VERIFICATION AND VALUATION OF ASSETS AND LIABILITIES

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Introduction

Spicer and Pegler have defined verification as “it implies an inquiry into the value, ownership and title, existence and possession and the presence of any charge on the assets”. Verification is a process by which an auditor satisfies himself about the accuracy of the assets and liabilities appearing in the Balance Sheet by inspection of the documentary evidence available. Verification means proving the truth, or confirmation of the assets and liabilities appearing in the Balance Sheet.

Thus, verification includes verifying:-

1. The existence of the assets
2.Legal ownership and possession of the assets
3.Ascertaining that the asset is free from any charge, and
4.Correct valuation

Of course it is not possible for the auditor to verify each and every asset. It was held in Kingston Cotton Mills case that “it is not part of an auditor’s duty to take stock. No one contend that it is. He must rely on other people for the details of stock in trade in hand”.

However, as per the decision given in Mc Kesson and Robins case (1939) the auditor must physically inspect some of the assets. Now the auditor has to report whether the balance sheet shows true and fair view of the state of affairs of the company. Hence, he is required to verify all the assets and liabilities appearing in the balance sheet. In case of failure, the auditor can be held liable for damages.

According to the `statement of auditing practices' issued by ICAI, "the auditor's object in regard to assets generally is to satisfy that :-

1. They exist.

2. They belong to the client.

3. They are in the possession of the client or the persons authorized by him.

4. They are not subject to undisclosed encumbrances or lien.

5. They are stated in the balance sheet at proper amounts in accordance with sound accounting principles, and

6. They are recorded in the accounts.

While conducting verification following points should be considered by the auditor:-

1. Existence: The auditor should confirm that all the assets of the company are physically existing on the date of balance sheet.

2. Possession: The auditor has to verify that the assets are in the possession of the company on the date of balance sheet.

3. Ownership: The auditor should confirm that the asset is legally owned by the company.

4. Charge or lien: The auditor has to verify whether the asset is subject to any charge or lien.

5. Record: The auditor should confirm that all the assets and liabilities are recorded in the books of account and there is no omission of asset or liability.

6. Audit report: Under CARO the auditor has to report whether the management has conducted physical verification of fixed assets and stock and the difference, if any, between the physical inventory and the inventory as per the book.

7. Event after balance sheet date: The auditor should find out whether any event after the date of balance sheet has affected any items of assets and liabilities.

SCOPE OF VERIFICATION

Verification includes information on the following:-

1. That the assets were in existence on the date of the balance sheet

2. That the assets had been acquired for the purpose of business only

3. That the assets had been acquired under a proper authority

4. That the right of ownership of the assets vested in the organization

5. That the assets were free from any charge and

6. That the assets were properly valued and disclosed in the balance sheet.

OBJECTS OF VERIFICATION:

Following are the objects of verification of assets and liabilities

1. To show correct valuation of assets and liabilities.

2. To know whether the balance sheet exhibits a true and fair view of the state of affairs of the business

3. To find out the ownership and title of the assets

4. To find out whether assets were in existence

5. To detect frauds and errors, if any

6. To find out whether there is an adequate internal control regarding acquisition, utilisation and disposal of assets.

7. To verify the arithmetic accuracy of the accounts

8. To ensure that the assets have been recorded properly.

ADVANTAGES OF VERIFICATION

Advantages of verification are as under:-

1. It avoids manipulation of accounts

2. It guards against improper use of assets

3. It ensures proper recording and valuation of assets

4. It exhibits true and fair view of the state of affairs of the company.

TECHNIQUES OF VERIFICATION:

1. Inspection: It means physical inspection of the assets i.e. company cash in the cash box, physical inventory, inspection of shares certificates, documents etc. Inspection provides reliable audit evidence about the existence of the tangible assets inspected but not necessarily as to the ownership or value of such assets. It involves examining records, documents or tangible assets and provides audit evidence of varying degrees of reliability depending on their nature and source and the effectiveness of internal controls over their processing. Inspection also provides three major categories of documentary audit evidence, listed in ascending degree of reliability, viz:
(a) Evidence created and held by the entity;
(b) Evidence created by third parties and held by the entity; and
(c) Evidence created and provided to auditors by third parties

2. Observation: The auditor may observe or witness the inspection of assets done by others. The auditor, by observation, looks at a procedure being performed by others, for example the auditors observe the counting of stock by the entity's staff or the performance of internal control procedures as part of the conduct of an audit.

