

Unit-1

Nature & Scope of Audit

Meaning and Nature, Scope of Audit, Objectives of Audit, Relationship of Audit with other disciplines, Difference between Audit and Investigation, Basic Principles Governing Audit, Types of Audit, Difference between Statutory Audit and Internal Audit, Internal Check- Objectives, Advantages and Limitations.

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1.0. Objectives:

After Studying this Unit you will be able to:

1. To understand the meaning, nature, scope and objectives of auditing.
2. To explain the basic principles governing the audit process and various types of audit.

3. To find relationship between auditing and other disciplines such as accounting, law and economics.
4. To differentiate between audit and investigation as well as statutory audit and internal audit.
5. To evaluate the objectives, advantages and limitations of the internal check system.

1.1 Introduction:

In the previous study of Accountancy, students learned how business transactions are recorded and how accounting records are maintained and final accounts are prepared. These records help in understanding the financial position and performance of a business. However, merely preparing accounts is not enough. It is equally important to ensure that the financial statements are accurate, reliable, and present a true and fair view of the organization's affairs. This requirement forms the basis of auditing.

In the earlier days, businesses were generally small and managed directly by their owners. Since the owners themselves looked after the business activities and accounts, there was little need for an independent examination of records. However, with the Industrial Revolution and the growth of large-scale business organizations, the situation changed significantly. Businesses expanded, more capital was required, and many investors and creditors became associated with business organizations. These stakeholders wanted assurance that their money was being used properly and that the financial information presented by the business was trustworthy.

The need for auditing became even more important with the development of joint-stock companies, where ownership and management are separate. Shareholders own the company, but its day-to-day operations are managed by directors and managers. Since it is not possible for every shareholder to examine the company's accounts personally, an independent expert called an auditor is appointed to verify the accounts and report whether the financial statements present a true and fair view of the company's financial position.

The origin of modern auditing is closely related to the development of accounting. In 1494, Luca Pacioli published the principles of the double-entry system of bookkeeping and also referred to the duties and responsibilities of an auditor. Over time, auditing has developed into an essential business function that promotes transparency, accountability, and confidence in financial reporting.

Today, auditing plays a vital role in strengthening the credibility of financial statements and protecting the interests of various stakeholders. It serves as an important link between accounting information and the users who rely on that information for decision-making. Therefore, a sound understanding of auditing is essential for every student of commerce and accountancy.

1. Meaning, Nature & Scope of Audit

To understand modern auditing, we must first look at its history. The word "audit" is derived from the Latin word *audire*, which means "to hear." In ancient times, book keeping as we know it did not exist. Instead, of that ancient governments, a king or a wealthy landowner wanted to check their financial records, they would appoint a trusted, independent person to literally listen to an oral recital of the accounts given by their managers or servants.

Financial verification has roots in several ancient civilizations:

1. **Egyptian Era:** Ancient Egyptians used a system of dual control, where two separate officials independently recorded fiscal receipts to prevent corruption.
2. **Greek Era:** The Greeks appointed specialized "checking clerks" whose sole job was to scrutinize the financial accounts of public figures.
3. **Roman Era:** The Romans engineered highly sophisticated financial administration systems to manage state funds and ensure accountability.

In contemporary business, auditing is the critical examination of an organization's books of accounts, supporting documents, and vouchers. The primary objective of this review is to verify whether the financial position presented in the Balance Sheet and the Profit and Loss Account accurately reflects the true financial state of the undertaking.

Experts define auditing in a few different ways. Let's look at two of the most famous definitions used in accounting.

"Auditing is such an examination of books, accounts and vouchers of a business as shall enable the auditor to satisfy himself whether the balance sheet is properly drawn up so as to exhibit a true and correct view of the state of affairs of the business..." By Spicer and Pegler

This definition focuses on accuracy. The auditor's job is to check the books and vouchers (receipts) to make sure the Balance Sheet is completely correct and does not contain lies or mistakes.

"Auditing is a systematic and independent examination of data, statements, records, operations and performance of an enterprise for a stated purpose. In any auditing situation the auditors understands and recognize the proposition before him for examination, collect evidence, evaluates the same and on this basis, formulate his judgment which is communicated through his audit report." Institute of Chartered Accountants of India – (ICAI)

This modern definition treats auditing as a step-by-step process. It emphasizes that the auditor must be independent (unbiased) and must collect real evidence before making a final judgment in an Audit Report.

Based on the definitions above, an auditor always follows a specific, logical sequence to perform his duties & complete their work.

- i) **Understand the Job:** The auditor looks at the business and identifies exactly what records, data, or accounts need to be checked.
- ii) **Collect Evidence:** The auditor gathers proof by checking receipts, invoices, bank statements, and account ledgers.
- iii) **Evaluate the Proof:** The auditor carefully studies the evidence to see if the math is correct and if the company followed proper accounting laws.
- iv) **Write the Report:** The auditor forms a final opinion and writes an official Audit Report to tell the owners and the public if the financial statements are honest.

An Auditor also consider the boundaries, depth, and limitations of his work. It establishes exactly what records will be checked, how deeply transactions will be verified, and what rules must be followed during the examination. The term scope refers to the range or reach of an audit. It defines the boundaries within which the auditor performs the examination of financial statements. The audit aims to enhance the degree of confidence among users of financial statements such as shareholders, employees, customers, government, and regulatory authorities. The expression of an auditor's opinion provides credibility to the financial statements prepared by management. The applicable financial reporting framework refers to the set of principles or rules adopted for the preparation and presentation of financial statements, which are acceptable considering the nature of the entity and the objective of the statements. For companies in India, this framework is prescribed under Schedule III of the Companies Act, 2013. The scope of audit of financial statements generally covers the following major areas:

1. Coverage of all Aspects of the Entity
2. Reliability and Sufficiency of Financial Information
3. Proper Disclosure of Financial Information
4. Expression of an Opinion on Financial Statement

An auditor does not have unlimited freedom when deciding these boundaries; instead, the scope is strictly determined by the terms of the audit agreement, relevant government laws, and the official professional guidelines of the ICAI. An auditor decides the limits of their work by looking at three things:

1. The agreement made with the client (Terms of Engagement).
2. The rules of the law (Statute).
3. The official guidelines of the ICAI.

The agreement made between Audit and client cannot overrule or change government laws or ICAI guidelines.

1. The audit must check every part of the business that relates to the financial statements.
2. The auditor must check if the information in the accounting records is sufficient and correct.
3. To do this, they must check the company's accounting systems and internal controls, ask questions, and test transactions and account balances.
4. To make sure the financial statements show information correctly, the auditor should compare the statements with the actual daily records and review the choices made by management when preparing those statements.
5. An auditor is not expected to do work that is outside their professional skill or knowledge.
6. If there are any restrictions that stop the auditor from doing their job properly and giving a clean opinion, those limitations must be clearly written in the audit report.

1.2 Presentation of Subject Matter

1.2.1 Objectives of Audit /Auditing

The main purpose of an audit is to determine whether the financial statements of an entity present a true and fair view of its financial position and performance in accordance with an applicable financial reporting framework.

I. Main Objectives of Auditing/Primary Objective

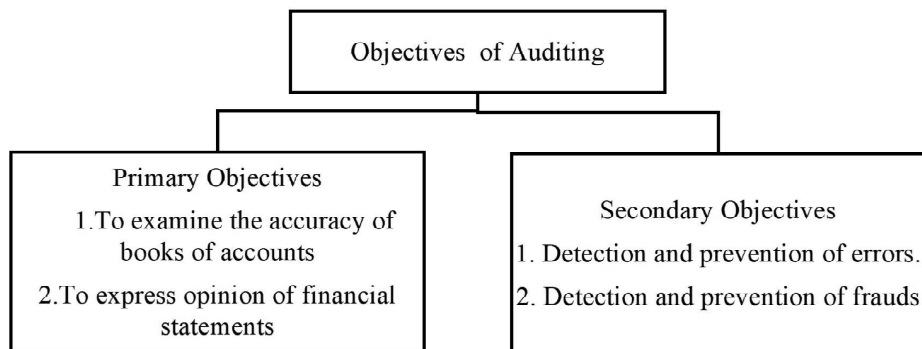
The principal objective of an audit is to verify and establish that the Balance Sheet presents a true and fair view of the financial position of the business and that the Profit and Loss Account reflects the true and fair profit or loss for the accounting period.

An auditor conducts an independent examination of the financial statements to assess their reliability and authenticity. To achieve this objective, the auditor examines the system of internal control, verifies accounting records, and confirms the existence and valuation of assets and liabilities.

The auditor should:

1. Assess the effectiveness of the internal control and internal check systems.
2. Verify the accuracy of posting, casting, balancing, and other accounting procedures.
3. Confirm the validity of transactions through supporting documents and vouchers.
4. Ensure proper distinction between capital and revenue items.
5. Verify the existence and valuation of assets and liabilities.

6. Ascertain compliance with statutory requirements relating to the maintenance of books of accounts and records.

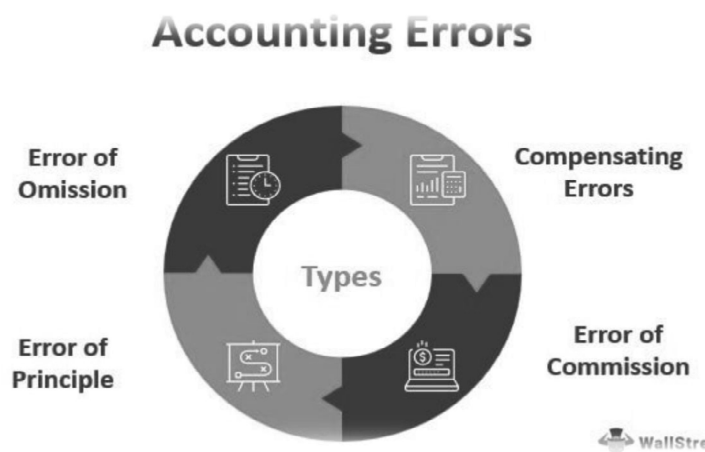


II. Subsidiary Objectives of Auditing/Secondary Objectives

A. Detection and Prevention of Errors

Errors are generally unintentional mistakes arising from negligence, oversight, or lack of knowledge. However, in some cases, errors may result from fraudulent intentions.

Classification of Errors



1. **Error of Principle:** When accounting principles and rules are not properly followed while recording transactions, the mistake is known as an Error of Principle. Exa. Treating capital expenditure as revenue expenditure.

2. **Error of Omission:** When a transaction is omitted either wholly or partially from the books of accounts, it is called an Error of Omission. Such errors generally occur due to oversight or negligence.
3. **Error of Commission:** Errors arising from incorrect recording, posting, casting, or balancing of accounts are known as Errors of Commission. These errors usually occur due to carelessness in recording business transactions and may or may not affect the Trial Balance.
4. **Error of Duplication:** When a transaction is recorded and posted more than once, it results in an Error of Duplication. Such errors generally do not affect the Trial Balance and are therefore difficult to detect e.g.- Recording both copies of a supplier's duplicate invoice separately.
5. **Compensating Errors:** When the effect of one error is offset by another error, the errors are known as Compensating Errors. Since the net effect is cancelled, the Trial Balance may still agree, making such errors difficult to identify.

B. Detection and Prevention of Fraud

According to the Institute of Chartered Accountants of India (ICAI), fraud refers to the intentional misrepresentation of financial information by one or more individuals among management, employees, or third parties.

Fraud may involve:

1. Manipulation, falsification, or alteration of accounting records and documents.
2. Misappropriation of assets.
3. Suppression or omission of transactions from records.
4. Misapplication of accounting principles and policies.

Detection and prevention of fraud are important subsidiary objectives of auditing.

Types of Fraud

1. Misappropriation of Cash

Misappropriation of cash generally occurs through theft or unauthorized use of cash receipts, petty cash, cheques, or negotiable instruments:

1. Recording fictitious purchases and misappropriating the cash involved.
2. Showing payment of wages to non-existent (dummy) workers.
3. Failure to record credit sales and pocketing the money received from customers.

4. Non-recording of cash sales.
5. Adopting the Teeming and Lading method, where money received from one customer is misappropriated and later covered by receipts from another customer.

2. Misappropriation of Goods

Fraud may also occur through theft or unauthorized use of goods. Such fraud is difficult to detect, particularly when goods are of high value and small size. Proper inventory records, periodic stock verification, and effective internal controls help in detecting such frauds.

3. Manipulation of Accounts

Manipulation of accounts is generally carried out by higher-level management to mislead stakeholders inside or outside the organization. This type of fraud may be committed by: Managers, Directors or Board of Directors. The objective may be to inflate profits, reduce tax liability, attract investors, obtain loans, or conceal poor financial performance.

Checklist for Objectives of Audit

1. Obtaining a reasonable assurance that financial statements as a whole are free from material misstatement due to fraud or error
2. Gaining a reasonable assurance leads to formation of opinion whether financial statements are prepared, in all material respects, in accordance with applicable financial reporting framework
3. To report on the financial statements
4. Reporting of opinion in accordance with audit findings
5. Communication of reporting
6. Reporting and communication in accordance with Standards on Auditing

Check Your Progress I:

Fill in the blanks and complete the following statements

1. The word "audit" is derived from the Latin word _____, which means "to hear."
2. In 1494, _____ published the principles of the double-entry system of bookkeeping and referred to the duties of an auditor.
3. Modern auditing became especially vital with the development of _____, where ownership and management are completely separate.

4. To prevent corruption, ancient Egyptians used a system of _____, where two separate officials independently recorded fiscal receipts.
5. According to Spicer and Pegler, the auditor's examination enables them to satisfy themselves that the _____ exhibits a true and correct view of the state of affairs.
6. The modern definition provided by the _____ treats auditing as a systematic and independent step-by-step process of examining data and formulating a judgment.
7. Contemporary auditing involves the critical examination of an organization's books of accounts, supporting documents, and _____.
8. For companies in India, the financial reporting framework is prescribed under _____ of the Companies Act, 2013.

1.2.2 Relationship of Audit with other Disciplines:

Auditing is a multidisciplinary function that extends far beyond the boundaries of accounting. Its primary objective is to examine books, accounts, and financial statements to ensure a true and fair view of the financial condition of a business. To achieve this, auditors must draw upon knowledge from several disciplines, each contributing to the effectiveness and reliability of the audit process.

- ♦ **Accounting:** The most fundamental relationship is with accounting, since auditors must understand accounting rules, principles, and standards to evaluate whether financial statements comply with accepted practices. Without this foundation, the audit cannot provide assurance of accuracy.
- ♦ **Economics:** Closely linked to this is economics, as auditors must consider the broader economic environment—such as inflation, taxation, and market trends—that influences business operations and financial reporting.
- ♦ **Mathematics & Statistics:** Auditing also relies heavily on mathematics and statistics. Auditors deal with large volumes of numerical data, requiring skills in calculations and statistical sampling to verify figures and draw meaningful conclusions.
- ♦ **Law:** Various laws are used and directly applied and implemented in business and organizations it plays a vital role, as audits must comply with company law, tax law, and other statutory provisions. Legal knowledge enables auditors to identify risks and ensure compliance with regulatory frameworks.
- ♦ **Computer Information system and Data:** In the modern era, auditing is inseparable from computer information systems. With digitized accounting records, auditors must be capable of auditing electronic systems, verifying accuracy, and

ensuring data integrity. This is closely related to data processing, which involves the systematic handling of information. Auditors must understand how data is collected, processed, and stored, as errors or manipulation in data processing can directly affect the reliability of financial statements.

- ♦ **Financial Management:** Another important discipline is financial management, which provides tools such as ratio analysis, capital structure evaluation, and cash flow management. These techniques help auditors assess the financial health of a business more effectively.
- ♦ **Production:** Alongside this, production is also relevant, as auditors must understand the production processes of a business. Knowledge of production helps in verifying cost records, efficiency reports, and inventory management, ensuring that financial statements reflect actual operations.
- ♦ **Behavioral Science:** Finally, auditing is influenced by behavioral science, since auditors interact with managers, employees, and stakeholders. Understanding human behavior and organizational dynamics helps auditors communicate effectively, handle resistance, and detect irregularities. In conclusion, auditing is not confined to accounting alone but is a multidisciplinary practice that integrates economics, mathematics, law, computer systems, data processing, financial management, production, and behavioral science. This holistic approach ensures that audits are comprehensive, reliable, and relevant to the complex environment in which businesses operate.

1.2.3 Difference between Audit & Investigation

An Audit is carried out to ensure that the Balance Sheet and Profit and Loss A/c show a true and fair picture. But, on the other hand, an investigation is carried out on for some predefined purpose e.g. to know the financial position of the company or its earning capacity.

Auditing	Investigation
Audit is a systematic and independent examination of data, statements, records, operations and performances (financial or otherwise) of an enterprise for a stated purpose.	Investigation is a process of searching enquiry into the profit-earning capacity or the financial position of a concern or to find out the extent of the fraud if there is any suspicious about it and so on
Audit is conducted on behalf of owners i.e. shareholders or proprietor etc.	Investigation is carried out on behalf of outsiders. Such outsiders may be potential buyer of the business or banker or money lenders to know the earning capacity or the financial position of the firm
According to Companies law, audit is compulsory.	Investigation is not compulsory.
It once audit is done, accounts are not again audited. The exception is only of special audit	Investigation may be conducted even though accounts are already audited.
The audit of accounts is done for a year or six months	Investigation may cover a period of over three to seven years
The accounts are audited with a view to ascertaining whether or not the Profit and Loss Account and Balance sheet are drawn up as per law and they exhibit a true and fair view of the state of affairs of a business.	Investigation is conducted with a particular object in view for e.g.- to know the financial position of the concern or its earning capacity
Audit is a kind of test checking.	Investigation is done thorough examination of the books of accounts for a particular year or a number of years.

B) Choose correct alternatives for following statements

- C) State True or False.**

- 1) The auditor should have the knowledge of Supply chain management.
- 2) Auditors needs to understand financial management concept to identify potential financial fraud.
- 3) Auditor use statistical techniques to develop financial strategies.
- 4) Auditor does not need to have understanding of fraud laws & tax laws.

AAS-1 (Auditing and Assurance Standard-1) lays down the fundamental principles that govern an auditor's professional responsibilities. These principles must be followed whenever an audit is conducted. Proper compliance with these principles ensures that

auditing procedures and reporting practices are applied effectively according to the circumstances of each audit.

1. Integrity, Objectivity and Independence

An auditor should be honest, sincere, and straightforward in carrying out professional duties. He must remain fair and unbiased, ensuring that personal interests or prejudices do not influence his judgment. The auditor should maintain complete independence and avoid any situation that may impair or appear to impair his integrity and objectivity.

2. Confidentiality

The auditor must maintain the confidentiality of all information obtained during the course of the audit. Such information should not be disclosed to any third party without proper authority unless disclosure is required by law or professional obligation.

3. Skills and Competence

An audit should be performed with due professional care by individuals possessing adequate knowledge, training, experience, and competence in auditing. Auditors acquire these skills through education, professional examinations, practical training, and continuous learning. They should also stay updated with the latest accounting standards, auditing standards, legal requirements, and pronouncements of the ICAI.

4. Work Performed by Others

An auditor may delegate certain tasks to assistants or rely on the work of other auditors and experts. However, the ultimate responsibility for the audit opinion remains with the auditor. He must properly supervise, direct, and review the work performed by others and ensure that such work is reliable and adequate for audit purposes.

5. Documentation

The auditor should maintain proper documentation of all important matters related to the audit. Audit documentation serves as evidence that the audit was conducted in accordance with the prescribed auditing standards and principles.

6. Planning

Proper planning is essential for conducting an effective and efficient audit. Audit planning should be based on a thorough understanding of the client's business, accounting system, internal controls, and policies. The planning process includes:

1. Understanding the accounting system and internal control procedures.
2. Determining the extent of reliance that can be placed on internal controls.
3. Deciding the nature, timing, and extent of audit procedures.
4. Coordinating audit activities effectively.

The audit plan should be reviewed and modified whenever necessary during the course of the audit.

7. Audit Evidence

The auditor should obtain sufficient and appropriate audit evidence to form a reasonable basis for expressing an opinion on the financial statements. Audit evidence is gathered through:

- (a) **Compliance Procedures:** Tests conducted to evaluate whether internal controls are operating effectively.
- (b) **Substantive Procedures:** Procedures designed to verify the completeness, accuracy, and validity of accounting information. These include: Tests of details of transactions and account balances and analytical procedures involving the examination of significant ratios, trends, and unusual fluctuations.

