuation and disclosure	◆ Cash at bank should be shown in the financial statements as per the recognised accounting principles and statutory requirements, if any. In case of limited companies, ensure that balances with scheduled banks and non-scheduled banks are shown separately. ◆ Ensure stale or dishonoured cheques are not included in the balance sheet. ◆ Examine whether proper disclosures have been made of balances or deposits with specific charge or restrictions, *for example*, amounts lying in banks which are under liquidation or moratorium and amounts lying in foreign banks which are subject to exchange control restrictions.

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h. **Inventories**

- MEANING - Inventories consist of tangible items that are held for sale or use in the production of goods and services. Inventories generally consist of raw materials including components; work-in-progress; finished products including by-products and materials such as maintenance supplies, stores and spare parts and loose tools to be used indirectly in production or related activities. The responsibility for proper determination of the quantity and value of inventories rests with the management.

- AUDITOR'S DUTY WITH REGARD TO VERIFICATION OF INVENTORY

  (*a*) The perception of auditor's duty with regard to verification of stock has changed in the last century. The earlier perception was based on the judgment given in *Kingston Cotton Mills* [1896] case. In this case, it was held that it is no part of the auditor's duty to take stock and he is not guilty of negligence if he accepts the certificate of a responsible official in this regard. It was further stated that the auditor is entitled to assume that 'tried' servants of the company are honest. He can rely on their representations, provided, he takes reasonable care. Thus, as per the judgment, *physical verification of stock was not the duty of the auditor.*

(*b*) The decisions in the *Westminster Road Construction and Engineering Co. Ltd.* [1932] case in Britain and McKesson and

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Robbins [1939] case in U.S.A. resulted in a reconsideration of auditor's duty in connection with the verification of stock-in-trade. In the *Westminster Road Construction* case, it was held that an auditor was guilty of negligence if he failed to detect over-valuation in work-in-progress despite the availability of evidence from which such over-valuation could be reasonably deduced. In *McKesson's* case auditor was held responsible for physical verification of stock-in-trade. Although auditor is no longer required to physically count the stock (as decided in *McKesson's* case), the standard audit practices with regard to verification and valuation are essentially based on the decisions given in these two cases. *The audit practices lay emphasis on observation of physical count of inventory by the auditor and testing of the client's procedures for physical count of inventories.*

(c) The Guidance Note on *Audit of Inventories* issued by the Institute of Chartered Accountants of India has also recommended audit procedures, for verification of inventories, based on the principle laid in *Westminster* case and *McKesson* case. The following discussion is based on the said note.

◆ AUDIT PROCEDURES TO BE FOLLOWED IN CASE OF VERIFICATION OF INVENTORIES

(i) **Verify existence, ownership and possession**

(a) Examine *stock records* (on a sampling basis) with reference to relevant documentary evidence such as *receiving reports, inspection reports, material issue notes,* etc. Stock records are generally maintained in the form of stores/stock ledger and, if not, the auditor should increase the extent of other verification procedures.

(b) Observe *physical count* of inventory by the management. This, though not a part of auditor's duty, is necessary if he is placing reliance upon the system of physical verification of inventories by the management.

(c) While attending the physical verification of the stock, the auditor should :

- inspect *inventory count instructions* given by the management to the staff performing such function and ensure they are being actually followed;
- review the *procedures* adopted by the entity to account *for the movement* of inventories from one location to another during physical count;

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- examine whether *cut-off procedures* over physical stocks are proper; and
- review the *procedures for identifying* defective, damaged, obsolete, excess and slow moving items of inventory.

(d) Review the *original verification sheets*, trace a sample of entries into the *final summary of inventories* and compare it with book stocks. In case of discrepancies between the book stocks and stocks as per physical verification, ensure that they have been properly investigated into and suitable adjustments on account of such discrepancies have been made.

(e) For verification of ownership, the auditor should inspect on a test basis, the documents underlying the acquisition of individual inventory items, including *purchase orders, receiving reports* and *vendors' invoices*.

(f) In case of stocks held by third parties such as consignees and agents, the auditor should obtain *direct confirmations* from them.

(g) Enquire about *liens* on inventory. They might have been subject to a floating charge.

(ii) **Examine valuation and disclosure**

(a) The auditor is not a valuer. His duty is only to verify the inventory valuation stated in the financial statements. He should begin his work with regard to this by investigating the valuation method used by the client and ensuring that inventories are valued in accordance with recognised accounting principles. Accounting Standard (AS) 2, *Valuation of Inventories*, issued by ICAI has enumerated the generally accepted accounting principles involved in valuation of most type of inventories.

(b) In order to assess the appropriateness of valuation of work-in-progress, the auditor should carefully ascertain its *stage of completion*. For this purpose he may examine the cost records, hold discussions with officers concerned and adopt other audit procedures, as he may think fit.

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3.3 VERIFICATION OF LIABILITIES

Meaning

3.3-1 The process of substantiation of liabilities recorded in the books of account by examination of legal and official documents and then forming an expert opinion as to existence, obligation, completeness, valuation and disclosure of liabilities of an entity is called **verification of liabilities.**

Objects of verification of liabilities

3.3-2 In order to verify the liabilities, the auditor has to ensure that they adhere to following objects—

(i) **Existence** - Liabilities shown in the balance sheet are actually payable.

(ii) **Obligation** - Liabilities represent obligations of business to third parties created for its legitimate operation.

(iii) **Completeness** - All known liabilities have been properly accounted for. Contingent liabilities should have also been shown as a footnote to the balance sheet.

(iv) **Valuation** - Liabilities are stated in financial statements at fair and reasonable amounts.

(v) **Disclosure** - Liabilities are classified and disclosed in the financial statements in accordance with recognised accounting principles and relevant statutory requirements.

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THANKYOU