3. Confirmation: It means obtaining written evidence from outside parties regarding existence of assets. Confirmation involves obtaining response to an enquiry to corroborate information previously made available to the auditors in the course of the audit. Examples of direct confirmation are as follows:

(a) Confirmation of debts by communication with debtors;
(b) Confirmation of legal cases by communication with the entity's solicitors; and
(c) Confirmation of bank balances by communication with the entity's bankers.

VERIFICATION OF ASSETS AND LIABILITIES

Share Capital Share Capital

When there are new issues Share capital is a special sort of liability of a company. When share capital has been issued during the year, auditors should:
(a) Ensure that the issue is within the limits authorised by Memorandum and Articles of Association of the entity;
(b) Ensure that the issue was subject to directors' minutes and shareholders' approval, where applicable;
(c) Ascertain and evaluate the system for the control of issue; and
(d) Verify that the system has been properly operated. This will involve examining the prospectus (where applicable), application and allotment sheets, the share register, cash received records, share certificate counterfoils, and refunds to unsuccessful applicants.

Where Stock Exchange approval was required, the auditors should:
(a) Ensure that permission has been obtained. If it has not been given all the money subscribed is returnable;
(b) Ensure that all the money is maintained in a separate bank account until all conditions were satisfied;
(c) Ensure that the minimum subscription has been received. If there are not enough subscribers then the whole amount is returnable; and
(d) Vouch the payment of underwriting and other fees.

Where there are no new issues

When no new issue of shares has been made, the auditor should:
(a) Determine the total of shares of each class as stated in the balance sheet and obtain a list of shareholdings, which in total should agree with the balance sheet total;
(b) Test the balances in the share register with the list;
(c) If this is not possible at the balance sheet date, it may be permissible to do

it earlier provided that the auditor is satisfied with the system of control over transfers; and

(d) Where the share register is maintained by an independent firm of registrars, the auditor should obtain a certificate as to the accuracy and completeness of the shares and their holdings. The certificate should state that the balances on the share registers agree with the issued capital at the balance sheet date.

Loans advanced

Loans may of different types like :

(a) Loans against the security of land and buildings.
(b) Loans against the security of goods
(c) Loans against the security of stocks and shares.
(d) Loans against the security of insurance policies, and
(e) Loans against the personal security of the borrower.

Therefore, in each case, the duty of auditor in general is as under:

1. Verify whether object clause of the Memorandum provides for granting of such loans.

2. Examining whether a proper loan ledger has been maintained and it is up-to-date or not.

3. Examination of the security lodged against each loan. The loan agreement is to be scrutinized regarding the rate of interest.Due dates of instalment, penalty, interest, etc.

4. He should ascertain whether any loan is doubtful of recovery in which case a provision for the expected loss is to be made.

5. Except in case of a banking or finance company, auditor has to ascertain whether the purpose of advancing is connected with business or not. Section 227(4A) of the Companies Act, 1956 requires an auditor to report whether the parties to whom the loans are given are regular in payment of interest and principal and the terms of the loan are not prima facie prejudicial to the interest of the company.

(a) ***Loans against the security of Land and building***

1. The auditor has to examine the mortgage deed, see if the copy has been properly executed and registered in favour of the client.

2. The auditor has to examine the title deeds deposited with the mortgage deed.

3. The auditor, if required, has to examine the valuer's certificate in order to ascertain the value and sufficiency of the security.

4. The auditor has to confirm that the property is properly insured and insurance premiums have been paid in time.

5. The auditor has to examine the title of the Borrower to the property, etc.

6. If the mortgage is a second mortgage, the auditor has to confirm that the same is brought to the knowledge of the first mortgagee. In this case he has to take the acknowledgement of title deeds from the first mortgagee.

(b) Loans against the security of goods.

1. The auditor has to examine the nature of the goods and confirm that the goods are really belonging to the borrower. He should see whether the loan is granted against railway receipt, lorry receipt, dock warrant, Godown keeper's receipt etc.

2. In case goods are stored in the godown, he has to see that the rent of the godown is paid in full and the goods are fully insured.