8. Accounting System and Internal Control

Management is responsible for maintaining an adequate accounting system and effective internal controls. The auditor should understand and evaluate the accounting system and related internal controls to determine the extent to which they can be relied upon. Where internal controls are found to be effective, the auditor may reduce the extent of substantive testing.

9. Audit Conclusions and Reporting

After evaluating the audit evidence obtained, the auditor should draw conclusions and form an opinion on the financial statements. The auditor should determine whether:

1. Appropriate accounting policies have been consistently applied.
2. Financial statements comply with relevant laws, regulations, and accounting standards.
3. **Adequate disclosure has been made of all material matters.**

The audit report should clearly express the auditor's opinion on the financial statements. An unqualified (clean) opinion indicates that the financial statements present a true and fair view in all material respects. If there are significant issues, the auditor may issue a qualified opinion, adverse opinion, or disclaimer of opinion, clearly stating the reasons for such modification.

The basic principles governing an audit ensure that the audit process is conducted professionally, objectively, and effectively. Adherence to these principles enhances the reliability and credibility of financial statements and promotes confidence among users of financial information.

1.2.5 Types of Audit

Auditing is an essential function in every organization as it helps ensure accuracy, transparency, accountability, and efficiency in financial and operational activities. Depending on the purpose, scope, authority, and timing of examination, audit can be classified into different categories. The major types of audits are discussed below.

A. Types of Audit Based on Authority

1. Statutory Audit

A statutory audit is an audit that is mandated by law. Certain organizations, such as companies, banks, insurance companies, and cooperative societies, are legally required to have their accounts audited by an independent auditor. The primary objective of a statutory audit is to ensure that the financial statements present a true and fair view of the organization's financial position and comply with legal requirements. Since it is compulsory, the auditor must follow the provisions prescribed under the relevant laws and regulations.

2. Non-Statutory Audit

A non-statutory audit is conducted voluntarily and is not required by any law. Organizations may choose to undertake such audits to obtain an independent opinion on their financial records and operations. These audits provide confidence to owners, investors, lenders, and management regarding the reliability of financial information and the efficiency of business operations.

3. Internal Audit

Internal audit is carried out by the organization's own employees or by a dedicated internal audit department. It is a continuous process aimed at evaluating internal controls, safeguarding assets, preventing fraud, and improving operational efficiency. Internal audit serves as a valuable management tool by identifying weaknesses and recommending corrective measures.

B. Types of Audit Based on Scope

1. Complete Audit

A complete audit involves a detailed examination of all books of accounts, records, vouchers, transactions, and financial statements of an organization. It provides a comprehensive review of the entire accounting system and helps determine whether the financial statements accurately reflect the organization's financial position. Since all aspects are covered, it offers a high degree of assurance.

2. Partial Audit

A partial audit is limited to a specific section of accounts, a particular department, or selected transactions. Instead of reviewing the entire accounting system, the auditor focuses only on the specific area identified by management or stakeholders. Such audits are often conducted when there is a need to investigate a specific issue or verify a particular set of records.

C. Types of Audit Based on Time

1. Continuous Audit

A continuous audit is conducted throughout the financial year at regular intervals. Auditors frequently examine transactions and records as they occur. This type of audit is particularly suitable for large organizations where financial transactions take place on a daily basis. Continuous auditing helps in the early detection of errors and frauds and ensures that accounting records remain up to date.

2. Final Audit

A final audit is undertaken after the completion of the accounting year and after the preparation of final accounts. The auditor examines the complete financial records for the year and expresses an opinion on the financial statements. This is the most common form of audit used by businesses and organizations.

3. Interim Audit

An interim audit is conducted before the end of the financial year, usually between two annual audits. It provides management with an early assessment of financial performance and internal controls. Interim audits help reduce the workload during the final audit and enable organizations to identify and rectify issues before the year-end audit.

D. Types of Audit Based on Objectives

1. Special Audit

A special audit is conducted for a specific purpose or under special circumstances. It may be conducted to investigate suspected fraud, verify a particular transaction, or examine a specific area of concern. The scope of a special audit is generally limited to the issue being investigated.

2. Cost Audit

Cost audit involves the examination and verification of cost records and cost accounting systems. It ensures that cost information is accurate and reliable. Cost audits help management control production costs, reduce wastage, improve efficiency, and make informed pricing decisions.

3. Management Audit

Management audit is a systematic evaluation of managerial policies, practices, and performance. It focuses on assessing how effectively management utilizes resources and achieves organizational objectives. The findings of a management audit help improve decision-making and overall organizational effectiveness.

4. Service Audit

Service audit examines the quality, efficiency, and effectiveness of services provided by an organization. It is widely used in service-oriented sectors such as banking, healthcare, education, hospitality, and public utilities. The main aim is to ensure customer satisfaction and improve service delivery.

E. Other & Recent Types of Audit

- 1. Balance Sheet Audit /Financial Statement Audit :** A balance sheet audit concentrates primarily on verifying the items appearing in the balance sheet, such as assets, liabilities, and capital. Some organization performs this audit in another way. Financial Statement Audit is modern form of audit focuses on verifying whether financial statements are prepared according to applicable accounting standards and present a true and fair view of the business.
- 2. Tax Audit :** A tax audit is conducted to verify compliance with tax laws and regulations. It examines the accuracy of income, deductions, and tax calculations maintained by the taxpayer. The objective is to ensure proper assessment and payment of taxes while reducing the possibility of tax evasion.

3. **Cash Audit :** A cash audit focuses on cash receipts, cash payments, and cash balances. It involves checking cash books, cash vouchers, and physical cash balances. This audit helps prevent misappropriation of funds and ensures proper control over cash transactions.
4. **Operational Audit:** Operational audit evaluates the efficiency, effectiveness, and economy of business operations. It examines processes, procedures, and resource utilization with the objective of improving organizational performance and achieving better results at lower costs.
5. **Social Audit:** Social audit assesses the social responsibilities and social impact of an organization. It evaluates how the organization's activities affect employees, consumers, community, and the environment. Social audits promote accountability and encourage responsible business practices.
6. **Efficiency Audit:** Efficiency audit examines whether the resources of an organization—such as manpower, materials, machinery, and funds—are being utilized in the most economical and productive manner. The purpose of this audit is to improve productivity, reduce wastage, and enhance overall efficiency.
7. **Forensic Audit:** Forensic audit is a detailed examination of financial records to detect fraud, embezzlement, money laundering, and financial irregularities. The findings of this audit can be used as evidence in legal proceedings.
8. **Compliance Audit:** Compliance audit examines whether an organization follows accounting standards, legal requirements, government regulations, and internal financial policies.
9. **Risk-Based Audit:** Risk-based audit focuses on high-risk areas of financial reporting and accounting systems. It helps auditors allocate more attention to areas where errors or fraud are most likely to occur.

Audits are an important instrument for ensuring the reliability of financial information and the efficient functioning of organizations. Different types of audits serve different purposes, ranging from legal compliance and financial verification to performance evaluation and operational improvement. By conducting appropriate audits, organizations can strengthen internal controls, improve decision-making, enhance transparency, and build confidence among stakeholders.

1.2.6 Difference between Statutory Audit and Internal Audit

Statutory Audit and Internal Audit are two fundamental forms of auditing that play significant roles in ensuring the financial integrity and operational effectiveness of an organization. Although both types of audits involve the systematic examination of records, controls, and processes, they differ considerably in terms of their objectives, scope, authority, and reporting relationships.

A Statutory Audit is an audit that is mandated by law. It involves the independent examination of an organization's financial statements by a qualified external auditor. The primary objective of a statutory audit is to express an opinion on whether the financial statements present a true and fair view of the financial position and performance of the organization in accordance with applicable accounting standards and legal requirements. Since statutory audits are legally required, the appointment, duties, and responsibilities of the auditor are governed by statutory provisions. The audit report is generally addressed to shareholders and other external stakeholders, providing assurance regarding the reliability of the financial information presented by the organization.

In contrast, an Internal Audit is an independent and objective assurance and consulting function established by the management of an organization. The purpose of internal auditing is to evaluate and improve the effectiveness of risk management, internal control systems, governance processes, and operational activities. Internal auditors assess whether organizational resources are being utilized efficiently and whether established policies and procedures are being followed. Through their findings and recommendations, internal auditors assist management in achieving organizational objectives and enhancing overall performance.

	Statutory Audit	Internal Audit
Meaning	A statutory audit is an audit conducted as per the requirements of law to verify the accuracy and fairness of an organization's financial statements.	An internal audit is an independent appraisal activity established within an organization to evaluate and improve internal controls, risk management, and operational efficiency.
Objective	Its primary objective is to express an opinion on whether the financial statements give a true and fair view of the financial position of the organization.	Its objective is to assist management by reviewing operations, identifying weaknesses, and recommending improvements.

Nature	It is an external audit conducted by an independent auditor.	It is an internal function carried out by employees or outsourced professionals appointed by management.
Legal Requirement	Mandatory under various laws and regulations such as the Companies Act.	Generally voluntary, although certain companies may be required by law to conduct internal audits.
Appointment of Auditor	The auditor is appointed by shareholders or as prescribed by law.	The internal auditor is appointed by management or the Audit Committee.
Scope of Work	Limited mainly to examination of financial statements and compliance with legal requirements.	Broad scope covering financial, operational, managerial, compliance, and risk-related activities.
Reporting Authority	Reports are submitted to shareholders and regulatory authorities.	Reports are submitted to management, the Board of Directors, or the Audit Committee.
Independence	The statutory auditor must remain completely independent of the organization.	Internal auditors maintain operational independence but are generally employees or agents of the organization.
Frequency	Usually conducted once every financial year.	Conducted continuously or at regular intervals throughout the year.

Focus Area	Focuses mainly on financial reporting and statutory compliance.	Focuses on efficiency, effectiveness, internal controls, risk management, and governance processes.
Responsibility	Responsible for expressing an audit opinion on financial statements.	Responsible for evaluating internal controls and suggesting improvements.
Users of Report	Shareholders, investors, creditors, government authorities, and regulators.	Management, Board of Directors, and Audit Committee.
Legal Liability	Statutory auditors have legal responsibilities and liabilities under the law.	Internal auditors generally have organizational responsibilities and limited legal liability.
Benefit	Provides assurance to external stakeholders regarding the reliability of financial statements.	Helps management improve operations, prevent fraud, and strengthen internal controls.

Check Your Progress III

D) Fill in the blanks

- 1] The primary objective of statutory audit
- 2] According to companies act 2013 mandatory types of audit are.....
- 3] Internal audit is now mandatory under section..... of company's act 2013.
- 4] Cost audit includes
- 5] Tax audit applicable to the concerns whose turnover during the financial year is..... in case of trading and manufacturing.
- 6] is “a comprehensive and constructive examination of an organizational structure of a company.

E) State True or False

1. Cost audit ensure that compliance with financial regulations.
2. Management audit focuses on strategic planning.
3. The primary objective of statutory audit is to detect and prevent frauds.
4. The management auditor is liable to the management only.

1.2.7 Internal Check:

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

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

According to D.R. Davar, "Internal check is a system or method introduced with defined Instructions given to staff as to their sphere of work with a view to control and the verification of their work and also the maintenance of accurate records as the ultimate aim.

According to Joseph Lancaster, "The internal check is a method of organizing the entire operations, office, warehouse, factory and the duties to the respective staff so that frauds and irregularities are impossible without collusion."

All the definitions of internal check give a common idea about system organized within the Concern itself, wherein the work of one employee is automatically checked up by the other and the Possibility of error or fraud is reduced to the minimum.

Objectives of internal check:

1. To exercise moral pressure over the staff.
2. To ensure that the accounting system produces reliable and adequate information.
3. To provide protection to the resources of the business against fraud, carelessness and in efficiency.
4. To distribute work in such a manner that no business is left unrecorded.
5. To allocate duties and responsibilities of each clerk in such a way that he may held responsible for particular fraud or error.
6. To increase the efficiency of clerks because the allocation of duties is based on the principle of division of labour.
7. To detect errors and frauds easily if it is committed, because in an efficient internal check system, there is a provision for independent checking.

Advantages of Internal Check:

1. **Proper division of work:** internal check entails a proper and rational distribution of work among the members of staff of the enterprise keeping in view their individual qualifications, experience and area of specialization.
2. **Detection of errors and frauds:** since no individual worker is allowed to handle a job completely from the beginning to the end, and the work of each clerk is automatically checked by the other, this helps in the early detection and discovery of errors and frauds.
3. **Increased efficiency coupled with economy:** A good system of internal check increases the Efficiency of work among the staff and leads to overall economy.
4. **Convenience to auditor:** where an organization is operating the system of internal check, the statutory auditor may conveniently avoid detailed checking of the transactions. He may apply a few tests here and there and can relieve himself from detailed checking.
5. **Accuracy of the accounts can be relied upon:** If there is a good system of internal check the owner of the concern may rely upon the genuineness and accuracy of the accounts.
6. **Increase in Profits:** overall efficiency and economy in operations result in more profits- thus ensuring larger dividends for the owners or shareholders.

Limitations of Internal Check

Although an internal check system helps in preventing errors and frauds and improves the efficiency of business operations, it has certain limitations. Some of the major limitations are as follows:

1. **Human Errors:** Employees may make mistakes due to carelessness, lack of experience, misunderstanding, or negligence. Such errors may not always be detected by the system.
2. **Collusion among Employees:** If two or more employees work together to commit fraud, they may be able to bypass the internal check system.
3. **Management Override:** Senior management may ignore or override established procedures, reducing the effectiveness of internal checks.
4. **Dependence on Employee Honesty:** The system works effectively only when employees perform their duties honestly and responsibly. Dishonest employees can misuse the system.

5. **Not Suitable for Small Businesses:** Small organizations often have limited staff, making it difficult to divide duties among different employees.
6. **Repetitive Nature of Work:** Employees performing the same tasks repeatedly may become careless, increasing the chances of errors.
7. **Additional Cost:** Implementing and maintaining an internal check system may require extra staff, supervision, and record-keeping, which increases costs.
8. **Difficult to Detect Complex Frauds:** Well-planned frauds may remain undetected, especially when employees have detailed knowledge of the system.
9. **Need for Regular Review:** Business conditions and technology change over time. Therefore, the internal check system must be regularly updated to remain effective.

1.3. Summary:

Auditing is an important process that involves the independent examination of a business's books of accounts, records, vouchers, and financial statements. Its main purpose is to ensure that the financial statements present a true and fair view of the financial position and performance of the organization. The need for auditing increased with the growth of large businesses and joint-stock companies, where ownership and management became separate. Since shareholders cannot personally examine the accounts, independent auditors are appointed to verify the records and provide assurance about their accuracy and reliability. As a result, auditing has become an essential tool for maintaining transparency, accountability, and confidence in financial reporting.

The primary objective of auditing is to verify whether the Balance Sheet and the Profit and Loss Account accurately reflect the financial position and results of the business. To achieve this, auditors examine accounting records, supporting documents, internal control systems, and the valuation of assets and liabilities. Besides this main objective, auditing also aims to detect and prevent frauds and errors. Frauds may arise from the misappropriation of cash or goods, or from manipulation of accounts, while errors may occur due to carelessness, oversight, or misunderstanding of accounting principles. Through systematic verification, auditing enhances the reliability and credibility of financial information.

An audit is conducted according to certain fundamental principles such as integrity, objectivity, independence, confidentiality, professional competence, proper planning, documentation, and the collection of sufficient audit evidence. Auditors evaluate the accounting system and internal controls of an organization before expressing their opinion through an audit report. Auditing is closely related to several disciplines, including accounting, economics, law, statistics, computer information systems, financial management, production, and behavioral science. Knowledge of these fields helps auditors perform a comprehensive and effective examination of business activities.

Auditing can take different forms depending on its purpose and scope. Common types include statutory audit, internal audit, continuous audit, final audit, cost audit, management audit, tax audit, forensic audit, and compliance audit. Another important concept discussed in this chapter is the internal check system, which involves dividing responsibilities among employees so that the work of one person is automatically checked by another. This system helps reduce errors, prevent fraud, improve efficiency, and safeguard business assets. Although it has certain limitations, it remains an important component of internal control. Overall, auditing plays a vital role in strengthening trust in financial statements and protecting the interests of shareholders, investors, creditors, and other stakeholders.

1.4. Glossary

Key Terms & Important Concepts

1. **Auditing:** The independent, systematic examination of an organization's financial records and operations to confirm that its financial statements reflect a true and fair view.
2. **Auditor:** An independent professional appointed to examine financial accounts, verify their accuracy, and report on whether the company's financial statements are reliable.
3. **Vouchers:** Supporting documents—such as bills, invoices, receipts, and bank statements—that serve as written proof of a business transaction.
4. **Audit Report:** The formal final document written by an auditor to communicate their official opinion on whether a company's financial statements are honest and clear.
5. **Investigation:** An in-depth, targeted examination of financial records carried out for a specific purpose, such as uncovering suspected fraud or checking a company's financial health before a purchase.
6. **True & Fair View:** It means that financial statements are factually accurate, legally compliant, and present an honest, unbiased picture of a business's real financial position without misleading users.

1.5. Answers to Check Your Progress

- | | | |
|-----------------|------------------|--------------------------|
| A) 1) Audire | 2) Luca Pacioli | 3) joint-stock companies |
| 4) dual control | 5) Balance Sheet | 6) ICAI |
| 7) Vouchers | 8) Schedule III | |

- B) 1) Accounting
 2) Assess the impact of economic factors on financial statement
 3) Psychology 4) Financial reporting 5) risk management
- C) 1) True 2) True 3) False 4) False
- D) 1) To ensure compliance with law and regulations.
 2) External audit and Internal audit.
 3) 138
 4) verification of correctness ,cost report and cost statement ,cost data and costing tech.
 5) 1 crore
 6) Management Audit
- E) 1.false 2.true 3.false 4.true

1.6. Exercise:

I) Long Answer Questions

1. What is audit? Define nature and scope of audit.
2. Explain basic principles governing an audit according to AAS-1.
3. Define audit Concept .Explain different types of Audit (only nature)
4. Distinguish between audit and investigation.
5. How can you justify and correlate the relationship of audit with other Disciplines?
6. What is the difference between internal audit and statutory audit?
7. What is Internal Check? Explain its advantages

II) Short Note Type Questions:

- (a) True and Fair View.
- (b) Objective of Auditing.
- (c) Internal Audit.
- (d) Balance sheet Audit
- (e) Cost Audit
- (f) Internal Check

1.7. Reference for Further Study:

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Unit-2

Vouching, Verification and Valuation

- a) Vouching – Voucher, Meaning and Process of Vouching, Precautions to be taken while vouching, Auditor's Rights, Duties and Responsibilities
- b) Verification and Valuation – Meaning, Process, Auditor's Rights, Duties and Responsibilities

2.0. Objectives

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2.2. Presentation of subject matter

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Check Your Progress - I

2.2.2 Verification

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2.2.2.2. Objectives of Verification

2.2.2.3 Significance of Verification

2.2.2.4 Process of Verification

2.2.2.5 Auditor's Rights Regarding Verification of Assets and Liabilities

2.2.2.6 Auditor's Duties and Responsibilities

2.2.2.7 Auditor's Position regarding Verification

2.2.2.8 Difference between Vouching and Verification

Check Your Progress – II

2.2.3 Valuation

2.2.3.1 Valuation – Meaning & Definitions

2.2.3.2 The basis for Valuation

2.2.3.3 Process of Valuation

2.2.3.4 Rights of Auditor in Valuation of assets and liabilities

2.2.3.5 Duties and Responsibilities of an Auditor during valuation of assets and liabilities

2.2.3.6 Difference between Verification and Valuation

2.2.3.7 Principles of Verification and Valuation

Check Your Progress – III

2.3. Summary

2.4. Terms to Remember

2.5. Answers to check your progress

2.6. Exercise

2.7. Reference for further study

2.1. Introduction

In the first unit we have studied meaning and basic concepts of auditing. We have understand the basic concept of governing auditing, various types of auditing. We understand the concept of internal check and its advantages. In this Unit we are going to understand actual process auditing. The Auditing starts where accounting ends. The Vouching means examination of the entries in the books of accounts with sufficient written evidences to satisfy the auditor himself about the authenticity, accuracy, validity and authority of the records. In verification an auditor satisfy himself by documentary evidence or by physical check that the asset is in existence, it is in the possession of the client and the value shown in the balance sheet is proper. In valuation an auditor examines whether assets and liabilities are valued correctly and according to generally accepted principles and standards. Let we understand the concept of vouching, verification and valuation.

