Learning Objectives

After studying this chapter, you will be able to –

- Gain knowledge on vouching of cash and trade transactions
- Understand types of accounts and various procedures of vouch of each account specifically.
- Prepare the bank reconciliation statement.

The act of examining vouchers is referred to as vouching. It is the practice followed in an audit with the objective of establishing the authenticity of the transactions recorded in the primary books of account. It essentially consists of verifying a transaction recorded in the books of account with the relevant documentary evidence and the authority on the basis of which the entry has been made; also confirming that the amount mentioned in the voucher has been posted to an appropriate account which would disclose the nature of the transaction on its inclusion in the final statements of account. On these considerations, the essential points to be borne in mind while examining a voucher are:

(i) that the date of the voucher falls within the accounting period;
(ii) that the voucher is made out in the client’s name;
(iii) that the voucher is duly authorised;
(iv) that the voucher comprised all the relevant documents which could be expected to have been received or brought into existence on the transactions having been entered into, i.e., the voucher is complete in all respects; and
(v) that the account in which the amount of the voucher is adjusted is the one that would clearly disclose the character of the receipts or payments posted thereto on its inclusion in the final accounts.

After the examination is over, each voucher should be either impressed with a rubber stamp or initialed so that it may not be presented again in support of another entry.
5.2 Auditing and Assurance

5.1 Audit of Cash Transactions

5.1.1 General Considerations: In any business probably cash transactions account for the largest bulk of transactions. Cash, being a highly liquid asset, is exposed to frauds of various types. Therefore, it is essential for an auditor to satisfy himself that the cash transactions entered into by the client have been correctly recorded in the books of account and all the procedures laid down for entering into such transactions have been complied with.

To verify cash transactions, more than anything else, it is necessary that the system of accounting and internal control operating in the organisation should be reviewed; also the recording of each transaction should be checked. It should also be seen that each relevant voucher has documentary evidence which is valid and that the statement is authorised by a competent official. Further, on its inclusion in the final accounts, its nature would be truly disclosed.

(i) **Internal Control System:** It is a combination of several procedures adopted by an entity designed:

(a) to give protection against losses through fraud, waste, mistakes, etc.,

(b) to ensure that the transactions entered into shall be correctly recorded; and

(c) to enable the concern to take policy decision as regards planning and operation of the business at the appropriate time.

**Steps involved in the verification of the system of Internal Control:**

(a) Study the system according to which accounting routines are being carried out to ensure that these do not leave any receipt of cash, material or any other asset remaining unaccounted for, permit any payment of money being made without relevant goods or services having been received or tendered or any property being given away without its price having been received or being accounted for.

(b) Examine the financial power vested in different persons and the conditions under which they can exercise them.

(c) Confirm whether the supervision over various managerial and accounting functions, exercised by different members of the staff to whom these duties have been assigned, is adequate.

(d) Ascertain whether any mechanical aids are being employed to ensure proper accounting of receipts and prevention of pilferage of cash, stamps, etc.

(e) Observe the working of the accounting system and routine and determine, by application of procedural tests, whether checks and counter-checks envisaged by the system of internal control are being properly applied.

(f) Confirm that there is a system according to which the physical existence of different forms of assets is being periodically reconciled with their balances in the books of
account or stores records and discrepancies noticed are reported and adjusted; also that balances of account receivables, account payables, bankers and persons with whom securities are deposited are reconciled periodically. Further, those persons who are in custody of valuable assets have furnished bonds of adequate value which would protect the company in the event of any misappropriation or misapplication thereof by such persons.

(g) Ascertain that the system of internal control is reviewed periodically and, where necessary, a change in procedures made to plug in any loopholes which might have been observed on such a review. Also, that policy decisions which are taken from time to time are translated into actual practice.

Students should remember that, unless the system of internal control is comprehensive it may fail to provide the protection expected of it. For example, if printed receipts with counterfoils are issued in respect of amounts collected, but there is no check against cash being collected by unauthorised persons, there will be no certainty that all amounts collected have been accounted for.

(ii) **Correctness of book-keeping records**: The audit of cash transactions entails detailed checking of the record of transactions for verifying that entries have been made in the books of account according to the system of accounting which is being regularly followed and the books of account balance as under:

(a) Vouching;
(b) Posting;
(c) Casting, cross-casting and tracing; and
(d) Reconciliation, scrutiny, confirmation, etc.

When accounts are checked in the foregoing manner, they may disclose one or more mistakes or manipulations in the accounts of different types stated below.