3. The auditor should examine the value of the goods by comparing them with the present market value. Regarding quality and quantity, he may rely on the inspector's reports.

4. If the goods are of perishable nature, the auditor has to examine the turnover of the stock of the client.

(c***) Loans against the security of stocks and shares***

1. He should call for a statement of stocks and shares given as security and confirm that all of them are fully paid up.

2. He should see whether an instrument of transfer is properly stamped and is properly executed.

3. He should see that their value is properly disclosed as per the prevailing market rates.

4. He has to ensure that there is a sufficient margin on the loans advanced.

5. He has to see whether the charge is properly registered or not.

(***d) Loans against the security of insurance policy:***

1. The auditor should see that the policy has completed at least two years.

2. The auditor should confirm that all the premiums have been properly paid and the policy is in force by examining the latest premium receipt.

3. The auditor should ascertain that due notice of assignment has been given to the insurance company.

4. The auditor should see that the loan has been advanced on the basis of surrender value of the policy as certified by the insurance company.

5. The auditor has to ensure that the premium, if any, paid up by the lender to keep the policy in force is properly debited to the Loan Account of the borrower together with the usual interest.

(***e) Loans against the personal security of the borrower***

The auditor has to examine the documents like Promissory Note, Guarantor's details and Salary Certificate of the borrower, etc.

Sundry Debtors:

Sundry Debtors represents the amount recoverable from the customers for sale of goods or rendering of services.

1. The under mentioned procedure should be applied for verification of `Book Debts' or `Sundry Debtors' after receiving a schedule or list of debtors from the client.

(a) Direct confirmation of balances from debtors by sending confirmatory letters.

(b) Year-end Scrutiny of ledgers.

(c) Verification of the position of debts considered bad or doubt ful.

(d) Compliance with legal requirement or presentation.

2. The auditor should arrange to send the letter of confirmation of balances by the client as per client's records and see that the reply of confirmation is forwarded to his office directly. Usually this should be sent within 15 or 20 days of close of the year under the supervision of the audit staff. After the reply is received, the same should be tallied with the balances shown in the Debtors Ledger and difference properly reconciled.

3. After the said procedure is carried out, he should carry out a thorough scrutiny of the debtor's individual accounts. Wherever the number of debtors is very large, Test Checks can be applied.

4. While scrutinizing the ledger, the auditor should focus the light on discounts, returns, cash received, rebates allowed, goods returned etc.

5. On ascertaining the balances of the debtors as genuine and correct, the auditor has to verify the debtors to find out bad or doubtful debts to make a provision for the same. If the debts are bad and irrecoverable or doubtful and they are not provided for properly, the financial statements will not portray a `True and Fair' view. Hence, appropriate provision is to be made by considering the age of the debtor, scrutiny of payments received, management opinion and any other information like financial position of debtors, etc. If the auditor fails in verifying the appropriateness of the provision made, he shall be held liable for negligence.

6. After ascertaining the position of bad or doubtful debts, he should see that the legal requirements of Schedule VI to the Companies Act, 1956 are complied with. For this purpose, the debtors are to be classified as:

(a) Outstanding for a period of more than six months; and

(b) Other debts.

7. Over and above this, other requirements like debts considered as good and which are fully secured, debts due from the officers, directors, managers of the company, etc., are to be ascertained for disclosure.

8. If the customers have purchased the goods on hire purchase system and some of the instalments are not due, the same is not to be shown as `stock out on hire purchase'.

9. Likewise, if the goods are sold on `return or approval' basis, such customer cannot be shown as a debtor at the close of the year.

10. Further, whenever there are credit balances in some debtors account, the same are not to be deducted from other debtors debit balances and net balance is not to be shown in the assets side, but former is to be shown as Sundry Creditors.

Valuation of Inventory

Generally accepted accounting principles require that inventories be reported at the lower of historical cost or market (current replacement cost), provided that the carrying value should not exceed net realisable value (estimated selling price minus costs of completion and disposal) or be lower than net realisable value reduced by the normal profit margin. To achieve the valuation objective for inventories, the auditor should test the inventory costing. In addition, he should:
(a) Review and test procedures for identifying obsolete or slow-moving items;
(b) Review the costing of damaged or obsolete items to determine that the assigned value does not exceed net realisable value; and
(c) Review and test the determination of market prices to determine whether market value is lower than cost.