2.2. Presentation of subject matter

2.2.1 Vouching

2.2.1.1 Vouching- Meaning

Before understanding the concept of vouching, we need to understand the concept of voucher, let us understand about voucher and its various forms used in different transactions.

Voucher:

It is one of the major responsibilities of the auditor to see all the transactions are properly accounted for and these are supported and substantiated by authentic documentary evidences. Every transaction must be supported by proper written evidences which could prove that the transaction has actually taken place.

“A documentary proof or evidence in support of a transaction is called a voucher”

Vouchers may be any of the following forms-

Receipts, Pay Sheets	Bills Payables	Dividend Warrant
Account Sales	Counterfoils	Bills
Letter of Collection	Bank Pass Book	Purchase Note
Minute	Carbon copies	Cash/Credit Memo
Bank Challans	Bills Receivables	Purchase Order
Invoice	Material Requisition	Delivery Note
Sales Note	Attendance Register	Resolution
Goods Received Note	Gate Keeper's Book	Order Book
Store Keeper's Book	Bank Advice	Register
Agreement/Deed/Contract	Bank Pass Book	Interest Warrant
Correspondence Inward/Outward	Certificate from Architect, Engineer, Solicitor, Valuer	Statement of Accounts (Confirmation) from Debtors & Creditors
Job Cards	Investment Certificates	Broker's Note

Vouching

Definitions

Vouching means examination of the entries in the books of accounts with sufficient written evidences to satisfy the auditor himself about the authenticity, accuracy validity and authority of the records. The following definitions explain the meaning of vouching

- ♦ R. B. Bose defines-‘Vouching means verification of authoritative and authenticity of the transactions recorded in the books of accounts’.
- ♦ According to R. A. Irish ‘Vouching is a technical term which refers to the inspection of documentary evidence supporting and substantiating a transaction by the auditor’.

According to De Paula -‘Vouching does not mean merely the inspection of receipts with the transactions of a business together with documentary and other evidence of sufficient validity to satisfy an auditor that such transactions are in order, have been properly authorized and are correctly recorded in the books’.

2.2.1.2 Characteristics of Vouching

From the above discussion and definitions we can understand that vouching is not merely to check the records in the books of accounts but to verify the proofs of the transactions recorded. The main characteristics of vouching can be stated as below –

1. It is an examination and verification of entries recorded in the books of accounts with supportive documentary and related evidences.
2. It is an examination of vouchers.
3. It is a process of ascertaining correctness and authenticity of the transactions.
4. It ascertains that whether all the transactions are related to the business and there is no omission in recording the transactions and at the same time no fraudulent entries are passed in the books of accounts.
5. It ascertains that the transactions have actually taken place and it is within the limit of authority.
6. It is the first step in auditing because it is related to the prime document of evidence and entries in the primary books.

2.2.1.3 Objectives of Vouching

1. To see whether the transactions which are recorded are related to the business.
2. To see that the transactions are actually taken place.
3. To verify authority and authenticity of every transaction.
4. To find whether any transaction has left off to be recorded.

5. To see that all the transactions are properly accounted for in the books of accounts.
6. To see that no fraudulent transactions are recorded.
7. To see that for all the transactions there are supporting documentary evidences

2.2.1.4 Significance of Vouching

While auditing the books of accounts it is expected that an auditor should not satisfy himself with the results of records but he has to go beyond the books of accounts and verify the existence and correctness of records. The degree of quality of auditing mainly depends upon the quality of vouching. Audit starts with vouching and so all the subsequent steps in

Auditing and the success or failures of audit work are mainly depend on vouching. De Paula has rightly said that ‘Vouching is the essence of auditing’.

- i) **Truth of entries:** Vouching reveals the truth of entries in the books of accounts. The validity, authenticity and correctness of the vouchers i.e. prime evidences and its proper accounting is being checked by the way of vouching.
- ii) **Detection of errors and frauds:** One of the objectives of audit is detection of errors and frauds. In this regard vouching is of great help to an auditor. It points out errors and frauds in the books of primary entries and hence, its reflection in further accounting can be easily detected. It means vouching is a base of auditing with the help of which auditor can proceed well further and can certify the accounts.
- iii) **Helps in showing true and fair view:** Vouching proves whether the final accounts reflect true and fair view of the state of affairs of the business. Vouching is the process of checking entries in the books of original records on which entire accounting of the business is based upon. Vouching ensures original entries by checking genuineness and authenticity of transactions and their postings in the books of accounts are made as per the principles of accounting.
- iv) **Verification of evidences:** Vouching verifies first the documentary and other related evidences which are the basis of entries. It points out the fraudulent and wrong vouchers and thus helps an auditor to find out errors and frauds at the initial stage of auditing.
- v) **Alerts to auditor:** Vouching alerts an auditor by pointing out errors and frauds at the beginning of auditing. If there are some mistakes in vouchers and original entries or there are some fraudulent vouchers, auditor will become alert and he will exercise careful complete checking and would not resort on test checking.

From all the discussion we can conclude that vouching is not merely checking the documentary evidences but the auditor should satisfy himself that the transactions or entries are in order, they are properly authorized and correctly recorded in the books of accounts following the accounting principles. For example, the auditor should not rely only on the receipt of the creditor for the payment made to him but he has to confirm that the goods are purchased from him on credit, of the given value after proper sanction from the competent authority and as per the agreement the payment is made by cheque. If the payment is made in cash, he should enquire why the payment is made in cash. He should also verify the accounting entry passed in the books of accounts.

2.2.1.5. Process of Vouching

Vouching is the process of examination of documentary evidences which are supporting to accounting transactions to verify their authenticity, accuracy and validity. Following steps are undertaken while vouching the transaction-

- i) **Selection of transactions for Examination:** selection of transaction for vouching is the first step in vouching. The auditor can select any transaction recorded in journal, cash book and ledgers for vouching.
- ii) **Get relevant vouchers:** The auditor has to collect supporting documents such as invoices, receipts, bills, debit notes, credit notes, wage sheets, contracts etc.,
- iii) **Verify the authenticity and authorization of vouchers:** The auditor has to ensure that vouchers are genuine, properly authorized and related to business. The auditor has to confirm that the transaction has been approved by appropriate authority of the organization.
- iv) **Check the date, amounts and calculations:** verify whether the transaction occurred during the accounting period under audit or not. The auditor has to check arithmetic accuracy and ensure the amount in the vouchers matches with the accounting records. The Auditor tally each and every item stated in the voucher with entries in the books of accounts. Thus the comparison is a part of vouching procedure.
- v) **Check supporting Documents and verify the recording:** the auditor has to ensure all necessary documents are attached and completed process. The auditor can confirm that transaction has been correctly recorded in the books and accounts.
- vi) **Mark the voucher:** After making above process, the auditor ticks or stamps the voucher to prevent it from being used again or duplication. Such ticks or symbols may differ from auditor to auditor because these are code words.

- vii) **If there is query:** sometimes the voucher may be missing or entries may be doubtful due to over writing or erasing, the auditor or audit staff can make word “Q” against such entry. This entry is recorded in working papers. They can ask to management about such doubtful entries. The management can verify such records in detail
- viii) **Reply from management:** The management may reply after one or two days about the doubtful entries. The auditor can scrutinize the reply of the managers. They can judge whether the reply is right or wrong.
- ix) **Clearance of query:** The auditor can clear the query if proper answer is received from managers. If the auditor is not satisfied with the answer of objections then he can inform the management about this unsatisfied query. The auditor may reject the unsatisfactory reply. He can use his skill, training and experience to test the truth. He can note down poor clarification in working papers.
- x) **Draw conclusion to form an opinion in audit report:** at lastly auditor determine whether the selected transaction is valid, properly recorded and free from material misstatement. The objection stated in the working papers can be discussed with the management at the end of audit. He can form an opinion on the basis of such objections and clarification and mention it in his report either clear or qualified

2.2.1.6. Precautions to be taken while vouching or important points to be considered while vouching transactions

Let we will study the main points which will make vouching effective and efficient.

i) **Serial** – All the vouchers must be serially arranged and numbered according to date and entries in the books of accounts. The entries in the books of accounts should also bear the serial number of vouchers that will easy to correlate the voucher with the particular entry.

All the vouchers should also be filed serially and properly. The files should be given serial numbers and the period should be mentioned clearly at the front of the file. These are also to be arranged serially. Otherwise the auditor will loss his valuable time in searching the right vouchers.

ii) **Date, Amount and Name** – There is a chance that the voucher of the same date of the last month or year may be produced again so, auditor should check the date of voucher carefully.

The voucher should contain the amount both in figure as well as in words. The auditor should see that the amount tally with the amount entered in the books of accounts.

Each voucher should be in the name of the business concern and not in the name of any individual i.e. official or partner or director. The vouchers of personal name should be rejected or should check other relevant documents to confirm that the voucher is related to the business. He should also confirm the name of the party issuing the voucher.

iii) Particulars – The nature of item matters. If the capital item recorded as revenue or vice versa, it affects greatly final statements of the concern. So, the auditor should read particulars column on the voucher carefully and ascertain the nature of item. Check the postings made accordingly. Besides from the particulars the auditor can ascertain head of account, title of the account, debit or credit effect of the transaction etc.

iv) Validity of Voucher – As far as possible the vouchers should be in printed form and wherever necessary it should bear revenue stamp also. At least the voucher should bear stamp of the receiving party. For petty expenses there may not be such vouchers so, auditor should take more regarding these vouchers because chances of fraud cannot be denied.

v) Period – The period of the item is much important. Receipts and payments may relate to the previous year, current year or next year. Entries are passed taking into account the period to which it relates. Prepaid or pre-received items as well as received in advance and paid in advance items should be properly accounted for taking into account any provisions or reserves made. The auditor should pay careful attention towards this.

Other Precautions –

- i. As far as possible vouching of a particular period should be made at a stretch.
- ii. Checked vouchers and related documents should be marked with stamp, signature or both so that they cannot be reproduced.
- iii. List of rejected vouchers should be made and they should be kept away from the particular voucher file or in a separate file.
- iv. List of missing vouchers is also to be prepared and the relevant documents must be checked more carefully.
- v. In the case of duplicate vouchers, auditor should be more alert and get information till he satisfies regarding why there is duplicate voucher. All the relevant documents must be checked more carefully.
- vi. Auditor should satisfy himself that entries are passed correctly in the books of accounts. Checked entries should be marked with particular sign or tick mark. Explanation should be collected regarding unticked items and these items be compared with missing vouchers for confirmation.
- vii. Doubtful and torn or spoiled vouchers should be checked carefully. These are to be consulted with responsible officer.
- viii. In any case help should not be taken from the employee of the concern in respect of vouching.

- ix. All his experiences and observations should clearly be noted down which will become part of his report.

2.2.1.7. Auditor's Rights while vouching the transactions:

Auditors Rights: The rights of auditor are the legal power and privileges granted to an auditor to enable to perform his duties effectively and independently. These rights help the auditor gather sufficient and appropriate audit evidences and express his unbiased opinion on financial statements.

While vouching an auditor has certain rights regarding the verification of correctness and authenticity of transaction recorded in the books of accounts. Let study the rights of an auditor regarding vouching.

- i) **Right to access the books of accounts:** the auditor has the right to access all accounting records, journals, ledgers, cash books and other financial records and documents.
- ii) **Right to examine the vouchers and supporting documents:** the auditor can demand and examine invoices, receipts, bills, contracts, agreements, business correspondence and supporting evidences. If the existing vouchers are unsatisfactory or insufficient, the auditor has right to get further documentary proofs.
- iii) **Right to get information and explanations:** the auditor can ask management, employees and outside parties like debtors, creditors, investors, banks etc., for explanation and information regarding any transaction or voucher especially in case of unusual, incomplete, doubtful and suspicious transactions.
- iv) **Right to check authorization:** the auditor has the right to check whether transactions have been properly approved by competent authority.
- v) **Right to mark or tick vouchers:** After examination, the auditor can mark stamp or tick vouchers to indicate that they have been verified and to prevent their reuse.
- vi) **Right to report:** the auditor has the right to report about any fraud, error, omission or irregularity revealed during vouching.

2.2.1.8. Auditors Duties and Responsibilities while vouching the transactions

Auditors Duties and Responsibilities: The duties and responsibilities of an auditors means the obligations that an auditors must perform while examining the books accounts and financial statement of a concern. It aims to ensuring the reliability and credibility of financial statements.

Auditor will be held responsible for any loss to his client due to negligence or carelessness of auditor in respect of vouching. So he should exercise his skills, knowledge and techniques to his best while vouching. It is expected that the auditor should not

mere compare the figures from vouchers and the entries in the books. He should go beyond the books and confirm that-

- i) **Authenticity of transactions:** the auditor should ensure that all transactions recorded in the books are genuine and actually occurred.
- ii) **Examine supporting documents:** the auditor should check invoices, bills, receipts, contracts, business correspondences, agreements and others supporting vouchers related to transactions.
- iii) **Verification of accuracy:** the auditor should ensure that date, amounts, particulars, calculations recorded in the books is matches with details in vouchers.
- iv) **Confirmation of authorization:** the auditor should confirm that transactions have been approved by the competent authority.
- v) **Ensure proper classification and completeness of records:** the auditor should verify that transactions are correctly classified into appropriate accounts such as capital, revenue, assets, liabilities, incomes and expenditures etc., and confirm that all transactions are recorded and no material transactions has been omitted.
- vi) **Compliance with laws and policies:** auditor should verify that transactions comply with legal requirements and organizational policies.
- vii) **Detection of errors and frauds:** he should be alert to any signs of manipulation, omission, duplication or misappropriation in recording of transaction. He should collect adequate audit evidence before forming conclusions regarding transactions,
- viii) **Maintain professionalism:** He should take proper care, diligence and independent judgment while examining evidences and forming opinion.
- ix) **Mark verified vouchers:** The auditor should mark, tick or stamp after examination of prevent their reuse.
- x) **Report on irregularities:** The auditor should report on any fraud, error or irregularity found during the vouching process.

Check Your Progress –I

Fill in the blanks.

1. A documentary proof or evidence in support of a transaction is called a -----
2. Every transaction must be supported by proper ----- which could prove that the transaction has actually taken place.
3. ----- means verification of authoritative and authenticity of the transactions recorded in the books of accounts

4. The auditor makes ----- after examination of any voucher to prevent its reuse.
5. The auditor should confirm that transactions have been approved by the -----

2.2.2 Verification

2.2.2.1. Verification –Meaning

Vouching examine correctness of the entries passed in the books of accounts by verifying documentary evidences available in support of the transactions. But this is not sufficient for assets and liabilities. Because vouching does not prove that the asset or liability was actually exist on the date of balance sheet and the valuation shown was correct. For example, vouchers

can prove that a car is purchased on a particular date during the year but they cannot prove that the car was in existence and in the possession of the client on the date of balance sheet with the given value. It may break, it may lose, it may not have the same value, so on and so forth. Existence of the car can be proved only by physical check-up and verifying its value.

Unless checking physical existence and values of assets and liabilities, an auditor cannot certify that the balance sheet is showing true and fair view of its state of affairs.

Definitions:

Verification means to confirm or substantiate the truth or accuracy by competent examination. An auditor satisfy himself by documentary evidence or by physical check that the asset is in existence, it is in the possession of the client and the value shown in the balance sheet is proper. This work of auditor is called as verification of assets.

- ♦ Spicer and Pegler defines verification as ‘The verification of assets implies and inquiry into the value, ownership and title, existence and possession, the presence of any charge on the asset’.
- ♦ As per J R Botliboi – ‘ In verification of assets the auditor must satisfy himself that they really existed on the date of balance sheet and were free from any charge and they have been properly valued. In verifying the liabilities, he has to see that all liabilities have been inserted at their proper figures and that no liability has been omitted’.

From the above discussion and definitions, we can say that verification involves the following considerations –

- i. Each asset or liability is clearly and properly disclosed and described,
- ii. The assets and liabilities were actually exist on the date of balance sheet,
- iii. The ownership and possession of the assets are of the business,
- iv. The assets are free from any charge and if there is any charge it is specifically mentioned,
- v. The assets and liabilities are correctly valued and recorded with proper figures.

2.2.2.2 Objectives of Verification

1. To see that assets and liabilities are valued on the basis of generally accepted accounting principles and the principles are applied consistently.
2. To verify that all the business assets and liabilities are shown in the balance sheet at their right value.
3. To check that the assets and liabilities shown are actually exist.
4. To check that the ownership and possession of the assets are with the company. If there is any charge, it is shown clearly.
5. To verify that all the assets and liabilities are properly shown in the balance sheet according to the provisions of the respective act, rules and requirements of the business organization.
6. To verify that balance sheet shows true and fair view of the state of affairs of the business.

2.2.2.3 Significance of Verification

- i) It verifies physical existence of the assets and genuineness of liabilities.
- ii) Any fraud or irregularity regarding assets or liabilities can be detected by verification.
- iii) Any mortgage, pledge, hypothecation or floating charge on any asset comes to light by verification.
- iv) Shareholders can know the true and fair value of assets and liabilities.
- v) Third parties such as creditors, financier, investors etc. can know the real worth of the business.
- vi) The auditor can state confidently in his report that the balance sheet shows true & fair view of the state of affairs of the business.

2.2.2.4 Process of verification:

In the process of verification of assets and liabilities an auditor examines and confirms the existences, ownership, valuation and correctness of assets and liabilities shown in balance sheet. Following procedure is carried out while verifying assets and liabilities-

- i) **Examination of books and records:** it is first step in verification of assets and liabilities. An auditor checks the balance sheet, ledger accounts, related schedules and supporting documents relating to the assets and liabilities.
- ii) **Check the existence of assets and liabilities:** the auditor ensure that the assets actually exist and liabilities are genuine as on balance sheet date. The auditor can conduct physical inspection for cash, stock and fixed assets.
- iii) **Verify ownership and title:** the auditor can examine title deeds, purchase agreements, registration certificates and other related documents to confirm ownership and title of assets.
- iv) **Examine possession and control:** the auditor can ensures that assets are under the possession and control of the business, he can also check any burden or mortgage on any assets and its related documents.
- v) **Confirmation of the liabilities:** the auditor can verify debentures, loans, creditors and other liabilities through the agreements and external confirmations.
- vi) **Examine the valuation:** The auditor ensures that assets and liabilities are valued according to generally accepted accounting principles and standards. Check whether adequate depreciation on assets and provisions for liabilities has been made.
- vii) **Examine adjustments and proper disclosures:** the auditor verify adjustments related to unrecorded transactions, outstanding expenses, prepaid expenses, accrued income and income received in advanced. The auditor confirms that all assets and liabilities are correctly classified and disclosed in the financial statements.
- viii) **Formation of opinion:** Based on the evidences obtained during the verification he form his opinion whether assets and liabilities are true and fairly stated in the balance sheet.

2.2.2.5. Auditors Rights Regarding Verification of Assets and Liabilities

During the verification of assets and liabilities, the auditor has following rights

- i) **Right to access books of accounts and documents:** the auditor has the right to examine all the books, ledger accounts, registers and financial records relating to assets and liabilities. The auditor has right to inspect invoices, receipts, titles deeds, agreements, contracts, loan documents and other supporting records.

- ii) **Right to physical inspection of assets:** the auditor can physically verify assets such as cash, inventory, machinery, furniture and other tangible assets whenever necessary.
- iii) **Right to acquire information and explanations:** the auditor may acquire explanations from directors, officers, managers and employees regarding any assets or liabilities
- iv) **Right to verify ownership:** the auditor has the right to examine legal documents which confirms ownership and title of assets.
- v) **Right to get external confirmation:** The auditor can get confirmation from banks, debtors, creditors, lenders and other third parties.
- vi) **Right to inspect branch records:** the auditor can access records and documents maintained at branches relating to assets and liabilities.
- vii) **Right to ask for additional evidence:** If the auditor is not satisfied with the existing evidences, the auditor can demand additional documents and explanations.
- viii) **Right to report misstatements and irregularities:** the auditor has the right and duty to report any overvaluation or undervaluation, fraud or misstatement found during verification.

2.2.2.6. Auditors Duties and Responsibilities

Verification of assets and liabilities is one of the significant duties of the auditor during the auditing. The auditor must confirm that the assets and liabilities shown in the balance sheet are genuine, properly valued and correctly disclosed. He must give his opinion on true and fair view of financial position of the concern. In this regards following are duties and responsibilities of auditor-

- i) **Verify compliance with laws and standards:** The auditor should ensure that all records made are in compliance with applicable laws, regulations and generally accepted accounting principles.
- ii) **Verify ownership, possession and control of assets:** the auditor should confirm that the legal ownership and title of the assets is with business and assets are under the control of business. He should go through title deeds, invoices, agreements, loan documents, certificates and other supporting records.
- iii) **Verify presence of assets and liabilities:** the auditor should ensure that all assets and liabilities shown in the balance sheet are actually exists on the balance sheet date.

- iv) **Ensure proper classification and disclosure:** the auditor should check that assets and liabilities are properly classified into fixed assets, current assets, long term liabilities, short term liabilities etc., and they are correctly disclosed in the financial statements.
- v) **Verify depreciation and provisions:** the auditor should ensure that adequate depreciation, amortization and provisions have been made.
- vi) **Detect errors and frauds:** He should carefully identify any overvaluation, undervaluation, misappropriation or fraudulent reporting. He should gather adequate and reliable evidences before presenting his opinion in audit report.
- vii) **Reporting irregularities:** The auditor should report if find any irregularities or frauds identified during the verification.

2.2.2.7. Auditor's Position Regarding Verification

Verification is very important duty of an auditor. When an auditor has to report whether the balance sheet shows a true and fair view of the state of affairs of the business concern, he is supposed to take verification of the assets and liabilities. If he proved negligent in this respect, he will be held guilty and responsible for damages.

In the case of London Oil Storage Co. Ltd. Vs. Seear, Hasluck & co., it is stated – 'It is the duty of the auditor to verify the existence of assets stated in the balance sheet and he will be liable for any damage suffered by the client if he fails in his duty'.

In the case of the Kingstone Cotton Mill Co. Ltd., it was held that, it was not the duty of the auditor to take stock. It was also held that if he accepted the certificate of a responsible official in the absence of suspicious circumstances, he was not guilty of negligence.

The judgments observed- 'It is no part of the auditor's duty to take stock. No one contends that it is. He must rely on other people for details of the stock-in-trade in hand'.

'He is a watchdog, but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest and to rely upon their representations, provided he takes responsible care. If there is anything calculated to excite suspicious he should probe into the bottom, but in the absence of anything of that kind he is only bound to be reasonably cautious and careful'.

In short, an auditor can rely on other's certificate only in the healthy environment and not in suspicious circumstances. He should be cautious and careful and exercise reasonable skill. Otherwise it will be held that it is the negligence of the duty.

2.2.2.8. Difference between Vouching and Verification

Vouching and verification, both are important tools of auditing, but not one and the same. Verification is wide term and it is totally different from vouching. The difference between these two can be briefed as below

Vouching	Verification
1. It means verifying the correctness of entries with the help of documentary evidences.	1. It means examining the existence, ownership, possession and valuation of the assets.
2. It is carried out with the help of vouchers.	2. It is carried out with the help of vouchers as well as valuation by experts and physical checkup.
3. It is possible any time during the year.	3. It is possible only after preparing the balance sheet
4. Vouching of asset is done for two times when it is purchased and when it is sold.	4. Verification is done every year.
5. It does not include verification and valuation of assets.	5. It includes vouching as well as valuation of assets.
6. It comes before verification. It is the first step in checking the assets.	6. It comes after the vouching. It is the next step in checking assets.

Check your Progress - II

Fill in the blanks.

1. The ----- of assets implies and inquiry into the value, ownership and title, existence and possession, the presence of any charge on the asset.
2. The verification is only possible after preparing -----.
3. The verification is the next step of -----
4. The auditor should ensure that all records made are in compliance with applicable laws, regulations and----- .
5. ----- confirms physical existence of the assets and genuineness of liabilities.

2.2.3 Valuation

2.2.3.1. Valuation- Meaning and Definition:

According to V.H. Kishnadwala, N. H. Kishnadwalla and M. V. Shetti- “Valuation is not merely the determination of the values of the assets as appearing in the balance sheet but is also the critical examination of these values on the basis of normally accepted accounting principles.”

The balance sheet will show true and fair view if the assets and liabilities are shown with proper values. But the question is which value is proper one. The valuation and the basis of valuation differ according to nature and type of asset and purpose of valuation. An auditor should try to get the answer of the following questions –

- a) What is and what should be the value?,
- b) What is and what should be the basis of valuation?,
- c) What method of valuation is applied and should be applied?,
- d) Whether generally accepted accounting principle are applied or not?,
- e) Whether the valuation is based on established practices of business or not?,
- f) Whether the business is applying the same method and basis for valuation from earlier years or it is changing its policy year to year, etc

2.2.3.2 The basis for Valuation

The various values used for the valuation of various assets are –

- i) **Cost Price** – The price which is paid for acquiring the asset including incidental and installation charges.
- ii) **Market Price** – The current market price of the particular asset on the date of valuation (the date of balance sheet)
- iii) **Replacement Value** – The value which would be necessary to acquire of the same type of asset to replace the existing asset. It also includes incidental and installation charges.
- iv) **Realizable Value** - The price which the existing asset, in the existing conditions, would fetch if sold on the date of valuation, excluding charges for realization.
- v) **Break up Value / Scrap Value**– The price which would be realized if the asset is sold as scrap.
- vi) **Book Value**– The value at which the asset appears in the balance sheet i.e. cost price minus depreciation.

2.2.3.3. Process of Valuation:

In valuation an auditor examines whether assets and liabilities are valued according to generally accepted principles and standards. Let see the process or steps of valuation-

- i) **Examine the relevant records and compare with accounting standards-** the auditor carefully examines the balance sheet, ledger accounts, schedules, invoices and other supporting documents. He ensures relevant records with applicable accounting standards, legal requirements and company policies.
- ii) **Understand the basis of valuation:** the auditor identifies and understands the methods used for valuation like historical cost, fair value, market value, realizable value.
- iii) **Check valuation of assets and liabilities:** the auditor check whether fixed assets, inventories, investment, debtors and other assets valued correctly. He ensures that liabilities are recorded at the correct amount including outstanding and contingent liabilities where applicable.
- iv) **Check depreciation, amortization and adjustments:** he verifies that proper depreciation and amortization have been charged according to accounting principles. The auditor checks adjustments related to outstanding expenses, prepaid expenses, accrued incomes and income received in advance.
- v) **Examination of provisions and reserves:** he ensures that adequate provisions are made for reserves, doubtful debts, taxation and other expected losses.
- vi) **Assessing the fair presentation:** The auditor determines the values shown in the balance sheet presents a true and fair view of the financial position of the company.
- vii) **Forming opinion or findings:** if valuation is incorrect or misleading in case of any asset or liabilities, the auditor should report it in the audit report.

2.2.3.4. Rights of auditor in valuation of assets and liabilities:

During the valuation of assets and liabilities, an auditor has certain rights to safeguard the assets and ensure that the financial statement shows a true and fair view of the financial position of the business.

- i) **Right to access books and records:** the auditor has the right to inquire all accounting records, ledgers, schedules and financial statements relating to valuation.
- ii) **Right to examine supporting documents:** the auditor has right to check invoices, bills, receipts, purchase deeds, valuation reports, contracts, agreements and other supportive documents to valuation. If the available evidences are insufficient, the auditor can demand further records, explanations or valuation reports.

- iii) **Right to obtain information and verify valuation methods:** the auditor can seek information and explanations from management and employees regarding the basis and methods of valuation used for valuation of assets and liabilities.

The auditor has right to verify whether valuation methods used are proper and consistent with generally accepted accounting principles and standards.

- iv) **Right to obtain expert opinion:** In the process of valuation if there is need for specialized knowledge and opinion, the auditor has right to obtain review and opinion from independent experts.
- v) **Right to get external confirmations:** The auditor can get information and confirmation from banks, debtors, creditors and other third party regarding assets and liabilities.
- vi) **Right to check depreciation and provisions:** The auditor has right to check whether adequate depreciation and provisions have been made or not.
- vii) **Right to report on inappropriate valuation:** the auditor has right to report on any overvaluation, undervaluation and misstatement of assets and liabilities.

2.2.3.5. Duties and responsibilities of an auditor during valuation of assets and liabilities:

The auditor has to report that the final account gives true & fair views of the profit or loss and state of affairs of the business. Correctness of the final accounts are largely depends upon the correctness of values of assets and liabilities. It means that an auditor should verify the values of assets and liabilities shown in the balance sheet.

- i) **Confirm compliance with accounting standards:** the auditor should check that valuation is in accordance with applicable accounting standards and requirements of laws.
- ii) **Check the basis of valuation:** the auditor should ensure that valuation is based on proper method and such method is used consistently.
- iii) **Verify valuation of assets and liabilities:** The auditor should verify that fixed assets, investment, stock, debtors and other assets are valued accurately. He should check that all liabilities recorded at correct amount and all other obligations are identified properly. He should detect that any asset or liability undervalued or overvalued.
- iv) **Check supporting documents and obtain sufficient audit evidences:** it is auditor's duty and responsibility to examine the supportive documents like invoices, valuation reports, agreements, contracts and other records and obtain adequate reliable evidences to support the valuation of assets and liabilities.

- v) **To take expert assistance if necessary:** The auditor should take opinion and assistance of valuers or other experts whenever specialized knowledge is required.
- vi) **Verify depreciation, amortization, provision and reserves:** The auditor should ensure that adequate depreciation and amortization have been charged on assets. He should verify that sufficient provisions are made for doubtful debts, taxation, depreciation and anticipated losses.
- vii) **Ensure appropriate disclosure:** The auditor should ensure that valuation basis, valuation methods and other significant matters are properly disclosed in the financial statements.
- viii) **To report on material misstatements:** The auditor should report on any incorrect valuation, misstatement or any non-compliance identified during the valuation process.

2.2.3.6. Difference between Verification and Valuation

Verification includes valuation of assets but there is difference between these two which can be stated in brief as under –

Verification Valuation

It means checking existence, ownership, possession, valuation and charge on the assets.	It means determining the proper value of assets and liabilities.
There is no fixed method for verification. It changes according to nature and type of assets and liabilities.	There is some basis for valuation. Different assets are valued on suitable basis.
It is not possible to get a certificate of verification from any authority. It should be done by the auditor himself.	The auditor can get and rely on the certificate of valuation from the responsible officer or authority.
It is a wide term. It includes vouching.	It is related only to the value of assets and liabilities and does not include verification.
It is not possible without valuation	It precedes the verification. In general it is the first step in verification.
It is a guard against improper valuation	It provides one basis for verification.

2.2.3.7. Principles of Verification and Valuation

For the purpose of verification and valuation of assets an auditor should follow the following principles.

1. Verify the internal control system regarding the acquisition, utilization and disposal of the assets.
2. Verify the record (account / ledger / register) maintained by the client for the assets showing quantitative details and situation of the asset.
3. Verify the values of assets shown in the balance sheet as per the ledger accounts / registers.
4. Verify that the accepted accounting principles are followed consistently.
5. Verify the physical existence of the asset.
6. Verify the ownership and title documents of the asset.
7. Verify that the assets are in the possession of the client.
8. Verify the mortgage or lien or charge or encumbrances on the assets.
9. Verify the values of the assets shown in the balance sheet
10. Verify that the assets are shown properly (under proper heading) in the balance sheet.
11. Verify that assets are acquired for the purpose of business.
12. Verify whether the management has verified the assets and noted accordingly.
13. Verify whether the assets are revalued during the year and the reasons for revaluation.
14. Note down all the observations and findings which should mention in the report.

Check Your Progress - III

Choose appropriate alternative.

1. The value at which the asset appears in the balance sheet is called as-----
 - a) Book Value
 - b) Cost Price
 - c) Market Price
 - d) Scarp Value
2. The price which is paid for acquiring the asset including incidental and installation charges is called as -----
 - a) Book Value
 - b) Cost Price
 - c) Market Price
 - d) Scarp Value

3. ----- is not merely the determination of the values of the assets as appearing in the balance sheet but is also the critical examination of these values on the basis of normally accepted accounting principles.
- a) Valuation
 - b) Verification
 - c) Vouching
 - d) Inspection
4. The auditor has following rights while valuation of assets and liabilities.
- a) Right to access the books of accounts related to assets and liabilities
 - b) Right to get expert opinion
 - c) Right to get confirmation for outside parties
 - d) All of above
5. The auditor has following duties and responsibilities in respect of valuation.
- a) Confirm compliance with accounting standards
 - b) Check the basis of valuation
 - c) Verify valuation of assets and liabilities
 - d) All of above

2.3. Summary

The main object of an audit is to see whether the Balance Sheet exhibits a true and fair view of the state of affairs of an enterprise and whether it is drawn as per requirement of applicable laws. The auditor can find out the material misstatements from the financial statements and presents the accurate financial position to the concern parties. The process of auditing is done through vouching, verification and valuation. Through these process auditor can achieve its main objective.

Vouching is the process of examination of documentary evidences which are supporting to accounting transactions to verify their authenticity, accuracy and validity. Audit starts with vouching and so all the subsequent steps in auditing and the success or failures of audit work are mainly depend on vouching. De Paula has rightly said that ‘Vouching is the essence of auditing’.

Unless checking physical existence and values of assets and liabilities, an auditor cannot certify that the balance sheet is showing true and fair view of its state of affairs. An auditor satisfy himself by documentary evidence or by physical check that the asset is in existence, it is in the possession of the client and the value shown in the balance sheet is proper. This work of auditor is called as verification of assets.

The balance sheet will show true and fair view if the assets and liabilities are shown with proper values. Valuation is not merely the determination of the values of the assets as appearing in the balance sheet but is also the critical examination of these values on the basis of normally accepted accounting principles.

Vouching is first step in auditing and it is closely related, supporting to the verification and valuation of assets and liabilities. All these are performed to ensure the accuracy, authenticity, ownership, existence and accurate valuation of assets. Vouching ensures authenticity of every transaction, verification authorizes the existence and ownership of assets and liabilities and valuation ensures their true and accurate monetary value. All process together helps the auditor express his opinion on the truth and fairness of the financial statements.

2.4. Terms to be Remember

- i) **Voucher:** A documentary proof or evidence in support of a transaction is called a voucher.
- ii) **Vouching:** Vouching is a technical term which refers to the inspection of documentary evidence supporting and substantiating a transaction by the auditor.
- iii) **Verification:** The verification of assets implies and inquiry into the value, ownership and title, existence and possession, the presence of any charge on the asset.
- iv) **Valuation:** Valuation is not merely the determination of the values of the assets as appearing in the balance sheet but is also the critical examination of these values on the basis of normally accepted accounting principles.
- v) **Auditors Rights:** The rights of auditor are the legal power and privileges granted to an auditor to enable to perform his duties effectively and independently. These rights help the auditor gather sufficient and appropriate audit evidences and express his unbiased opinion on financial statements.
- vi) **Auditors Duties and Responsibilities:** The duties and responsibilities of an auditors means the obligations that an auditors must perform while examining the books accounts and financial statement of a concern. It aims to ensuring the reliability and credibility of financial statements.

2.5. Answers to Check Your Progress

Check your progress I

- | | | |
|------------------------|--------------------------------|-------------|
| 1. Voucher | 2. Written evidences / voucher | 3. Vouching |
| 4. Mark, tick or stamp | 5. Competent authority | |

Check Your Progress II

- | | | |
|---|------------------|-------------|
| 1. Verification | 2. Balance Sheet | 3. Vouching |
| 4. Generally Accepted Accounting Principles | 5. Verification | |

Check your progress III

- | | | |
|-----------------|-----------------|--------------|
| 1. Book Value | 2. Cost Price | 3. Valuation |
| 4. All of Above | 5. All of above | |

2.6. Exercise

A) Write the long answer of following questions.

1. What is meant by Vouching? What precautions taken while examining the voucher?
2. "Vouching is the essence of Audit". Explain the statement and give significance of vouching.
3. What is voucher? What are the duties and responsibilities of auditor while vouching?
5. What is meant by Verification of Assets? How does it differ from the term Valuation of Assets?
6. What is meant by Verification of Assets and Liabilities? How far is an auditor responsible for verification of assets?
7. What is valuation? State the rights of auditor's while valuation.
8. What is valuation? State how it is differ from verification and vouching.
9. What is Verification? What is process of verification of assets and liabilities?
10. What are principles of verification and valuation of assets and liabilities?

B) Write Short answers of following questions.

1. What are the objectives of Vouching?
2. Writ the significance of Vouching.
3. What is Process of verification?

4. Differentiate between Vouching and verification
5. Differentiate between Verification and Valuation.
6. State auditors' rights while vouching the transaction.

2.7. References for further study

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Unit-3

Audit Reports

Meaning, Elements, Types of Reports – Clean, Qualified, Adverse: Disclaimer of Opinion, Preparation of Audit Reports Audit of Specific Entities - Audit of Banks, Insurance Companies.

3.0. Objectives

3. 1. Introduction

3.2 Presentation of subject matter

3.2. 1 Audit Reports

3.2.1.1 Meaning,

3.2.1.2 Elements of Audit Report

3.2.1.3 Types of Audit Report

3.2.1.4 Preparation of Audit Report

Check your Progress I

3.2.2 Audit of Specific Entities

3.2.2.1. Introduction

3.2.2. 2 Audit of banks

3.2.2.3 Audit of Insurance Companies

Check Your Progress II

3.3 Summary

3.4. Glossary

3.5. Answers to check your progress

3.6. Exercise

3.7. References for further study

3.0. Objectives

After Studying this Unit you will be able to:

1. Understand the concept of Audit Report and Audit of Specific entities
2. Explain elements of Audit Report & types of Audit Report.
3. Explain the Audit of Specific entities like banks, and Insurance companies

3.1 Introduction

Audit can be defined as the examination in an orderly manner and in a critical, independent way of the accounts, records, and statements of an organization. In an audit, the primary purpose is to determine if the statements give an accurate and complete picture of the financial status and operations of the organization. The audit process involves various techniques such as vouching, verification, and valuation. After all this, the auditor analyses all the gathered evidence to form an opinion about the financial statements. This opinion is then made public in an audit report. An audit report, therefore, is the end result of the entire auditing process, and it acts as a means of communication between the auditor and the user of the financial statement.

3.2 Presentation of subject matter

3.2.1 Audit Report Meaning, Elements and types of Audit Report:

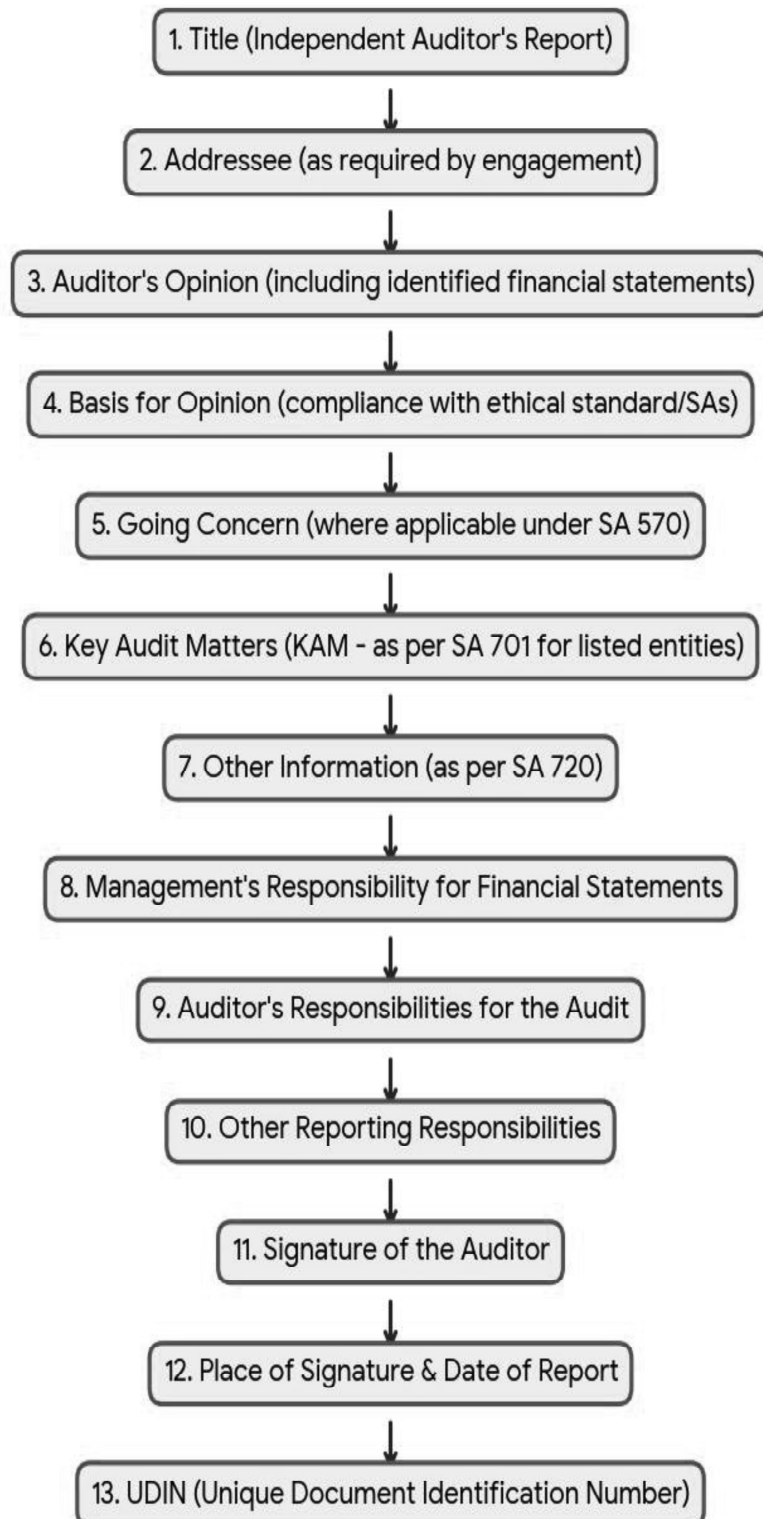
3.2.1.1 Meaning:

Audit Report can be defined as a formal letter issued by an independent auditor after assessing the financial statements, accounting records, and other related reports of the company. According to the SA 700 (Revised)-Forming an Opinion and Reporting on Financial Statements, the auditor provides their opinion regarding whether the financial statements give a true and fair view of the financial position and results of operations of the company. The audit report provides standardization in reporting in that it states explicitly the opinion of the auditor as well as the respective roles of the management and the audit.