The auditor should:
(a) Consider not only finished goods but also work in process and raw materials that will eventually become finished goods in the review for obsolete items;
(b) Compare quantities with those in previous inventories on test basis to identify slow-moving items or abnormally large or small balances; and
(c) Reviews of usage records can provide further indications of slow-moving items.

If the client does not maintain perpetual records, the auditor may examine purchase orders or production orders to determine how recently certain items of inventory were acquired. Many companies have formulae or rules of thumb that translated overall judgements on obsolete stocks into practical detailed applications, for example:

(a) All items over a year's supply;

(b) All items that have not moved within six months; and

(c) All items bearing certain identifying numbers with regard to date or class of product.

The auditor should review whether the rules are realistic and comprehensive enough as well as whether they are fully and accurately applied. In addition to reviewing and testing the client's rules, the auditor must evaluate, based on an understanding of the client's business climate, whether inventory can be realised in the normal course of operations. Past experience can be a good guide to the net realisable value of items that must be disposed of at salvage prices.

When certain finished goods are declared obsolete or severe markdowns are required, consideration should be given to related raw materials and work-in process inventories write down.

Patent and Trademarks:

1. The ownership of patent rights is verified by inspection of certificate issued for grant of patent, by the prescribed authority.

2. If it has been purchased, the agreement surrendering it in favour of the client should be examined.

3. If there are a number of patents held by the client, obtain a schedule giving the full details thereof or verify with reference to the register maintained by the client.

4. It must be verified that patent rights are alive and legally enforceable and renewal fees have been paid on due dates and charged to Revenue Account. The last renewal receipt should be examined to ascertain that the patent has not lapsed.

5. See that the patents are properly registered in the name of the client only.

6. See that the cost of patent is being written off over its useful period of life.

7. In case the patent is acquired, cost paid for the same and all relevant expenses are to be capitalized.

8. If the patent is created by the client by the research experiments and laboratory work, only the actual expenses incurred for it in the process are to be capitalised.

Copyrights

1. The auditor has to examine the written agreement of assignment along with the royalty paid to the authors etc., for such copyrights.

2. He has to see that such assignments are properly registered.

3. If the client is the owner of many copyrights, the auditor should ask the client to prepare a schedule of copyrights and get the detailed information to confirm that the same is shown in the Balance Sheet.

4. Regarding the value of copyrights, it should be remembered that this asset has no value in the long run. Hence, value is determined on revaluation basis and period of copyrights.

5. If any copyright doesn’t command the sale of any books, then the same should be written off in such year. The auditor has to verify the same in detail.

Investments:

Investment may be a share certificate, government bond certificate, government loan certificate, debenture certificate, etc. For verification of such securities, the following procedure is adopted.

1. Obtain a schedule of investments in hand at the beginning of the audit period. Obtain the details of description of investments together with distinctive number of face value, date of purchase, book value, market value, rate of interest, date of payment of interest or, date around which dividend is declared, etc., with also the details of interest or dividend received along with tax deducted at source.

2. Add to the above list, purchase made during the year and delete the investments sold during the year with all the above details.

3. Balance this schedule and compare the balance with general ledger and Balance sheet.

4. Check the market value of investments with reference to stock exchange quotations or other suitable method, on Balance Sheet date and see that the values are disclosed in the Balance sheet.

5. Inspect the certificates or securities physically on the Balance Sheet date.

6. Compare the income received with amount due and adjust the accrued income.

7. Confirm the uncalled liability on partly paid shares held as investment shown as contingent liability by way of a note to the Balance Sheet.

8. See that adequate provision is made for any shortfall in the book value of investment shown in the Balance Sheet.

9. See that, regarding the investment in subsidiaries, disclosure requirement of section 212 of Schedule VI of the Companies Act, 1956 are complied with.

10. For investment in the capital of partnership, the partnership deed and copy of accounts of partnership firms, is to be verified. Also adjust the share of profit and loss for the partnership period.

11. Investments which stand in the name of persons other than that of the company are to be confirmed with appropriate sanction.

12. For investment lodged with others as security or lying with banks or share brokers, obtain a certificate from the parties concerned.