3.2.1.2. Elements of Audit Report:

SA- 700 requires the use of specific headings, which are intended to assist in making the auditor's report more recognizable, where audit is conducted in accordance with the relevant Standards on Auditing.

The flowchart below illustrates the sequential order of elements required in an audit report under SA 700



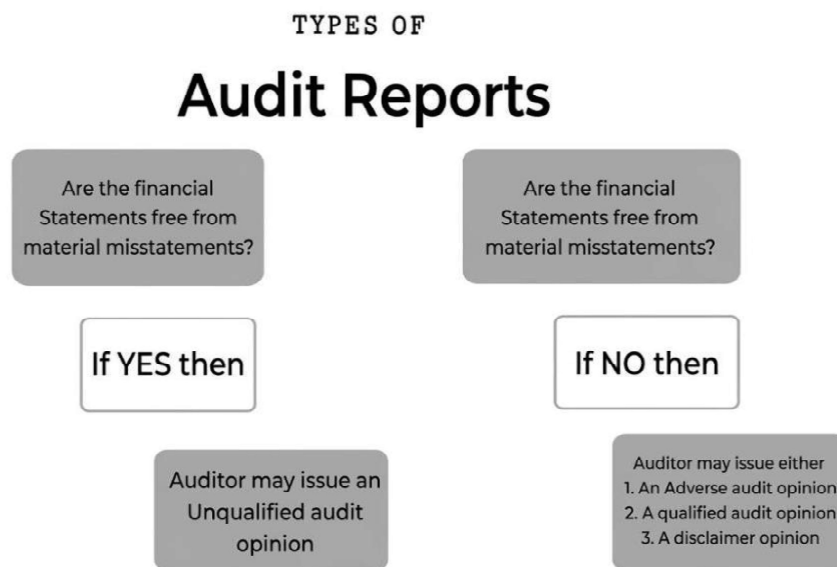
Mandatory Elements of the Audit Report

1. **Title:** Title should mention "Independent Auditor's Report".
2. **Addressee:** The addressee would generally be the shareholders /members/ those charged with governance.
3. **Opinion of the Auditor:** Mentioned just after the title. The opinion mentions the entity, says that financial statements have been audited, title of the statements, and clearly mentions the auditor's opinion (e.g., give a true and fair view).
4. **Basis for Opinions:** Mentions that the audit was carried out in accordance with SAs. It mentions the section about auditor responsibility, as well as mentioning the independence of the auditor and ethics related issues.
5. **Going Concern:** If any, then it will be mentioned in the report about the matters and uncertainties involved.
6. **Key Audit Matter (KAM):** KAM is to be communicated in case of Listed Entities or when required by law or regulation or when auditor decides to communicate key audit matters in the auditor's report.
7. **Other Information:** Mentioned here are other information included in the annual report apart from financial statements and auditor's responsibilities.
8. **Responsibilities of Management:** This mentions the responsibilities of the management of an entity related to the preparation and reporting, maintenance of internal control, and going concern.
9. **Responsibilities of Auditor:** Indicates that the aim is to provide reasonable assurance. Defines scope, exercising of professional scepticism, and risk reporting.
10. **Other Reporting Requirements:** Deals with other reporting requirements arising from legal and regulatory aspects (e.g., CARO reporting in India).
11. **Signature:** The signature may be individual or that of the firm's. Along with the signature, there shall be a member ID number.
12. **City of Signature and Date:** Mentions the place where the report is made and the date of signing by the auditor (not to be before the date on which management approves financial data).
13. **UDIN:** Unique identifier that can be verified on the ICAI website portal.

3.2 .1.4 Types of Audit Reports:

The Audit Report is the entire official document written by the auditor. It acts as a formal communication channel to shareholders, investors, and regulators. It contains the context of the audit, the responsibilities of management, and the work performed.

The Audit Opinion is a specific section located near the very beginning of the audit report. It is the core conclusion where the auditor delivers their final judgment on the financial statements.



1. Unqualified Audit Report (Clean Report):

An Unqualified Audit Report means that the auditor has reached the conclusion that:

- i. The financial statements are not materially misleading.
- ii. The accounting principles have been followed appropriately.
- iii. The disclosure has been adequate.
- iv. There has been enough audit evidence gathered.

Auditor's Opinion

The auditor will conclude that the financial statements present a true and fair picture of the financial affairs of the business.

Characteristics

- i. The best possible report.
- ii. Depicts good accounting systems.
- iii. Lack of any reservations on the part of the auditor.

Illustration

The business has maintained proper books of account and followed accounting principles. It has supplied all relevant data to the auditor. An unqualified report has been issued.

2. Modified Audit Report

When Financial Statements ARE NOT Free From Material Misstatements When the auditor identifies material issues or does not have sufficient evidence, he prepares a Modified Audit Report. This report may be:

- i. Qualified Opinion
- ii. Adverse Opinion
- iii. Disclaimer of Opinion

3. Qualified Report

This opinion is expressed where there is a material misstatement or scope limitation found by an auditor; however, the problem is not pervasive in nature (that means not impacting all of the accounts).

Opinion of the Auditor

"In our opinion, except for the effects of the above-mentioned matter, the financial statements provide a true and fair view."

- i. Qualification for a Qualified Opinion
- ii. Lack of sufficient information disclosures.
- iii. Wrong valuation of inventories.
- iv. Lack of compliance with accounting principles.
- v. Scope limitations.

Characteristics

- i. Majority of the information contained in the financial statements are reliable.
- ii. The problem is confined to certain areas only.
- iii. The reader must give importance to the qualification.

Example

No proper depreciation has been charged against the company's one type of asset. This is a material problem, but is not pervasive.

4. Audit Report with an Adverse Opinion

Definition: The Adverse Opinion is given when there are materiality and pervasiveness of misstatements that materially affect the overall set of financial statements.

Auditor's Opinion

The auditor opines that The financial statements lack the true and fair representation.

Reasons for Adverse Opinion

- i. Gross deviation from the requirements of accounting standards.
- ii. Material errors in accounting treatments.
- iii. Concealment of assets, liabilities, income or expenses.

Characteristics

- i. The most severe type of negative opinion.
- ii. The financial statements lack credibility.
- iii. The users need to use caution while using them.

Example

A business entity deliberately reports excess profits and assets, resulting in a gross misrepresentation in its financial statements. An adverse opinion is issued by the auditor.

5. Disclaimer of Opinion in Audit Report

Definition: Disclaimer of Opinion occurs where an auditor is unable to gather sufficient evidence and consequently cannot issue an opinion.

Auditor's Opinion

"An opinion about the financial statements cannot be expressed."

Causes of Disclaimer

- i. Lack of complete accounts.
- ii. Business management denies the auditor access to necessary information.
- iii. A severe limitation of scope in auditing.
- iv. Inability of the auditor to substantiate major transactions.

Characteristics

- i. The auditor is not able to form an opinion.
- ii. Not necessarily an indication of erroneous accounts.
- iii. Shows lack of substantial evidence.

Example

The accounting records of a firm are destroyed due to a fire incident. As such, the auditor cannot substantiate major balances. He gives a disclaimer of opinion.

The auditor's report is the final outcome of the audit process. If the financial statements are free from material misstatements, an Unqualified (Clean) Report is issued. If significant issues exist, the auditor issues a Qualified Opinion, Adverse Opinion, or Disclaimer of Opinion, depending on the nature and severity of the problem. These reports help shareholders, investors, creditors, and other users assess the reliability of the financial statements.

3.2.1.4 Preparation of Audit Report: The preparation of an audit report marks the final phase of the auditing process. Having examined the accounting records and statements, the auditor makes his/her judgment on the audit findings and issues a statement on the financial statements in form of the audit report.

Stages Involved in the Process of Preparing Audit Report:

1. **Concluding Audit Activity:** Completion of all procedures including auditing, verification, vouching, and testing of accounts.
2. **Assessment of Audit Evidence:** Review and analysis of audit evidence gathered to decide on its adequacy and relevance.

3. Examination of Financial Statements

Examination of:

- i. Balance Sheet
- ii. Profit and Loss Account
- iii. Cash Flow Statement
- iv. Notes to Accounts to verify its accordance with accounting principles.

4. Detection of Misstatements

Misstatements, omissions, fraudulent entries, and non-compliances are discovered by the auditor.

5. Formation of Auditor's Opinion

Audit conclusions are reviewed to formulate an opinion regarding financial statements:

- i. Unmodified or Unqualified Opinion
- ii. Qualified Opinion
- iii. Adverse Opinion
- iv. Denial of Opinion

6. Preparation of Audit Report: Auditing report is written following set guidelines and professional accounting principles.

7. Discussion of Report with Management: Major observations and findings are discussed with management prior to signing the report.

8. Conclusion and Signing of Report: Report is concluded, signed, and issued.

Auditing report preparation forms the last stage and is very crucial in auditing process. It entails evaluation of audit evidence, generation of audit opinion, preparing audit reports, and communication of audit results. This type of report increases credibility and accuracy of accounting information and enables the users to make informed decisions.

Check your progress: I

A) Multiple Choice Questions (MCQs)

- i) Audit Report is issued by:
 - a) Management
 - b) Internal Auditor
 - c) Independent Auditor
 - d) Accountant
- ii) Which Standard on Auditing deals with Audit Reports?
 - a) SA 230
 - b) SA 700
 - c) SA 500
 - d) SA 315
- iii) A Clean Audit Report is also called:
 - a) Qualified Report
 - b) Adverse Report
 - c) Disclaimer Report
 - d) Unqualified Report

- iv) Which opinion is issued when financial statements do not present a true and fair view?
 - a) Qualified Opinion
 - b) Unqualified Opinion
 - c) Adverse Opinion
 - d) Clean Opinion
- v) How many main types of audit opinions are there?
 - a) 2
 - b) 3
 - c) 4
 - d) 5

B) True or False

- i) Audit Report is the final outcome of the audit process.
- ii) A Qualified Opinion is the best type of audit opinion.
- iii) An Unqualified Report is also known as a Clean Report
- iv) An Audit Report is issued by the management of the company.
- v) A Disclaimer of Opinion is issued when the auditor cannot obtain sufficient audit evidence.

3.2.2 Audit of Specific Entities:

3.2.2.1 Introduction: Audit of Specific Entities means the examination of the accounts and financial statements of specialized organizations such as banks, insurance companies, cooperative societies, educational institutions, hospitals, and charitable trusts. Since these entities operate under different laws and regulations, the auditor must follow specific audit procedures. The main objective is to ensure the accuracy of financial records, compliance with legal requirements, and the presentation of a true and fair view of the entity's financial position. Among them, the audit of banks and insurance companies is of great importance due to their unique nature of operations and strict regulatory requirements

3.2.2.2 Audit of Banks:

Introduction: A bank is a financial institution that accepts deposits from the public and provides loans and other banking services. Since banks deal with public money, their audit is very important. Bank audit refers to the independent examination of the books of accounts, records, and financial statements of a bank to ensure that they present a true and fair view of its financial position and comply with the provisions of banking laws and regulations.

Meaning of Bank Audit: Bank audit refers to the evaluation and examination of the books of accounts and transaction of a bank by an independent auditor. This process ensures that there is no manipulation and also protects the money of the account holders.

Types of Bank Audit

Bank audits can be classified into the following types

- 1) **Statutory audit:** is performed in accordance with the provisions of the Banking Regulation Act of 1949 and Reserve Bank of India guidelines. It is conducted by independent Chartered Accountants who have been appointed for the purpose of giving their opinion on the bank's accounts.
- 2) An internal audit is carried out either by the bank's internal audit team or external individuals who have been selected by the bank.
- 3) **Concurrent Audit:** Concurrent audit is a continuous audit conducted throughout the year. Transactions are checked simultaneously with their occurrence.
- 4) **Revenue Audit:** Revenue audit focuses on the income and expenditure of the bank.
- 5) **Inspection Audit:** This audit is conducted by officials of the Reserve Bank of India to assess the financial health and compliance status of banks.
- 6) **Credit Audit:** Credit audit examines the quality of loans and advances granted by the bank.
- 7) **Information System (IS) Audit:** IS audit evaluates the bank's computerized systems, software, and information security measures.
- 8) **Special Audit:** Special audit is conducted when specific issues, frauds, or irregularities are suspected.

Conducting the Audit of Banks The audit of banks or their branches involves the following stages –

1. Initial consideration by the statutory auditor in regards to:
 - a) Declaration of Indebtedness
 - b) Internal Assignments in Banks by Statutory Auditors
 - c) Planning an Audit of Financial Statements
 - d) Communication with Previous Auditor
 - e) Terms of Audit Engagements
 - f) Initial Engagements
 - g) Assessment of Engagement Risks
 - h) Understanding the Bank and its Environment

2. Identifying and Assessing the Risks of Material Misstatements
3. Understanding the Bank and Its Environment including Internal Control
4. Understanding the Bank's Accounting Process
5. Understanding the Risk Management Process
6. Engagement Team Discussions
7. Establishing the Overall Audit Strategy
8. Developing the Audit Plan
9. Summarizing the audit plan by preparing an audit planning memorandum
10. Determining the Audit Materiality by considering the relationship between the audit
11. While obtaining an understanding of the bank, the auditor should consider whether there are events and conditions which may cast significant doubt on the bank's ability to continue as a going concern
12. Assessing the Risk of Fraud including Money Laundering
13. Assessing specific risks
14. Assessing the risk associated with outsourcing of activities
15. Responses to the Assessed Risks
16. Reviewing the other reports by taking into account the adverse comments, if any, such as:
 - a) previous year's audit reports
 - b) Latest internal inspection reports of bank officials
 - c) Reserve Bank's latest inspection report
 - d) Concurrent / Internal audit report
 - e) Report on verification of security
 - f) Any other internal reports specially related to particular accounts
 - g) Manager's charge-handing-over report when incumbent is changed

Audit of Assets and Liabilities in Banks: During the audit of a bank, the auditor is required to carefully examine each asset and liability. The specific matters that require special attention in respect of individual assets and liabilities are explained below."

Audit of Major Heads of Bank Balance Sheet:

1. Capital Audit: Procedures

- i. Verification of authorized, issued, subscribed and paid up capital from Memorandum and Articles of Association.
- ii. Inspection of share register and share certificates.
- iii. Verification of resolutions pertaining to issuance of shares.
- iv. Conformity of any variation in capital with appropriate authorization.
- v. Proper disclosure in Balance Sheet.

2) Reserves & Surplus: Audit Procedures

- i. Verification of balance of each reserve against corresponding figure in the last audited balance sheet.
- ii. Board's resolutions for appropriation of profits.
- iii. Statutory reserves in accordance with banking regulations.
- iv. Verification of the Profit and Loss Appropriation Account.
- v. Proper disclosure of reserves and surplus.

3) Deposits:

- i. Balance verification from Deposit Ledgers.
- ii. Balances of Savings Current and Fixed Deposit Accounts.
- iii. Test verification of customer account balances.
- iv. Verification of interest calculation of deposits.
- v. Large, unusual entries to be scrutinized.
- vi. Deposits to be correctly classified.

It is the responsibility of the auditor to ensure that there is no omission of deposits in the books.

4) Borrowings

- i. Confirm borrowings with RBI and other banks.
- ii. Verify loan agreements and sanction letters.
- iii. Verify interest charges on borrowings.
- iv. Borrowings must be accounted for and disclosed.
- v. Verify the outstanding balance

5) Other Liabilities and Provision: Audit Procedures

- i. Confirm bills payable against relevant documentation.
- ii. Confirm uncharged expenses and accrued liabilities.
- iii. Confirm provision for taxation and bad debts.
- iv. Evaluate contingent liabilities like guarantees and letters of credit.
- v. Liabilities should not be overvalued or undervalued.
- vi. Assets Side

6. Cash In-hand and With Reserve Bank of India (RBI) Audit Procedures:

- i. Physical verification of cash on hand.
- ii. Cash counting involving notes and coins.
- iii. Verification of balances with RBI through certificates of confirmation.
- iv. Comparing balances with Cash Book and General Ledger.
- v. Reconciliation statements should be reviewed.
- vi. Noteworthy: Cash is highly prone to fraud; thus, physical verification is very important.

7. Balances with Other Banks and Money at Call and Short Notice Audit Procedures

- i. Taking confirmations from other banks.
- ii. Checking inter-bank reconciliation.
- iii. Reviewing short term loan contracts.
- iv. Classification of balances should be verified.

8. Investments: following procedure for Investment checking and verification:

- i. Check the List all investments.
- ii. Inspect securities or dreamt accounts.
- iii. Insure documentation of ownership.
- iv. Check that investments are being appropriately valued as per RBI.
- v. Confirm receipts of interest and dividends.
- vi. Sale and purchase confirmations.
- vii. The auditor should make sure that the same investment is not being listed twice.

9. Advances (Loans, Overdrafts, and Cash Credits) Audit Procedures for Advances checking :

- i. Advances represent the largest item on the assets side of the balance sheet of a bank.
- ii. Check NPAs.
- iii. Check the sanction letter and agreement.
- iv. Classify loans into standard, sub-standard, doubtful, and loss assets.
- v. Confirm interest calculation and recovery.
- vi. Confirm provisions against doubtful debts.
- vii. Government securities, Fixed deposits, Properties, Stock-in-trade, Life insurance policies, Bullion
- viii. Look into security and collateral.
- ix. See that the loans have been properly authorized.
- x. Special Verification of Advances against:

10. Bills Purchased and Discounted

- i. Audit should: Verify bills actually held by the bank.
- ii. Confirm maturity dates. Detect overdue bills.
- iii. Confirm discounting income earned.
- iv. Compare balance with Bills Discounted Ledger.

11. Fixed Assets: Audit Procedures

- i. Check title deed of land/buildings.
- ii. Verify purchase invoices. ,Conduct physical inspection of fixed assets. Confirm calculations related to depreciation.
- iii. Ensure fixed assets recorded at proper amount.
- iv. Included under: Land & Buildings, Furniture & Fixtures
- v. Computers, Office Equipment

12. Other Assets: Verify interest accrued on account.

- i. Check advance payments for taxes.
- ii. Check stationery record.
- iii. Verify other miscellaneous assets.

In short During an audit of the bank, the auditors will give more emphasis to accounts like Cash, Investments, Loans and Advances, Deposits, Borrowings, and Other Liabilities because these particular accounts have a huge effect on the financial status of the bank. Verification helps in avoiding errors and frauds in the financial statements.

Audit of Bank Income (Revenue) – Auditor's Duties

The auditor's main objective is to ensure that all income of the bank is correctly recorded, relates to the relevant accounting period, and is recognized according to accounting standards and RBI guidelines.

- 1) Interest, fees, commission, and discount income are usually accrued since these incomes occur when realized, and not when received. The accrual of income can happen if there is reasonable assurance about the collection of the amount. Hence, the auditor needs to ensure if there was a correct application of the principle in the recognition of income by the bank. Where it comes to non-performing assets (NPA), interest income should not be accrued since there is uncertainty in recovering the same. It should be accrued only when cash is received. Moreover, any accrued interest recognized as an income for accounts which turned into NPA accounts should have been reversed.
- 2) The auditor should carefully examine interest income earned on loans, advances, overdrafts, and cash credit accounts. In the case of advances secured against Term Deposits, National Savings Certificates (NSCs), Kisan Vikas Patras (KVPs), Indira Vikas Patras (IVPs), and Life Insurance Policies, the auditor should ensure that adequate margin is available before recognizing interest income on the due date.
- 3) Particular attention should be paid to bills purchased and discounted. The auditor should verify that the discount received on such bills is properly apportioned between the current accounting year and the subsequent year whenever bills remain outstanding at the balance sheet date. He should also ensure that any discount or interest paid by the bank on rediscounting bills with other financial institutions is shown separately and is not deducted from the discount income earned.
- 4) The auditor should also examine income from bills sent for collection. He must verify that customers' accounts are credited only after the actual realization of the bills and that commission income is recognized only when the collection has been successfully completed. Similarly, fees and commissions earned from banking services such as guarantees, letters of credit, remittances, and other customer services should be checked with supporting records and properly accounted for.
- 5) Where loans have been renegotiated or rescheduled, any fees and commissions earned should not be recognized immediately. The auditor should verify that such income is recognized on an accrual basis over the period covered by the revised credit arrangement. Finally, the auditor should review all major income accounts, compare them with previous

years, investigate unusual variations, and ensure that the bank has complied with RBI guidelines and accounting standards relating to income recognition. Through these procedures, the auditor can ensure that the income reported in the financial statements presents a true and fair view of the bank's earnings.

Audit of Bank Expenses:

Expenditure is to be shown under three broad heads:

- 1) Interest expense
- 2) Operating expense
- 3) Provisions and contingencies.

The auditor is primarily concerned with assessing the overall reasonableness of the amount of interest expense by analyzing ratios of interest paid on different types of deposits and borrowings to the average quantum of the respective liabilities during the year. For this, an auditor may obtain from the bank analysis of various types of deposits outstanding at the end of each quarter. From such information, the auditor may work out a weighted average interest rate. The auditor may then compare this rate with the actual average rate of interest paid on the relevant deposits as per the annual accounts and enquire into the difference if material. Also, an analytical review of corresponding figures for the previous years should be done to find out material differences, if any.

Long Form Audit Report The terms of appointment of auditors of public sector banks, private sector banks, and foreign banks including its branches. Besides, the audit report requires auditors to furnish a long-form audit report (LFAR). It includes a detailed questionnaire prepared by the Reserve Bank of India. LFAR is to be submitted before 30th June every year for the completion of which on time proper planning is required. LFAR does not have the requirement for executive summary. However, members may consider providing the same to bring out the key observations from the whole document.

Reporting to RBI RBI issued a Circular relating to the liability of the accounting and auditing profession, where the matter should be referred to RBI, in case an auditor finds any fraudulent activity or act of excess power or any foul play in any transaction. Any deliberate failure on the part of the auditor should render himself liable for action.

An audit is performed in a bank to verify whether or not its financial statements give a true and fair view of its financial performance and position. The auditor reviews the loans and advances, deposits, investments, income generation, provisions for NPAs, cash, and any other guidelines provided by the Reserve Bank of India. Focus is particularly laid on internal control, risk management, statutory issues, and correctness of accounting records. This helps to gain reasonable assurance about the bank's accounts.

3.2.2.3 Audit of Insurance Companies:

Meaning of Audit of Insurance Companies:

Auditing of an insurance company refers to the impartial checking of its accounts, financial statement, policies, claims, investments, and internal control system to ascertain that the company complies with Insurance Act, IRDAI regulations, and other laws relevant to insurance business. In auditing, the auditor checks whether the financial statement reflects a true and fair view of financial status and performance of the insurance company.

Legal and Regulatory Environment

- 1) The auditing process of the insurance companies is guided by the below stated laws and regulations; Insurance Act of 1938, IRDA Act of 1999, IRDAI Regulations, Companies Act of 2013
- 2) Reserve for Unexpired Risks IRDA (General Insurance-Claim Reserving) Regulations, 2013 requires creation of a minimum amount of unexpired risks reserve at a specified percentage of net premium as under:
 - For Marine Hull insurance – 100% of net premium
 - For Fire, Marine Cargo & Misc. business – 50% of net premium.

Note: Sec. 64V of Insurance Act, 1938 also specifies these percentages. Subsequent to Amendment Act of 2015, these percentages are no more specified in amended Section 64V

Regulatory Requirements:

1 Requirement as to Capital – Sec. 6 Minimum paid-up equity share capital of an Indian insurance company carrying on insurance business should be Rs 100 crores excluding preliminary expenses incurred in the formation and registration of company.

2 Appointment of Auditors • Appointment of statutory auditors of GIC, its subsidiaries and divisions are made by the CAG of India. • In case of others, auditor is appointed at the AGM ensuring compliance of IRDAI Guidelines on Corporate Governance. • An auditor can conduct audit only for 3 insurance companies and not more than 2 Life or 2 General. • Guidelines also mandate a mandatory joint audit for all insurance companies.

3 Sufficiency of Assets or Solvency Margin – Sec. 64VA • Requirement of solvency margin: Every insurer and re-insurer shall at all times maintain an excess of value of assets over the amount of liabilities of, not less than 50% of the amount of minimum capital. • Non-compliance of solvency margin: Insurer or re-insurer, who does not comply with requirement of solvency margin shall be deemed to be insolvent & may be wound-up by court on application made by IRDA. • Power of authority to prescribe level of solvency:

Audit of Life Insurance Business:

Actuarial Valuation: The actuary performs the calculation of liability, reserves, rates, and adequacy of the provision for solvency.

Role of Auditor:

- i. To certify, whether the actuarial valuation of liabilities is duly certified by the appointed actuary, including to the effect that the assumptions for such valuation are in accordance with the guidelines and norms, issued by IRDA.
- ii. For this purpose, auditors generally rely on the Certificate issued by the Appointed Actuary, certifying the Policy liabilities. However, he may discuss with the Actuaries with respect to process followed and assumptions made by him before certifying the Policy liabilities

Process of Underwriting

Underwriter assesses the risk and determines the premium to be charged

Audit Procedure: To review the process of acceptance of risk through the underwriting process.

I. Evaluate and test the effectiveness of internal controls in place to ensure timely and accurate Insurance policy, adherence to the IRDA Act and Rules and regulations made thereunder.

Reinsurance: It is a risk mitigating tool adopted by Insurer whereby the risk underwritten by one Insurer is transferred partially to another Insurer.

Auditor Require to check:

- i. To check and confirm that reinsurance premium calculation and payment is in accordance with the agreement with the reinsurer.
- ii. To check whether necessary provision has been made for outstanding reinsurance premium and is properly accounted for in books of account.
- iii. To verify the agreements entered with the reinsurer
- iv. To verify whether Insurer has adhered to terms and conditions of agreement.
- v. To verify payments made to the reinsurer

Free Look Cancellation (FLC): It is an option wherein policyholder has a period of 15 days from date of receipt of policy document to review the T & C and in case of any disagreement, he/she has the option to return the policy

- i. To check and confirm that Free Look Cancellation requests are received within 15 days from receipt of policy document by the policy holder.
- ii. To verify signatures of the policy holder and processing of Free look cancellation request within time defined by the insurer.
- iii. To check recording of appropriate accounting entries for refund.

Policy Lapse and Revival: Discontinuation of policy owing to non-payment of premium dues is known as lapse. A lapsed policy ceases to provide insurance protection to the insured. Terms & conditions of the policy stipulate, that where the premium is not paid within the grace period, the policy lapses but may be revived during the life time of the life assured

Auditor require:

- i. To check and confirm that due dates are recorded and monitored properly and policies are marked as “lapsed” on non-receipt of renewal premium within grace period.
- ii. In case of revival request, check whether adequate checks are in place for receipt of outstanding amounts and adequate documents are obtained before reviving the policy

Policy Surrender: Voluntary termination of the insurance contract before expiry of the term of the contract is known as surrender of policy. A policy becomes eligible for surrender on completion of 3 years from the commencement of the policy provided that 3 years premium have been paid within the due dates. • The policy holder has to submit surrender request form duly signed off by him along with the original policy document and the discharge voucher.

Role of Auditor:

- (a) To check and confirm that surrender requests are received from the policy holder only.
- (b) To check that adequate controls are in place to ensure proper verification process for checking of request, whether premiums are paid on regular basis.
- (c) To check whether surrender amount is paid only to the policy holder and is paid only as per T & C.
- (d) To check whether appropriate accounting entries are passed.

Premium Collection: Premium refers to consideration received by insurance company from the policy holder.

Following point considered for Audit of Premium:

- a) Collection of Premium • To check existence of appropriate mechanism to ensure all the collections are deposited into the Bank on timely basis. • To check whether there is daily reconciliation process to reconcile the amounts collected, entered into the system and deposited into the bank.
- b) Calculation of Premium • Check that accounting system calculates premium amounts & due dates correctly. • Check that system is equipped to calculate all types of premium modes correctly.
- c) Recognition of Income • Ensure that premium is recognised only on the basis of 'Issued Policies'. • To check that there is appropriate mechanism in place to conduct reconciliation on daily basis and reconciling items, if any, are rectified.
- d) Accounting of 'Advance Premium' • To check, whether system has capability to identify regular and advance premium. • To check whether there is a process of applying advance premium to a contract when premium is due.

Claims: Primary objective of Audit of Life Insurance Companies is checking of accuracy of processing and accounting of claims with focus on the following areas:

Review policy document to ensure that it prescribes documentary evidence needed to support a claim.

- i. Ensure that a register of claims is maintained, in which every claim is entered along with details.
- ii. Review the reasons for the rejections, in case of rejection of claims.
- iii. Ensure complete recording of all claims received.
- iv. Ensure that appropriate provisioning has been carried out, in cases of claims intimated but not paid.
- v. Ensure that cost of claims includes the claims settlement cost.
- vi. Ensure that there is system of regular reconciliation is carried out between claims management system and General ledger.
- vii. Ensure that liability of claims should be booked net of reinsurance.

Investments: The Investment portfolio of Life Insurance companies comprise of Shareholders' funds and Policyholders' funds.

Auditor require to follow following procedure:

- (a) Review management structure to ensure adequate segregation of duties.
- (b) To review the operating procedures prescribed by the IRDA Regulations.

- (c) To review of investment policy.
- (d) To review the functioning and scope of Investment Committee.
- (e) To check compliance of Investment regulations.
- (f) To review cash management system to track funds available for investment considering the settlement obligations and subscription and redemption of units, etc.
- (g) To review fund wise reconciliation with investment accounts, bank, & custodian records.
- (h) To ensure that there is split between Shareholders' and Policyholders' funds, and earmarking of securities between various funds namely Life, Pension, Group etc.
- (i) To review the arrangements and reconciliations of holdings with the insurer's custodian.
- (j) To review and check insurer's Investment Accounting and valuation policy.
- (k) To review the controls around personal dealings and insider trading.

Commission Payable: Agency commission contributes towards significant portion of expenses incurred by the Insurance Commission.

Audit Procedure for that:

- (a) Review the system established by the Insurer with respect to calculation of commission to eligible agents accurately and processing the same in timely manner.
- (b) Review the commission payment system is in sync with the premium collection system.
- (c) Check whether commission paid is within the limit prescribed under Insurance Act.
- (d) Check whether commission is clawed-back on the cancelled policies.
- (e) Check the completeness of commission processing system.

Operating Expenses: All administrative expenses are broadly classified under 14 heads as mentioned in Schedule 3 forming part of Financials statements

- a) To ensure that operating expenses are first aggregated and then apportioned to the Revenue Account of each class of business on a reasonable and equitable basis.
- (b) To ensure that the accounting policy should clearly indicate the basis of apportionment of these expenses to the respective Revenue Accounts (i.e., Participating and Nonparticipating policies and in between Linked and Non-Linked business) along with

the certificate that all expenses of management, wherever incurred, directly or indirectly, read with the accounting policy, have been fully debited to the respective Revenue.

In addition, compliance with the prescribed code of conduct and other statutory requirements for insurance companies must also be ensured. Lastly, the auditor needs to check whether the annual accounts have been prepared in the prescribed form and in accordance with applicable law.

Check your progress: II

A) Multiple Choice Questions (MCQs)

- i) Non-Performing Asset is known as:
 - a) NPV
 - b) NPA
 - c) NPC
 - d) NPB
- ii) LFAR stands for:
 - a) Long Form Audit Report
 - b) Legal Form Audit Report
 - c) Long Financial Audit Report
 - d) Limited Form Audit Report
- iii) Which authority regulates insurance companies in India?
 - a) RBI
 - b) SEBI
 - c) IRDAI
 - d) NABARD
- iv) Premium is paid by:
 - a) Insurance Company
 - b) Auditor
 - c) Policyholder
 - d) Agent
- v) Reinsurance means:
 - a) Cancellation of policy
 - b) Transfer of risk to another insurer
 - c) Refund of premium
 - d) Payment of claim

B) True or False

- i) Interest on NPAs should be recognized on an accrual basis.
- ii) Reinsurance helps an insurer reduce risk.
- iii) Premium is paid by the insurance company to the policyholder.
- iv) Claims represent amounts payable by an insurance company to policyholders.
- v) Audit of insurance companies includes verification of claims and investments.

3.3 Summary:

An Audit Report refers to the final report produced by the auditor following their assessment of the financial statements of an organization. Based on the findings of the audit, there are several types of audit reports including unqualified, qualified, adverse, and disclaimer of opinion reports.

Audit of Specific Entities includes the audit of specialized organizations such as banks and insurance companies, which are governed by specific laws and regulations. In a bank audit, the auditor examines deposits, loans and advances, investments, cash balances, income recognition, NPAs, and compliance with RBI guidelines. In an insurance company audit, the auditor verifies premium collections, claims settlement, reinsurance transactions, investments, commission payments, reserves, and compliance with IRDAI regulations.

3.4 Glossary:

- 1 **Audit** : Independent examination of financial records to express an opinion on financial statements.
- 2 **Audit Report** : Final report issued by the auditor expressing an opinion on the financial statements.
- 3 **SA 700** : Standard on Auditing dealing with forming an opinion and reporting on financial statements.
- 4 **Unqualified Report** : A clean audit report indicating that financial statements present a true and fair view.
- 5 **Qualified Report** : Audit report issued when specific material misstatements exist but are not pervasive.
- 6 **Adverse Opinion** : Opinion stating that financial statements do not present a true and fair view.
- 7 **Disclaimer of Opinion** : Report issued when the auditor cannot obtain sufficient audit evidence.
- 8 **Key Audit Matter (KAM)** : Significant matters that required special attention during the audit.
- 9 **Going Concern** : Assumption that an entity will continue its operations in the foreseeable future.
- 10 **Bank Audit** : Examination of a bank's accounts, records, and financial statements
- 11 **NPA (Non-Performing Asset)** : A loan on which interest or principal remains overdue for a specified period.
- 12 **LFAR** : Long Form Audit Report submitted by bank auditors to the RBI.

- 13 Insurance Audit :** Audit of insurance companies to ensure compliance with insurance laws and regulations.
- 14 IRDAI :** Insurance Regulatory and Development Authority of India, the regulator of the insurance sector. Insurance Regulatory and Development Authority of India
- 15 Reinsurance :** Transfer of a part of insurance risk from one insurer to another insurer.
- 16 Actuarial Valuation :** Scientific assessment of insurance liabilities and reserves by an actuary.
- 17 Premium :** Amount paid by a policyholder to obtain insurance coverage.
- 18 Claim :** Amount payable by an insurance company to the insured on occurrence of an insured event.
- 19 Solvency Margin :** Excess of assets over liabilities maintained by an insurance company to meet future obligations.

3.5 Answers to check your progress –

Section I . A) MCQ

- | | |
|----------------------------|------------------------|
| i) c) Independent Auditor | ii) b) SA 700 |
| iii) d) Unqualified Report | iv) c) Adverse Opinion |
| v) c) 4 | |

B) True or False

- i) True ii) False iii) True iv) False v) True

Section II: A) MCQ:

- | | |
|---|-------------------------------|
| i) b) NPA | ii) a) Long Form Audit Report |
| iii) c) IRDAI | iv) c) Policyholder |
| v) b) Transfer of risk to another insurer | |

B) True or False

- i) False ii) True iii) False iv) True v) True

3.6. Exercise -

Long Answer Type Questions:

- 1) Define Audit Report. Explain the meaning and elements of an Audit Report.
- 2) Explain the different types of Audit Reports

- 3) Discuss the audit procedures for major assets and liabilities of a bank.
- 4) Explain the auditor's duties in the audit of bank income and expenses
- 5) Explain the audit procedures relating to premium collection, claims, and investments in an insurance company

Short Notes

- 1) What is meant by an Unqualified Audit Report
- 2) What is Actuarial Valuation?
- 3) What is meant by Premium?
- 4) State the auditor's duties regarding investments in insurance companies
- 5) What is a Disclaimer of Opinion?

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Unit-4

Audit of Companies

– Provisions regarding Audit in the Companies Act 2013 Eligibility, Qualifications and Disqualifications of Auditors; Appointment of auditors; Removal of auditors; Remuneration of Auditors; Powers and duties of auditors; Reporting requirements under the Companies Act, 2013 including CARO.

4.0. Objectives

4.1. Introduction

4.2. Presentation of Subject Matter

4.2.1. Section I

4.2.1.1. Eligibility, Qualification & Disqualification of an Auditor

4.2.1.2. Appointment of Auditors

4.2.1.3. Removal of Auditors

4.2.1.4. Remuneration of Auditors

Check Your Progress I

4.2.2. Section II

4.2.2.1. Powers /Rights of Auditors

4.2.2.2. Duties of an Auditor

4.2.2.3. Reporting Requirements under the Companies Act, 2013 Including CARO, 2020

Check Your Progress II

4.3. Summary

4.4. Glossary

4.5. Answer to Check Your Progress

4.6. Exercise

4.7. Reference for further study

4.0. Objectives:

1. After studying this unit you will be able to:
 1. Understand the concept, importance, and legal provisions relating to audit under the Companies Act, 2013.
 2. Explain the eligibility, qualifications, and disqualifications of auditors as prescribed under the Act.
 3. Describe the procedures for appointment, reappointment, removal, and remuneration of auditors.
 4. Identify the powers, rights, and duties of auditors in carrying out an independent audit of a company.
 5. Understand the reporting responsibilities of auditors and the contents of the auditor's report.
 6. Explain the provisions and significance of the Companies (Auditor's Report) Order (CARO), 2020.
 7. Analyze the role of auditors in ensuring transparency, accountability, and good corporate governance in companies.

1. Introduction:

The Companies Act, 2013 lays down a comprehensive framework for the audit of companies through Sections 139 to 148. These provisions specify the criteria for the appointment of auditors, including their qualifications and disqualifications, and prescribe the procedures for their appointment, reappointment, resignation, and removal. The Act also defines the powers and duties of auditors to ensure that they perform their duties independently and objectively. In addition, it covers matters relating to audit reports, auditor remuneration. Collectively, these provisions aim to promote transparency, strengthen corporate governance, and enhance the reliability of financial statements for the benefit of shareholders.

4.2. Presentation of Subject Matter

4.2.1. Section I

4.2.1.1. Eligibility, Qualification & Disqualification of an Auditor:

The provisions relating to eligibility, qualifications and disqualifications of an auditor are governed by section 141 of the Companies Act, 2013. The main provisions are stated below:

4.2.1.1.1. Qualification:

i) As per section 141 (1) of the Companies Act, 2013, a person shall be eligible for appointment as an auditor of a company only if he/she is a Chartered Accountant (CA). It may be noted that a firm (including LLP) whereof majority of partners practicing in India are qualified for appointment as auditor may be appointed by its firm name to be auditor of a company.

ii) Where a firm including a Limited Liability Partnership (LLP) is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm.