13. In case of application money paid for shares which are still to be allotted, that fact is to be specially disclosed in the Balance Sheet.

Goodwill

1. Whenever the company has purchased or acquired a running business and has paid for it an amount, in excess of the book value of its net assets, the excess is called `Goodwill’. It can be verified from the vendor’s agreement and

the auditor has to see whether there is a specific sum which is paid or whether it is the excess of price paid over the tangible assets and see that it is properly recorded.

2. When the company has written up the values of all its assets on a revaluation and has raised a Goodwill Account in the books, the Goodwill appears in the Balance Sheet. In this case, the auditor has to see the basis of valuation and get satisfied about the same. If he is not satisfied, the fact should be reported to the shareholders.

3. He has to see that such excess is credited to a Capital Reserve or Revaluation Reserve and no dividend is being declared from it.

4. He has also to see the disclosure requirement of Schedule VI and ensure that the fact are disclosed for 5 years subsequent to the date of revaluation.

5. Sometimes, Goodwill which is written off earlier may be brought back in the books of account to adjust the debit balance of Profit and Loss account. In this case, the auditor should investigate the fact and satisfy in full before approving such method of creating Goodwill. He should also refer to the board resolution. In case he is not satisfied, the fact should be reported to the shareholders.

6. If Goodwill has been created by any other means, the auditor should see that all relevant facts are properly disclosed and are supported by documentary evidence.

Plant and Machinery:

1. Now-a-days as per provision of Section 227(4A) of the Companies Act, 1956 every company is required to maintain a Fixed Asset Register showing full particulars including cost, location, depreciation, details of purchase, expenses capitalised, etc. Therefore, the auditor should ask for such a register maintained by the client and see that all items of plant and machinery are recorded properly giving full details.

2. As per the provision of the same section, all fixed assets are required to be physically verified by the management. Therefore, the auditor should enquire whether such physical verification was undertaken or not. If yes, he should ask

for necessary papers pertaining to the same. If there is any discrepancy, reasons for the same should be asked.

3. Any new purchase made during the year are to be verified with reference to purchase invoice and other papers regarding installation of the same.

4. Total value of plant and machinery as shown by Fixed Asset Register should tally with ledger account maintained in the financial books.

5. Where any item of plant and machinery is sold, scrapped or transferred the auditor should check relevant entries for the same and verify that they are removed from the Fixed Assets Register.

6. The auditor should verify that adequate depreciation is provided on all items of plant and machinery and method of depreciation is consistently followed from year to year.

7. Auditor should see that the entire plant and machinery stands in the name of the client and are free from any charge or encumbrances. If plant and machinery is mortgaged, then he has to verify that the documents are properly executed and mention of mortgage is made in the Balance Sheet.

Freehold Property (Land & Buildings):

1. The auditor has to examine the title deeds of the property owned by the client and confirm that the same is freehold.

2. If the property has been purchased during the year, the auditor has to examine the correspondence with the broker, or solicitor in details.

3. When a building has been constructed on the freehold property, the same is to be verified from builder’s bill or architect’s certificate.

4. Where the title deeds are deposited with the mortgagee on a mortgage, then a certificate from him to that effect is to be obtained for verification.

5. If the title deeds are deposited with the bankers or solicitors for safe custody, the auditor should get a certificate from them to confirm the fact.

6. If required, the auditor should ask the solicitor of the client to confirm the validity of the title deeds relating to the property.

7. The auditor has to see that the conveyance of the property is in the name of the client and the same is properly registered.

8. The auditor has to ensure that the property is properly insured.

9. The auditor should see that separate account for land and building is maintained, because on land, usually no depreciation is provided.

10. In case there is appreciation of land and buildings value by revaluation, the auditor has to see the basis of revaluation and confirm that the same is properly disclosed in the Balance Sheet, to comply with the generally accepted accountancy principles and also the provision of Companies Act, 1956.

Preliminary, Expenses

1. These are the expenses incurred for creating or incorporating a company i.e. legal expenses for drafting Memorandum of Association, Articles of Association, Stamp fees, etc.

2. Auditor should check the prospectus or the statement in lieu of prospectus for amount of preliminary expenses.

3. Contract with promoters, vendors, underwriters should be checked.

4. Board of Directors authorization for payment of expenses should be checked. Receipts should be obtained for payments.

5. Actual expenditure for preliminary expenses should not exceed amount mentioned in prospectus or statement in lieu of prospectus. Such excess should be approved by shareholders in general meeting.

6. Preliminary expenses can be written off against Share Premium Account (Section 78), if any.

7. Preliminary expenses should be written off in a reasonable number of years (usually 3 to 5 years).

8. Preliminary expenses to the extent not written off should be shown under Miscellaneous Expenditure, on the Asset side of the Balance Sheet.

9. Preliminary expenses written off during the year should be shown separately in the Profit & Loss Account.

Trade Creditors:

1. The auditor should ask for a schedule of creditors and check the same with the purchase ledger as that is already examined by him.

2. He should ensure that all purchase made during the year especially at the end of the year are included in the accounts of the creditors.

3. In case of suspicion about any creditors, the auditor with the consent of the client can ask the statement of account to be sent and verify the same by scrutinizing ledger accounts.

4. He should see the various debts given for discount, goods returned etc, and confirm that the same are genuine.

6. The auditor should ask for the reason for not paying any overdue creditors.

DIFFERENCE BETWEEN VOUCHING AND VERIFICATION

Point of Difference	***Vouching***	***Verification***
1. Meaning	The act of examining the vouchers is known as vouching. A voucher is any documentary evidence in support of a transaction entered in the books of account.	Verification can be explained as establishing the truth or securing some kind of confirmation with respect to the assets and liabilities appearing in the Balance Sheet of a concern
2. Nature & Purpose	Vouching involves establishing the arithmetical accuracy and the authenticity of the transactions of a concern. Vouching proves that an asset ought to exist.	Verification goes beyond vouching. It seeks to establish that assets as stated in the Balance Sheet of a concern exist in fact and that the liabilities are properly disclosed. Verification proves that an asset does exist.
3. Time	It is done during the whole year.	It is done at the end of the year.
4. Utility	Certifies correctness of records.	Certifies correctness of assets and liabilities.
5. Personnel	It is done by the junior staff of the auditor under the supervision of a senior person	It is done by the auditor himself assisted by senior

INTERNAL AUDIT

Meaning and Definition

Internal audit is an evaluation and analysis of the business operation conducted by the internal audit staff. It is the part of overall system of internal control established in an organization.

Internal audit is the independent appraisal activity within an organization for the review of accounting, financial and other business practices as protective and constructive arms of management. It is a type of control which functions by measuring and evaluating the effectiveness of other type of controls.

According to Professor Walter B. Meigs, Internal Auditing means "Internal auditing consist of a continuous, critical review of financial and operating activities by a staff of auditors functioning as full time salaried employees."

In big organization, an internal audit is carried out by the team of professionals in the organization. The internal audit is not mandatory but organization gets the internal audit done with a view to evaluate the effectiveness of internal control, the soundness of financial system, effectiveness of business processes etc. This provides management an assurance about the control process in the organization and it aids in early detection of inefficiencies/fraud etc. it helps the statutory auditors too in getting the statutory audit done effectively. As per company audit report order, 2003, statutory auditor also requires to comment whether the company is having sound internal audit system or not.

Objective of Internal Audit

(i)*Proper Control*:The purpose of internal Audit is to keep proper control over business activities. When there is proper control there is maximum efficiency. The internal control can determine the degree of control over work.
(ii)*Accounting System*:The purpose of internal audit is to evaluate the accounting system. It is concerned with checking proper authority for

transactions like purchase, retirement and disposal of fixed assets. The voucher can be compared with entries in order to determine that figures and facts.

(iii) *Help Management*: The purpose of internal audit is to help the management. Internal auditor can point out the weaknesses. The internal audit can be used as a tool to correct the situation. The management functions can be performed properly.

(iv)*Working Review*:The purpose of internal audit is to review the working of business. The working of current year can be reviewed in detail. There is a need to locate the weak points. The corrective measures can be taken for proper working.

(v*) Asset Protection:* The purpose of internal audit is to protect the assets. The proper records of assets must be there. Internal auditor can examine the valuation, verification and possession. The purchase and sale of assets must be made under proper authority.