4.2.1.1.2. Disqualification: Under section 141 (3) along with Rule 10 of the Companies (Audit and Auditors) Rules, 2014 (hereinafter referred as CAAR), the following persons shall not be eligible for appointment as an auditor of a company, namely-

- a) A body corporate, except a Limited Liability Partnership (LLP) registered under the Limited Liability Partnership Act, 2008.
- b) An officer or employee of the company.
- c) A person who is either a partner of, or employed by, an officer or employee of the company.
- d) A person who or whose relative or partner:
 - i) Holds securities or interest in the company or its related companies (subsidiary, holding or associate companies) not exceeding Rs 100000.
 - ii) Is indebted to the company or its related companies (subsidiary, holding or associate companies) exceeding Rs 500000.
 - iii) Has provided guarantee or security for the debt of a third person to the company or its related companies (subsidiary, holding or associate companies) exceeding Rs 100000.
- e) Any individual or audit firm that maintains a direct or indirect business relationship with the company, its subsidiary, holding company, associate company, or their subsidiaries, of a nature prescribed under the relevant rules.
- f) A person whose relative is a director of the company or is employed in the company as a director or Key Managerial Personnel (KMP).
- g) A person engaged in full-time employment elsewhere, or a person or partner of an audit firm who already holds audit appointments in more than twenty companies,

excluding One Person Companies, dormant companies, small companies, and private companies having a paid-up share capital of less than Rs. 100 crore.

- h) A person who has been convicted by a court of an offence involving fraud and for whom a period of ten years has not elapsed from the date of conviction.
- i) A person who directly or indirectly renders any service referred to section 144 to the company or its holding company or its subsidiary company.

4.2.1.2. Appointment of Auditors

Section of 139 of Companies Act, 2013 provides provisions regarding appointment of auditors. Following points describes appointment provisions of auditors of companies:

Appointment of Auditor			
First Auditors		Subsequent Auditors	
Other than Government Company [Section 139(6)] ↓ Appointment by BOD within 30 days from DOR ↓ In case of Failure: Members in EGM within 90days ↓ Hold the office till the conclusion of the first AGM	Government Company u/s 2(45) [Section 139(7)] ↓ Appointment by C&AG within 60 days from the DOR ↓ In case of Failure: BOD within 30days ↓ In case of Failure: Members in EGM within 60days ↓ Hold the office till the conclusion of the first AGM	Other than Government Company [Section 139(1)] ↓ Appointment by Members in GM ↓ Hold the office from 1 st AGM to 6 th AGM	Government Company u/s 2(45) [Section 139(5)] ↓ Appointment by C&AG within 180days from the commencement of financial year ↓ Hold the office till the conclusion of the AGM
BOD: Board of Directors, EGM: Extraordinary General Meeting, C&AG: Comptroller and Auditor General of India		AGM: Annual General Meeting, DOR: Date of Registration	

4.2.1.2.1. Appointment of First Auditor

A. Appointment of First Auditor in Non-Government Companies (Other than Government Companies):

1. According to Section 139 (6) of the Companies Act, 2013, the Board of Directors shall appoint the first auditor within 30 days from the date of registration of the company.
2. If the Board of Directors fails to make the appointment within this period (within 30 days from registration), it must inform the shareholders. The shareholders will then appoint the first auditor at an Extraordinary General Meeting (EGM) within 90 days from the date of registration.
3. The first auditor appointed in this manner will continue in office until the conclusion of the first Annual General Meeting (AGM).

B. Appointment of First Auditor in Government Companies:

1. As per Section 139 (7), the first auditor of a Government company is appointed by the Comptroller and Auditor General of India (C&AG) within 60 days from the date of registration.
2. If the Comptroller and Auditor General of India (C&AG) does not appoint the first auditor within this period, the Board of Directors shall appoint the auditor within the next 30 days.
3. If the Board also fails to appoint the auditor, the shareholders must appoint the auditor at an Extraordinary General Meeting within the following 60 days. The first auditor so appointed will hold office until the conclusion of the first AGM.

Government Company: A Government company is a company in which at least 51% of the paid-up share capital is owned by the Central Government or any State Government or two or more State Governments, or jointly by Central Government & State Government. It also includes a subsidiary of such a company.

4.2.1.2.2. Appointment of Subsequent Auditor/Reappointment of Auditor:

A. Appointment of Subsequent Auditor in Non-Government Companies (Other than Government Companies):

Under Section 139(1), every company must appoint an auditor at its first AGM. The auditor may be an individual or a firm and will hold office from the end of that AGM until the end of the sixth AGM.

Before the appointment is made:

1. The auditor must provide written consent and a certificate to act as auditor shall obtained accordance with the conditions as may be prescribed.
2. The auditor must submit a certificate confirming that he, she, or the firm meets the eligibility requirements specified under Section 141.

After the appointment:

1. The company must inform the auditor about the appointment.
2. The company must file the details of the appointment with the Registrar of Companies (ROC) within 15 days of the AGM.

B. Appointment of Subsequent Auditor in Government Companies:

1. According to Section 139(5), the Comptroller and Auditor General of India (C&AG) appoints an auditor duly qualified to be appointed as auditor of Government companies for each financial year.
2. The appointment must be made within 180 days from the beginning of the financial year. The auditor remains in office until the conclusion of the relevant annual general meeting.

Quick Summary (Appointment of Auditor)

Type of Company	First Auditor	Subsequent Auditor
Non-Government Company	Board within 30 days; if not, shareholders within 90 days, holds office until the conclusion of first AGM	Appointed at first AGM and holds office till sixth AGM
Government Company	C&AG within 60 days; then Board within 30 days; then shareholders within 60 days, holds office until the conclusion of first AGM	Appointed by C&AG within 180 days from the commencement of the financial year holds office until the conclusion of relevant AGM

4.2.1.2.3. Appointment to Fill a Casual Vacancy

A casual vacancy arises when the office of an auditor becomes vacant before the completion of the auditor's tenure due to reasons such as resignation, death, or disqualification.

A. Casual Vacancy in a Non-Government Companies/other than government Companies:

1. According to Section 139(8) of the Companies Act, 2013, the Board of Directors must fill a casual vacancy within 30 days.
2. If the vacancy occurs because of the auditor's resignation, the appointment made by the Board must also be approved by the shareholders at a General Meeting held within three months of the Board's recommendation.
3. The auditor appointed to fill such vacancy will continue in office until the conclusion of the next Annual General Meeting (AGM).

B. Casual Vacancy in Government Companies:

1. In the case of a Government company, the casual vacancy is filled by the Comptroller and Auditor-General of India (C&AG) within 30 days.
2. If the C&AG fail to fill the vacancy within this period, the Board of Directors must appoint an auditor within the next 30 days.

4.2.1.2.4. Casual Vacancy Caused by Resignation

As per Section 140(2), when an auditor resigns from a company, he or she must submit a statement explaining the reasons for resignation and any relevant facts.

For other than Government companies, this statement must be filed in Form ADT-3 (as per Rule 8 of CAAR) with the company and the Registrar of Companies (ROC) within 30 days from the date of resignation.

For Government companies, the auditor must also send a copy of the statement to the C&AG along with the company and the Registrar of Companies (ROC).

Penalty for Non-Compliance

Under Section 140(3), if the auditor fails to file the required statement:

1. A penalty of Rs. 50,000 or the auditor's remuneration, whichever is lower, may be imposed.
2. In case the failure continues, an additional penalty of Rs. 500 per day may be charged.
3. The maximum penalty cannot exceed Rs. 5,00,000.

4.2.1.2.5. Other Important Provisions Relating to Appointment of Auditors

i) Reappointment of a Retiring Auditor: A retiring auditor can be reappointed at an AGM if the following conditions are satisfied:

- a) The auditor is eligible and not disqualified for reappointment.
- b) The auditor has not informed the company in writing that he or she does not wish to continue.
- c) The shareholders have not passed a special resolution appointing another auditor or specifically deciding not to reappoint the retiring auditor.

ii) Continuation of Existing Auditor: If no auditor is appointed or reappointed at an AGM, the current auditor will continue to act as the auditor of the company until a new appointment is made according to the provisions of the Act.

4.2.1.3. Removal of Auditors

An auditor appointed under Section 139 of the Companies Act, 2013 cannot be removed from office before the completion of his or her term merely at the discretion of the company. According to Section 140(1), an auditor may be removed before the expiry of the term only after obtaining the prior approval of the Central Government and passing a Special Resolution in a general meeting of the company. The procedure for obtaining such approval is prescribed under Rule 7 of the Companies (Audit and Auditors) Rules, 2014. Following points explain the procedure of removal of auditors:

- 1. Passing of Board Resolution:** The process of removal of auditors begins with a meeting of the Board of Directors. If the Board considers it necessary to remove the auditor before the expiry of the term, it must pass a resolution proposing such removal and authorizing the filing of an application with the Central Government.
- 2. Application to the Central Government:** After passing the Board Resolution, the company is required to submit an application to the Central Government in Form ADT-2. The application must be accompanied by the prescribed fee as specified under the Companies (Registration Offices and Fees) Rules, 2014.
- 3. Time Limit for Filing ADT-2:** The application in Form ADT-2 must be filed within 30 days from the date on which the Board Resolution is passed. Failure to comply with this time limit may affect the validity of the removal process.
- 4. Approval of the Central Government:** The Central Government examines the application and the reasons provided by the company for seeking removal of the auditor. If satisfied, it grants approval for the proposed removal.
- 5. Passing of Special Resolution:** Once the approval of the Central Government is received, the company must convene a General Meeting of its members. A Special Resolution for the removal of the auditor must be passed within 60 days from the date of receipt of such approval.

- 6. Opportunity of Being Heard:** Before any action is taken for the removal of an auditor, the auditor concerned must be given a reasonable opportunity of being heard. This is a statutory right provided under the Act to ensure fairness and natural justice. The auditor may present explanations, objections, or representations regarding the proposed removal.

The requirement of prior approval from the Central Government and the passing of a Special Resolution prevent arbitrary removal of auditors by management. These safeguards help maintain the auditor's independence, strengthen investor confidence, and ensure that auditors can perform their duties without undue influence from the company.

Process of Removal of Auditors: Board Resolution proposing removal of Auditor(s) ? Filling of Form ADT-2 to Central Government (within 30 days) ? Obtaining Central Government Approval ? General Meeting within 60 days ? Special Resolution Passed ? Auditor Removed

4.2.1.4. Remuneration of Auditors:

Remuneration refers to the compensation paid to an auditor for carrying out audit duties and responsibilities. It is intended to compensate the auditor for the professional services rendered in examining the financial statements and expressing an independent opinion on them. Section 142 of the Companies Act, 2013 deals with the remuneration payable to the auditor of a company. The provision specifies the authority responsible for determining the auditor's remuneration and clarifies the components that constitute such remuneration.

Authority to Fix Remuneration: As per Section 142(1), the remuneration of an auditor shall generally be determined by the members of the company in a General Meeting. The shareholders may either directly fix the remuneration or authorize a specific method for determining it.

However, in the case of the first auditor appointed by the Board of Directors, the Board is empowered to fix the remuneration of such auditor. This provision ensures that the company can function smoothly during its initial stage without waiting for approval from the shareholders.

Components of Auditor's Remuneration: The remuneration payable to an auditor is not limited only to the audit fee. It also includes:

- i) **Audit Fees** – The professional fee charged by the auditor for conducting the audit.
- ii) **Reimbursement of Expenses** – Any expenses incurred by the auditor while performing audit-related work, such as travel expenses, communication expenses, or other necessary expenditures connected with the audit.

- iii) **Facilities Provided by the Company** – Any facility, benefit, or assistance extended to the auditor in connection with the audit assignment is also considered part of the auditor's remuneration.

Check Your Progress I

A) Choose the appropriate alternative from the alternatives given below and rewrite the statement.

1. First auditor of a company other than a Government company is appointed by _____.
A) Shareholders
B) Board of Directors
C) Central Government
D) Audit Committee
2. _____ of the Companies Act, 2013 specifies the qualifications and disqualifications of auditors.
A) Section 139
B) Section 140
C) Section 141
D) Section 143
3. _____ is disqualified from being appointed as an auditor.
A) Practicing Chartered Accountant
B) LLP of Chartered Accountants
C) Officer of the company
D) Audit Firm
4. Before the expiry of auditor's term, an auditor can be removed only after obtaining approval of _____.
A) Registrar of Companies
B) Board of Directors
C) Central Government
D) SEBI
5. _____ section specifies the powers and duties of auditors.
A) Section 139
B) Section 141
C) Section 142
D) Section 143
6. An auditor has the right to access _____.
A) Only financial statements
B) Only books of accounts
C) All books, accounts and vouchers of the company
D) Only bank statements

B) State following statements are True or False.

- 1) An employee of the company can be appointed as its auditor.
- 2) The first auditor of a company is generally appointed by the Board of Directors.
- 3) Auditors are appointed for one year only in all companies.
- 4) The company can remove an auditor at any time without following legal procedures.
- 5) The remuneration of the first auditor appointed by the Board may be fixed by the Board.

4.2.2. Section II

4.2.2.1. Powers /Rights of Auditors:

Auditor plays a vital role in ensuring the reliability and transparency of a company's financial statements. Section 143 of Companies Act, 2013 grants certain powers and rights to auditors to perform audit work independently and effectively. These rights enable auditors to access company records, obtain necessary information, participate in meetings, and report their findings to the shareholders. Without these powers, auditors would not be able to verify the accuracy of financial statements and fulfil their responsibilities properly. The major rights and powers of auditors under the Companies Act, 2013 are discussed below.

1. Right of Access to Books of Account:

One of the most important rights given to an auditor is the right to access the books of account and other records of the company. According to Section 143(1), the auditor has the right to inspect the books of account, vouchers, financial records, and supporting documents of the company at all times during the course of the audit. This right can be exercised regardless of whether the records are kept at the registered office of the company or at any other place. The auditor may examine financial books or statutory books or statistical books or memoranda books, e. g., inventory books, costing records, cash books, ledgers, journals, invoices, contracts, bank statements, and any other documents necessary for conducting the audit. The auditor also has the right to inspect the records maintained by branch offices of the company. The purpose of this right is to enable the auditor to verify the transactions recorded in the books and ensure that the financial statements are prepared correctly and present a true and fair view of the company's affairs.

2. Right to Obtain Information and Explanations from Officers:

Section 143(1) of Company Act, 2013, also provides auditors with the right to seek information and explanations from the officers of the company. During the audit, there may be situations where accounting records alone are not sufficient to understand a transaction or verify its authenticity. In such cases, the auditor can ask directors,

managers, accountants, and other responsible officers to provide additional information and explanations. This right is very broad and important because it helps the auditor obtain complete knowledge about the company's financial affairs. The auditor may ask questions regarding unusual transactions, contingent liabilities, provisions, related-party transactions, investments, loans, or any other matter affecting the financial statements. If the officers fail to provide satisfactory information or explanations, the auditor is required to mention this fact in the audit report. Such disclosure alerts shareholders and other stakeholders about the limitations faced during the audit process.

3. Right to Receive Notices and Attend General Meetings:

Under Section 146 of Company Act, 2013, every auditor of a company has the right to receive all notices and communications relating to any general meeting of the company. The auditor is entitled to attend such meetings either personally or through an authorized representative who is qualified to be an auditor. The auditor also has the right to be heard at the meeting on any matter concerning his duties as an auditor. For example, if shareholders raise questions regarding the audit report, accounting policies, qualifications in the audit report, or any financial matter, the auditor can provide explanations and clarifications. This right ensures direct communication between the auditor and the shareholders, thereby strengthening corporate governance and enhancing transparency in the company.

4. Right to Submit Audit Report to Members:

The auditor has the statutory right and duty to prepare and submit an audit report to the members of the company. As per Section 143(2) of Company Act, 2013, the auditor must report whether the financial statements give a true and fair view of the state of affairs and financial performance of the company.

Section 143(3) of Company Act, 2013, specifies various matters on which the auditor must report. These include:

1. Whether all information and explanations necessary for the audit were obtained.
2. Whether proper books of account have been maintained.
3. Whether branch audit reports have been properly dealt with.
4. Whether the financial statements comply with accounting standards.
5. Whether any director is disqualified under the Companies Act.
6. Whether adequate internal financial controls are in place and operating effectively.

This right enables the auditor to communicate his professional opinion independently to the shareholders, who rely on the audit report while making decisions regarding the company.

5. Right of Lien:

The right of lien allows an auditor to retain possession of books, documents, or records that are legally in his custody until the audit fees due to him are paid. Although the Companies Act, 2013 does not expressly provide this right, it is recognized under the general principles of law. The auditor can exercise this right only in respect of documents on which he has performed work and which are lawfully in his possession. The purpose of this right is to protect the auditor against non-payment of professional fees by the client. However, the right of lien is subject to legal limitations and cannot be exercised in a manner that violates statutory requirements or prevents the company from complying with legal obligations.

6. Right to Sign the Audit Report:

The auditor has the legal right to sign the audit report and any other document required under the Companies Act, 2013. The audit report must be signed by the individual auditor if the auditor is a sole practitioner. In the case of an audit firm, the report must be signed by a partner of the firm who is authorized to sign on behalf of the firm.

7. Right to Receive Remuneration

An auditor is entitled to receive remuneration for the professional services rendered by him. According to Section 142 of the Companies Act, 2013, the remuneration of the auditor is generally fixed by the company in its general meeting or in such manner as may be determined therein. However, the remuneration of the first auditor appointed by the Board of Directors may be fixed by the Board itself.

The Companies Act, 2013 grants auditors several important rights to ensure the independence and effectiveness of the audit process. Through the rights of access to books, obtaining information and explanations, attending general meetings, and reporting to members, auditors can perform their duties professionally and objectively. The right of lien further safeguards their professional interests. These rights collectively help auditors maintain transparency, accountability, and trust in corporate financial reporting.

4.2.2.2. Duties of an Auditor:

An auditor plays important role in ensuring the accuracy, reliability, and transparency of a company's financial statements. The auditor acts as an independent examiner of the company's accounts and reports whether the financial statements present a true and fair view of the company's financial position. Section 143 of the Companies Act, 2013 specifies the duties and responsibilities of an auditor. Over the years, the scope of an auditor's duties has expanded to protect the interests of shareholders and other stakeholders. By examining records, following auditing standards, reporting important

findings, and disclosing frauds or irregularities, the auditor helps maintain transparency and accountability in corporate management. Following are duties of Auditor as per Companies Act, 2013:

1. Duty to Inquire into Certain Matters [Section 143(1)]:

The auditor is required to investigate and inquire into certain important matters during the audit. These inquiries help in identifying irregularities, frauds, or practices that may be harmful to the company or its members.

The auditor must examine:

- a) **Loans and Advances:** Whether loans and advances granted by the company against securities are properly secured and whether the terms of such loans are prejudicial to the interests of the company or its members.
- b) **Book Entry Transactions:** Whether transactions recorded merely through accounting entries, without actual movement of assets or cash, are harmful to the interests of the company.
- c) **Sale of Investments at Loss:** Where the company is not an investment company or banking company, whether shares, debentures, or other securities owned by the company have been sold at a price lower than their purchase cost.
- d) **Loans Shown as Deposits:** Whether loans and advances given by the company have been wrongly shown as deposits in the books of accounts.
- e) **Personal Expenses Charged to Revenue:** Whether any personal expenses of directors, officers, or employees have been charged to the company's revenue account.
- f) **Shares Allotted for Cash:** Whether cash has actually been received for shares stated to have been allotted for cash. If cash has not been received, the auditor must verify whether the accounts and balance sheet disclose the correct position and are not misleading.

2. Duty to Sign the Audit Report [Section 145 read with Section 141(2)]:

The auditor is responsible for signing the audit report after completing the audit examination.

- 1. Every auditor appointed under the Companies Act must sign the auditor's report or sign or certify any other document of the company.
- 2. If an audit firm or Limited Liability Partnership (LLP) is appointed as auditor, only a partner who is a Chartered Accountant can sign the audit report on behalf of the firm.

3. By signing the report, the auditor accepts responsibility for the opinion expressed in the report.

This duty ensures accountability and authenticity of the audit report.

3. Duty to Comply with Auditing Standards [Sections 143(9) and 143(10)]:

Every auditor is legally required to conduct the audit in accordance with the prescribed Auditing Standards.

1. Section 143(9) mandates compliance with auditing standards.
2. Section 143(10) empowers the Central Government to prescribe auditing standards based on the recommendations of the Institute of Chartered Accountants of India (ICAI) and after consultation with the National Financial Reporting Authority (NFRA).