(vi) *Internal Check*: The purpose of internal audit is to evaluate the internal check system. There is division of duties among the employees. When all staff member are working properly it means there is effective internal check system. The work of an auditor is reduced. He can apply test checks to complete audit duty.

(vii)*Fair Statements*:The purpose of internal audit is to detect the error in the accounting records. The work of internal audit can help the management to see that accounting record is in order.

(viii) *Check Error:* The purpose of internal audit is to detect the errors in the accounting records. If the work of internal auditor goes side by side therefore there are minimum chances of errors. The accounting staff can rectify mistake to prepare accounts at the end of year in order to help the external auditor.

(ix) *Detect Fraud*: The purpose of internal audit is to detect frauds in the books of accounting. When the work of accounting staff is over the internal audit is started. Accounting staff remains alert because there is no time gap between recording and checking. Thus detection of fraud is possible with it.

(x)*New Ideas*:The purpose of internal audit is to seek new ideas relating to procedures, marketing, financing and other business matters. The internal audit staff can provide new ideas about various business matters. The viable ideas can be put in to practice for the benefit of business

BASIC PRINCIPLES OF ESTABLISHING INTERNAL AUDIT

The basic principal of establishing internal audit in a business concern are-

1. *Independence :* the internal audit department should have an independent status in the organization. He may be required to report directly to the board of directors.

2. *Objectives*: the objectives of the internal audit function should be made very clear and unambiguous. The objectives should be properly communicated so that internal audit is not viewed as "over-the-shoulder check" by other departments.

3. *Clarity in Scope*: the scope pf internal audit department must be specified in a comprehensive manner. The department must at all times, have authority to investigated from the financial angle, every phase of organizational activity under any circumstances.

4. *Definition of Duties*: The internal audit Department's duty is to review operations as part of the internal control system. It should not be involved in performance of executive actions.

5. *Internal Audit Department:* The size and qualification of staff of the internal audit department should be commensurate with the size of the business. The cost of internal audit department should not exceed the benefits expected to be derived from it.

6. *Reporting*: The Programme of internal audit should be time-bound. There should be provisions for periodic reporting on various operational and other aspects.

7. *Follow Up and Review*: There should be sufficient scope for the follow up actions on the various points raised in internal audit report. Top management should take active part in ensuring compliance with actions points raised in the report.

8. *Relationship with statutory auditor:* The copy of the internal audit report should be made available to the statutory Auditor, who can deal with the same in the manner as he deems fit.

TEST CHECKING

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- Objectives
- Advantages and Disadvantages
- Auditing in depth
- Cut off Examination/ Checking

Meaning

The term 'test checking' stands for the method of auditing, where instead of a complete examination of all the transactions recorded in the books of accounts, only some of the transactions are selected and verified. The underlying intention is to test some of the transactions to form an opinion for the whole. According to Professor Meig, "test checking means to select and examine a representative sample from a large number of similar items". The justification of test checking lies on theory of probability which states, in effect that a sample selected from a series of items will tend to show the same characteristics present in the full series of items, which is commonly referred to as "population" or "universe".

Objectives

Objectives of Test Checking Accounts of large Organisations usually include an enormous number of transactions. But the auditor is not in a position to check each and every transaction within the limited time and due to the constraint of resources available to him. So, he has to depend on selective verification of the transactions. The selection of transactions will be made in such a way that the auditor will verify a small but representative number of transactions and he can draw conclusions about the transactions as a whole. So, the basic objective of test checking is to draw a valid conclusion by undertaking examination of some transactions from the large number of transactions and thereby save time and cost.

Advantages

i. It is one of the best techniques of auditing through which cost of audit can be reduced.

ii. It can ensure the speed of audit work.

iii. It can easily locate the deficient areas and thus helps to come to the conclusion as to the acceptability of financial records.

iv. It is a labour saving device.

v. It acts as a guide to the auditor to arrive at a conclusion regarding the true and fair view of the state of affairs of the business.

Disadvantages

i. It will prove inefficient where internal check and control system are not operating or found ineffective.

ii. It is not suitable for small concerns.

iii. It bounds to show incorrect result if the samples are not proper representative of the population.

iv. It does not offer any consistency in selecting the percentage of check that will be adopted by all concerns.