Compliance with auditing standards ensures:

1. Uniformity in audit procedures.
2. Reliability of audit reports.
3. Professional quality and ethical conduct in auditing.
4. Duty to Report on Financial Statements [Section 143(3)]:

The audit report serves as an important source of information for shareholders, investors, lenders, regulators, and other stakeholders. Therefore, auditor must prepare a detailed audit report containing various observations and opinions regarding the company's accounts and financial statements. The auditor's report must state:

- a) Whether all necessary information and explanations required for the audit were obtained.
- b) Whether proper books of accounts have been maintained as required by law.
- c) Whether branch audit reports, if any, have been received and properly considered.
- d) Whether the Balance Sheet and Statement of Profit and Loss agree with the books of accounts.
- e) Whether the financial statements comply with applicable accounting standards.
- f) Any observations or comments on financial transactions that may adversely affect the functioning of the company.
- g) Whether any director is disqualified under Section 164(2) from being appointed or reappointed as a director.
- h) Any qualification, reservation, or adverse remark regarding maintenance of accounts.

- i) Whether the company has adequate internal financial controls and whether such controls are operating effectively.
- j) Any other matters prescribed by law.

5. Duty to Report Matters Prescribed under Rule 11 of the Companies (Audit and Auditors) Rules, 2014: Apart from the matters specified under Section 143(3), the auditor must also report on the following:

- a) **Pending Litigations:** Whether the company has disclosed the impact of pending legal cases on its financial position.
- b) **Foreseeable Losses:** Whether adequate provision has been made for material foreseeable losses on long-term contracts, including derivative contracts.
- c) **Transfer to Investor Education and Protection Fund (IEPF):** Whether there has been any delay in transferring amounts required to be transferred to the Investor Education and Protection Fund.

6. Duty to Report Frauds [Section 143(12)]:

The Companies Act places a special responsibility on auditors to detect and report fraud.

- A) **Reporting Fraud to the Central Government:** If the auditor has reason to believe that a fraud involving Rs. 1 crore or more has been committed by the company's officers or employees, the auditor must report the matter to the Central Government in the prescribed manner and within the prescribed time.
- B) **Reporting Fraud to Audit Committee or Board:** Where the fraud amount is less than Rs. 1 crore, the auditor must report the matter to The Audit Committee constituted under section 177 or to The Board of Directors where applicable.
- C) **Disclosure in Board's Report:** Frauds reported to the Audit Committee or Board, but not to the Central Government, must be disclosed by the company in its Board's Report in the prescribed manner.

7. Duty to Report on Other Matters Specified by the Central Government:

The Central Government, after consultation with National Financial Reporting Authority (NFRA), may direct auditors of specified classes of companies to include statements on additional matters in their audit reports. The auditor is legally bound to report on such matters whenever required by government notification or order.

8. Duty to State Reasons for Qualification or Adverse Remarks [Section 143(4)]

If the auditor is unable to give a clean or unqualified opinion, and any matter in the audit report is answered negatively or with qualifications, reservations, or adverse

remarks, the auditor must clearly state the reasons for such opinion. This requirement ensures, transparency in reporting, proper disclosure of shortcomings, better understanding of issues by shareholders and stakeholders.

4.2.2.3. Reporting Requirements under the Companies Act, 2013 Including CARO, 2020

Under the Companies Act, 2013, auditors are required to report on various matters relating to the company's operations and financial affairs. In addition, auditors must also comply with the provisions of the Companies (Auditor's Report) Order, 2020 (CARO 2020). CARO requires auditors to comment on specific aspects of a company's activities so that shareholders and other stakeholders receive more detailed information about the company's performance and compliance with legal requirements. CARO applies to most companies but excludes certain entities such as banking companies, insurance companies, Section 8 companies, One Person Companies (OPCs), small companies, and some private companies that satisfy prescribed conditions. The following are the major reporting requirements under CARO:

1. Property, Plant and Equipment (Fixed Assets) – Clause 3(i):

Fixed assets are long-term assets used in business operations, such as land, buildings, machinery, furniture, vehicles, and equipment. The auditor must verify:

- a) Whether the company maintains proper records of all fixed assets. These records should contain complete details such as the description of the asset, quantity, location, and value. Proper records help the company track its assets and prevent misuse or loss.
- b) whether the management physically verifies these assets at regular intervals. If any differences are found between the records and the actual assets, the auditor must ensure that such discrepancies have been properly corrected in the books of accounts.
- c) whether the legal ownership documents (title deeds) of immovable properties such as land and buildings are in the name of the company. This helps confirm that the company legally owns these properties.

2. Inventory – Clause 3(ii):

Inventory includes raw materials, work-in-progress, finished goods, and other stock held by the company for sale or production. The auditor must examine whether the company conducts physical verification of inventory at reasonable intervals. Physical verification helps ensure that the stock recorded in the books actually exists. The auditor should compare the physical stock with the stock records maintained by the company. If significant differences are found, the auditor must check whether those differences have been properly adjusted in the accounting records.

3. Loans Granted by the Company – Clause 3(iii):

In some cases companies provide loans to other companies, firms, Limited Liability Partnerships (LLPs), or persons covered under Section 189 of the Companies Act, 2013. In case of Loans granted by the company the auditor should examine:

- a) whether the terms and conditions of such loans are fair and do not adversely affect the interests of the company. For example, the interest rate, repayment schedule, and security should be reasonable.
- b) whether borrowers are regularly repaying both the principal amount and interest. If any loan remains unpaid for more than 90 days, the auditor must report the amount overdue and verify whether the company has taken appropriate steps to recover the money.

4. Loans, Guarantees, Securities and Investments – Clause 3(iv):

The Companies Act, 2013 places restrictions on loans and investments made by companies. Sections 185 and 186 regulate loans to directors and investments in other entities. The auditor must verify whether the company has complied with these legal provisions while granting loans, providing guarantees, offering securities, or making investments. Any violation of these sections must be reported.

5. Acceptance of Deposits – Clause 3(v):

Some companies accept deposits from members or the public. Such deposits are regulated by Sections 73 to 76 of the Companies Act, 2013.

- a) The auditor must verify whether the company has followed all legal requirements while accepting deposits. This includes compliance with the rules prescribed by the Companies Act and directions issued by regulatory authorities such as the Reserve Bank of India (RBI).
- b) The auditor must also check whether the company has complied with any orders issued by courts, tribunals, or other authorities regarding deposits. If any non-compliance is found, it must be clearly reported.

6. Maintenance of Cost Records – Clause 3(vi):

Certain industries are required by the Central Government to maintain cost records under Section 148(1) of the Companies Act, 2013. Cost records contain detailed information about the cost of production, materials, labour, and other expenses involved in manufacturing goods or providing services. The auditor must verify whether such records have been maintained properly and in the prescribed manner. Proper maintenance of cost records helps management control costs and improves efficiency.

7. Statutory Dues – Clause 3(vii)

Every company is required to pay various taxes and statutory contributions to government authorities.

- a) The auditor must verify whether the company regularly deposits dues such as: Provident Fund (PF), Employees' State Insurance (ESI), Goods and Services Tax (GST), Customs Duty, Excise Duty, any other statutory dues.
- b) The auditor must also report any unpaid dues that have remained outstanding for more than six months.
- c) In addition, if any tax or duty has not been paid because of a dispute, the auditor must disclose the amount involved and mention the authority before which the dispute is pending.

8. Repayment of Borrowings – Clause 3(viii)

Companies often borrow money from banks, financial institutions, government agencies, or debenture holders. The auditor must check whether the company is making timely repayment of principal and interest on these borrowings. If the company has defaulted in repayment, the auditor must report the amount of default and the period for which it has remained unpaid.

9. Utilisation of Funds Raised – Clause 3(ix)

Companies may raise funds through Initial Public Offers (IPOs), Further Public Offers (FPOs), issue of debt securities, or term loans. The auditor must verify whether these funds have been used for the specific purposes stated by the company at the time of raising the funds. If the funds have been diverted to other purposes or remain unused for an unreasonable period, the auditor must report such facts.

10. Reporting of Fraud – Clause 3(x)

Fraud refers to any intentional act of deception for personal gain or to cause loss to the company. The auditor must report any fraud committed by the company, its officers, or employees that comes to notice during the audit. The report should mention the nature of the fraud, the amount involved, and other relevant details. Reporting fraud helps improve accountability and protects stakeholders from financial losses.

11. Managerial Remuneration – Clause 3(xi)

The Companies Act, 2013 prescribes limits on the remuneration payable to directors and key managerial personnel. The auditor must verify whether managerial remuneration has been paid according to these legal provisions. If any excess remuneration has been paid, the auditor must disclose the amount and indicate whether steps have been taken to recover the excess payment.

12. Nidhi Companies – Clause 3(xii)

A Nidhi Company is a special type of company formed to encourage savings among its members. In the case of a Nidhi Company, the auditor must verify whether:

- The ratio of Net Owned Funds to Deposits is maintained at 1:20.
- At least 10% of outstanding deposits are maintained as unencumbered term deposits as required by the Nidhi Rules, 2014.

13. Related Party Transactions – Clause 3(xiii)

Related party transactions are transactions between the company and persons or entities having a close relationship with the company, such as directors, relatives of directors, subsidiaries, or associate companies. The auditor must verify whether such transactions comply with Sections 177 and 188 of the Companies Act, 2013. The auditor should also ensure that these transactions are properly disclosed in the financial statements. Proper disclosure prevents conflicts of interest and promotes transparency.

14. Preferential Allotment and Private Placement – Clause 3(xiv)

Companies may raise capital by issuing shares or debentures to selected investors through preferential allotment or private placement. The auditor must verify whether the company has complied with all legal requirements while making such issues. The auditor should also check whether the funds raised have been utilized for the intended purposes.

15. Non-Cash Transactions with Directors – Clause 3(xv)

A non-cash transaction occurs when assets or services are exchanged without involving cash payments. The auditor must verify whether any such transactions between the company and its directors or their relatives comply with the provisions of the Companies Act, 2013. If any non-compliance is found, it must be reported. This requirement prevents directors from obtaining undue benefits from the company.

16. Registration under the RBI Act – Clause 3(xvi)

Certain companies carrying on financial activities are required to register as Non-Banking Financial Companies (NBFCs) under the Reserve Bank of India Act, 1934. The auditor must determine whether the company is required to obtain such registration. If registration is necessary, the auditor must verify whether it has been obtained.

Check Your Progress II

A) Choose the appropriate alternative from the alternatives given below and rewrite the statement.

1. The auditor's report is addressed to _____.
A) Board of Directors B) Creditors
C) Members of the company D) Registrar of Companies
2. _____ order prescribes additional reporting requirements for auditors.
A) AS-1 B) SA-200
C) CARO D) IND AS
3. CARO stands for _____.
A) Companies Accounting Report Order
B) Companies Auditor's Report Order
C) Corporate Audit Reporting Order
D) Corporate Accounting Regulation Order
4. Under CARO, auditor's report on _____.
A) Fixed assets records B) Inventory verification
C) Statutory dues D) All of the above
5. An auditor's primary duty is to _____.
A) Prepare accounts
B) Detect all frauds
C) Express an independent opinion on financial statements
D) Manage company affairs
6. _____ is NOT a right of an auditor.
A) Access to books of account B) Receive notice of general meetings
C) Vote in general meetings D) Seek information and explanations
7. The auditor should report whether financial statements give _____.
A) Maximum profit B) Tax savings
C) True and Fair View D) Dividend guarantee

8. The maximum term of appointment of an individual auditor in a listed company is _____.
A) One term of 5 consecutive years B) Two terms of 5 years each
C) One term of 10 years D) Lifetime
9. Auditor's remuneration is generally fixed by _____.
A) Board of Directors B) Audit Committee
C) Shareholders in General Meeting D) Central Government
10. Which of the following is disqualified from being appointed as an auditor?
A) Practicing Chartered Accountant B) LLP of Chartered Accountants
C) Officer of the company D) Audit Firm

B) State following statements are True or False.

- 1) CARO applies to every company without exception.
- 2) Reporting on fraud is one of the auditor's responsibilities under the Companies Act, 2013. 3) An auditor can attend and speak at general meetings on matters concerning him.
- 4) An auditor has the right to vote at the Annual General Meeting.
- 5) The auditor must report frauds as required under the Companies Act, 2013.

4.3. Summary:

The Companies Act, 2013 provides a comprehensive legal framework for conducting audits in companies and ensuring the reliability of financial reporting. Audit plays a vital role in safeguarding the interests of shareholders, creditors, investors, and other stakeholders by verifying whether the financial statements of a company present a true and fair view of its financial position. The provisions relating to audit are mainly contained in Sections 139 to 148 of the Act. These provisions deal with the appointment, qualifications, powers, duties, remuneration, and reporting responsibilities of auditors.

The Act specifies that only a Chartered Accountant in practice, or a firm or LLP whose majority of partners are Chartered Accountants in practice, can be appointed as an auditor of a company. To maintain the independence and objectivity of auditors, the Act also prescribes several disqualifications. Persons having financial interests in the company, employees of the company, relatives of directors in specified situations, and persons providing certain prohibited services to the company are not eligible to act as auditors. These restrictions help ensure that auditors perform their duties without bias or conflict of interest.

The appointment of auditors is governed by detailed provisions. The Board of Directors appoints the first auditor of a company within the prescribed period after incorporation. Thereafter, the shareholders appoint auditors in the Annual General Meeting. The Act also contains provisions regarding the filling of casual vacancies and the rotation of auditors for specified classes of companies. Auditor rotation aims to strengthen independence and prevent long-term associations that may affect professional judgment.

The removal of an auditor before the completion of the term is subject to strict legal procedures. Such removal requires the approval of the Central Government and the passing of a special resolution by shareholders. Similarly, when an auditor resigns, he or she must communicate the reasons for resignation to the concerned authorities. These provisions protect the independence of auditors and ensure transparency in the audit process.

The remuneration of auditors is generally determined by the shareholders of the company. In certain cases, the Board of Directors may fix the remuneration of the first auditor. Auditor remuneration includes audit fees, expenses incurred in connection with the audit, and facilities provided during the performance of audit work. Adequate remuneration enables auditors to perform their responsibilities effectively and professionally.

To enable auditors to discharge their responsibilities efficiently, the Companies Act grants them various rights and powers. Auditors have unrestricted access to the books of account, records, vouchers, and other relevant documents of the company. They can seek explanations and information from company officers and employees whenever necessary. Auditors also have the right to visit branch offices, receive notices of general meetings, attend such meetings, and sign the audit report. These powers ensure that auditors can obtain sufficient evidence before expressing their opinion on the financial statements.

The duties of auditors are equally significant. Auditors are required to examine the financial statements and verify whether they comply with accounting standards and legal requirements. They must investigate specific matters such as loans, advances, related transactions, and the proper maintenance of accounting records. Auditors are also responsible for reporting instances of fraud and ensuring that the company follows applicable laws and regulations. By carrying out these duties diligently, auditors contribute to the credibility and integrity of financial reporting. One of the most important responsibilities of auditors is the preparation of the audit report. The auditor's report communicates an independent opinion regarding the financial statements of the company. The report must state whether proper books of account have been maintained, whether accounting standards have been followed, and whether the financial statements present

a true and fair view of the company's affairs. Auditors are also required to comment on the adequacy and effectiveness of internal financial controls and other matters prescribed under the Companies Act, 2013.

In addition to the standard audit report, auditors are required to comply with the provisions of the Companies (Auditor's Report) Order (CARO), 2020, where applicable. CARO requires auditors to provide detailed comments on various aspects of a company's operations and financial management. These include fixed assets, inventory verification, loans and advances, statutory dues, borrowings, frauds, related-party transactions, internal audit systems, and corporate social responsibility compliance. CARO enhances the scope of audit reporting and improves the level of transparency available to stakeholders.

4.4. Glossary

Term	
1. Audit	: An independent examination of a company's financial records to verify their accuracy and reliability.
2. Auditor	: A qualified professional, usually a Chartered Accountant, appointed to examine and report on a company's financial statements.
3. Companies Act, 2013	: The principal law governing the incorporation, management, and regulation of companies in India.
4. Financial Statements	: Documents such as the Balance Sheet, Profit and Loss Account, and Cash Flow Statement that show the financial position and performance of a company.
5. True and Fair View	: An auditor's opinion that financial statements accurately represent the company's financial condition without material misstatements.
6. Chartered Accountant (CA)	: A professional accountant qualified under the Chartered Accountants Act, 1949, and eligible to act as an auditor.
7. Eligibility of Auditor	: Conditions prescribed by law that must be fulfilled for a person or firm to be appointed as an auditor.
8. Qualification of Auditor	: Professional requirements, such as being a Chartered Accountant in practice, necessary for appointment as an auditor.
9. Disqualification of Auditor	: Circumstances under which a person is prohibited from being appointed or continuing as an auditor.

10. Audit Firm	:	A partnership firm or LLP engaged in providing audit and assurance services.
11. Independence of Auditor	:	Freedom from any influence, conflict of interest, or relationship that may affect the auditor's objectivity.
12. Appointment of Auditor	:	The process of selecting and approving an auditor according to legal provisions.
13. First Auditor	:	The auditor appointed after the incorporation of a company to hold office until the first Annual General Meeting.
14. Annual General Meeting (AGM)	:	A yearly meeting of shareholders where important business matters, including auditor appointments, are discussed and approved.
15. Board of Directors	:	A group of individuals elected by shareholders to manage and oversee the affairs of a company.
16. Removal of Auditor	:	The legal procedure for terminating the services of an auditor before the completion of the term of office.
17. Resignation of Auditor	:	Voluntary withdrawal by an auditor from the position before the completion of the tenure.
18. Remuneration of Auditor	:	Fees, expenses, and facilities provided to an auditor for performing audit services.
19. Books of Account	:	Records maintained by a company to document its financial transactions and business activities.
20. Voucher	:	Documentary evidence supporting an accounting transaction.
21. Right of Access	:	The auditor's legal right to inspect all books, records, and documents of the company.
22. Information and Explanations	:	Details and clarifications that auditors may seek from company management during the audit process.
23. Audit Evidence	:	Information collected by the auditor to support conclusions and audit opinions.
24. Audit Report	:	A formal written report issued by the auditor expressing an opinion on the company's financial statements.

- 25. Internal Financial Controls** : Policies and procedures established by a company to ensure accuracy, efficiency, and reliability in financial reporting.
- 26. Shareholders** : Owners of a company who invest capital by purchasing shares.
- 27. CARO (Companies)** : An order issued by the Central Government requiring auditors Auditor's Report to report on specified matters in addition to the standard audit Order) report.
- 28. CARO 2020** : The latest version of the Companies Auditor's Report Order, effective for applicable companies from the financial year 2020-21 onwards.

4.5. Answer to Check your Progress:

4.5.1. Answer to Check your Progress - I

A) Choose the appropriate alternative from the alternatives given below and rewrite the statement.

- 1) B) Board of Directors,
- 2) C) Section 141,
- 3) C) Officer of the company,
- 4) C) Central Government,
- 5) D) Section 143,
- 6) C) All books, accounts and vouchers of the company,

B) State following statements are True or False.

- 1) False,
- 2) True,
- 3) False,
- 4) False,
- 5) True

4.5.2. Answer to Check your Progress - II

A) Choose the appropriate alternative from the alternatives given below and rewrite the statement:

- 1) C) Members of the company,
- 2) C) CARO,
- 3) B) Companies Auditor's Report Order,
- 4) D) All of the above,
- 5) C) Express an independent opinion on financial statements,
- 6) C) Vote in general meetings,
- 7) C) True and Fair View,
- 8) A) One term of 5 consecutive years,
- 9) C) Shareholders in General Meeting,
- 10) C) Officer of the company

B) State following statements are True or False.

- 1) False, 2) True, 3) True, 4) False, 5) True

4.6. Exercise

A) Long Answer Questions:

- 1) Explain the qualifications and disqualifications of auditors under the Companies Act, 2013.
- 2) Explain the procedure for appointment of auditors under the Companies Act, 2013.
- 3) Explain the procedure for appointment of auditors in government companies.
- 4) Discuss the appointment of first auditor and subsequent auditor in case of companies other than government companies.
- 5) Explain the provisions relating to appointment of auditors in Government companies.
- 6) Explain the powers and rights of auditors under the Companies Act, 2013.
- 7) Discuss the duties and responsibilities of auditors under Section 143 of the Companies Act, 2013.
- 8) Explain the reporting requirements of auditors under the Companies Act, 2013.
- 9) Explain the various matters on which auditors are required to report under CARO 2020.

B) Short Answer Questions:

- 1) Qualifications & Disqualifications of company auditors.
- 2) Appointment of Auditors in government Companies
- 3) Appointment of Auditors in non government Companies
- 4) Removal of auditors
- 5) Remuneration of auditors
- 6) Powers and rights of auditors
- 7) Duties of auditors
- 8) Appointment of first auditor
- 9) Appointment of subsequent auditor

4.7. Reference for further study:

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