AUDITING IN DEPTH

Auditing in depth is a technique that assists the auditor in conducting test checking and adoption of such a system becomes essential in large organisations, where detailed examination of all the records is not possible. It is a method of auditing under which a few selective transactions are subjected to a thorough scrutiny for arriving at the accuracy of the data.

This technique involves the selection of a sample of transactions from one area of accounting and tracing them from the beginning to the conclusion. This system is undertaken to examine the effectiveness of the internal control and internal check system. In order to conduct the work of auditing in depth of a specific transaction, the auditor has to examine thoroughly the different stages of the transaction.

For example, in respect of goods purchased, the auditing in depth technique will be applied through the following stages:
i. Examine the requisition note from the stores, ensuring that it has been signed by the appropriate official.

ii. Examine the copy of the order placed by the purchasing department, ensuring that it was properly executed on the official form, complied with all the client's regulations and was authorised by the appropriate official.

iii. Examine the delivery note from the supplier and compare it with the copy of the order. iv. Examine the goods inward note made out when the goods were received, noting if it has been properly signed, if it indicates that the correct goods have been received and if their quantity and condition have been checked.

v. Check the entries in the store records.

vi. Check in the accounts department that the invoice received from the supplier has been matched with the copy of the order and the copy of the goods received note before being processed, and that the calculations have been checked.

vii. Check the appropriate entries in the accounting records, and viii. Compare the returned cheque with the invoice and supplier's statement, if any. From the above example, it can be seen that the auditor would trace the transaction right through the system. He would not merely satisfy himself that the entries in the records were correct, but would ensure that the appropriate internal controls relating to authorisation of transactions, the checking of one document against another and physical inspection of goods has been properly operated at the appropriate times. He would also ensure that a proper system was in force to claim credits in respect of short deliveries or deliveries of defective goods.

Where the examination of successive stages in the depth test produces satisfactory results, it is accepted practice that the auditor may progressively reduce the number of items to be examined at subsequent stages. However, if the tests reveal an unacceptable number of errors, it will be necessary for the auditor to increase the number of items examined in order to discover whether the original sample was representative.

Advantages

i. Precision in course of audit work can be achieved.

ii. It guards against the fraudulent manipulation of accounts.

iii. It does not offer any monotony in work to the auditor. Because the auditor will have to deal in all the time with new ideas and techniques.

iv. It saves the cost of audit.

v. The experience in auditing in depth can be widely used in preparing audit plan.

Disadvantages

i. As the concept is linked with selective verification, its application may be fruitless if the selection of item is wrong.

ii. Instead of saving cost and time, this technique entails loss of time and extra cost because of unskilled handling of audit affairs.

iii. Proper selection of transactions for conducting auditing in depth is too much risky. If the items are not properly selected, it will not at all serve its purpose.

iv. This technique cannot be applied to small organisations. v. It has been observed that the auditor relies too heavily upon intuition. Here, he uses no objective method of measuring the adequacy of samples.

CUT OFF EXAMINATION

Cut-off procedures are the procedures designed to ensure that at the year-end trading transactions are entered in the period to which they relate. In other words, the term ‘Cut-off’ refers to the procedure adopted to ensure the separation of transactions as at the end of one accounting year from those at the commencement of the next following year, especially for items which may overlap, e.g., sales, purchase, stock etc.

Significance of Cut-Off in Auditing

The cut-off procedure is very significant in auditing to ensure that the revenue and expenditure of one year do not get recorded in the following year as that will distort the true and fair view of the accounts. The auditor must either establish that there are satisfactory internal controls in respect of cut-off and carry out compliance tests to ensure that these controls are functioning properly or carry out appropriate substantive tests. An obvious way in which accounts can be manipulated is for purchase invoices in respect of goods purchased shortly before the year-end to be held over and entered in the following accounting period, the goods will be included in stock, but the purchases will not be included in the accounts as either a liability or a charge. Similarly, the profits and assets can be inflated by including goods that have been sold, but not yet despatched, in both stock and sales. Tests should be carried out between the purchase invoices, goods inward records and store records on the one hand, and the sales invoices, goods outward records and store records on the other, to ensure that there is consistency in treatment. Cut-off manipulation was an important feature in which the auditors of Thomas Gerrard & Son Ltd. (1967) were held to have been negligent. The auditors' negligence arose primarily from their failure to follow up the alterations of the purchase invoices.