- Errors of omission or commission which are accidental, e.g., failure to enter some sales invoices, mistakes made in computing amounts payable for purchase, etc.
- Cases of deliberate omission or commission:
  - to cover up a defalcation of cash, e.g., amount received from A having been posted to the account of B and subsequently, the amount paid by B having been misappropriated; or
  - to overstate profit or assets, e.g., no provision having been made for outstanding liabilities or the goods already sold before the close of the year having been included in closing inventory;
  - to overstate liabilities and understate assets, with a view to providing a basis for effecting fictitious payments in the former case and misappropriation of the sale proceeds in the latter case.
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- Errors of principle such as revenue expenditure having been charged to capital.
- Compensation errors, e.g., “Furniture Account”, having been undercast by ₹100 and “Repairs Account” overcast by the same amount.

(iii) Observance of accounting principles: It is of utmost importance that the transactions should be recorded in the books of accounts having regard to the principles of accounting. The principles include:

(a) Distinction being drawn between capital expenditure and revenue expenditure;
(b) Distinction being drawn between capital receipts and revenue receipts;
(c) The expenses or cost should be matched to the income or benefit;
(d) The expenditure and income should be treated on accrual basis;
(e) That the fixed assets should be depreciated on a consistent basis;
(f) That book debts should be valued only at realisable amounts;
(g) That fictitious assets are written off at the earliest; and
(h) Outstanding assets and liabilities have been properly adjusted.

(iv) Evidence of Transactions: Entries in the account books are usually made on the basis of some kind of documentary evidence. It generally exists in a variety of forms e.g., payee’s receipts, suppliers’ invoices, statements of account of parties, minutes of Board of Directors or of the shareholders, contracts, documents of title, entries in subsidiary ledger etc. The process of verification of entries in the books of account with the documentary evidence is referred to as vouching. As stated earlier, documentary evidence is of two types: (1) Internal; and (2) External. Documents which are part of the records of the concern, and have been prepared in the normal processes of accounting constitutes internal evidence, e.g., counterfoils of receipts, carbon copies of cash memos or invoices, wages books, etc. On the other hand, a document issued by a person with whom some business transaction had been entered into or who paid or was advanced an amount constitutes external evidence, e.g., a payee’s receipt, an invoice for purchases, a court decree, a lease agreement, a bank statement, etc. because these documents are issued by persons not belonging to the concern. External evidence, in respect of certain transactions, sometimes may have to be obtained directly by the auditors, e.g., certificate as regards bank balances, or confirmation balances of account receivables and account payables, etc.

The auditor, obviously, should endeavour in the course of his examination to get as much external evidence as possible since such evidence ordinarily provides confirmation. When, however, it is not possible to obtain external evidence and he is obliged to accept internal evidence, he should first satisfy himself on a careful consideration of the position whether the evidence which has been produced to him can be reasonably assumed to have come into existence in the normal course of working of the business and that there
exists a system of internal check which would act as a safeguard against its being altered subsequently.

External evidence should be preferred, since the likelihood of its being duplicated or fabricated is much less. This is because it requires collusion with an outsider which normally is not practicable. However, every evidence ‘whether internal or external’ should be subjected to appropriate scrutiny and corroboration should be obtained, if possible. The auditor will always keep in mind the circumstances of the case and see whether the evidence is *prima facie* authentic and correct.

*Note:* Students should observe carefully in the course of their practical training, the various forms in which documentary evidence usually exists in support of different types of transactions and also the sources from which further evidence can be mustered because it is more re-assuring to verify a transaction from two or more sources which are mutually independent.

(v) **Validity of Transactions:** It is also the function of audit to establish that payments have been made validly to persons who are shown to be recipients. For example, it must be verified that salaries to partners were paid according to a provision contained in the partnership deed and the directors fees were paid according to the provisions in that regard in the Articles of Association or the resolution passed by members of the company at a general meeting. For checking the validity of a transaction, it is usually necessary to refer to documentary evidence. It may exist in any of the following forms.

- The legal provisions, if any, having bearing on the accounts of the entity under audit.
- The rules or regulations governing the internal working of the organisation, e.g., the Articles of Association, Partnership Deed, Trust Deed, etc.
- Minutes of the proceedings of a meeting of members of the company, that of the directors or that of the Managing committee
- Copy of an agreement, e.g., Managing Director’s agreement, Lease Deed, vendor’s agreement, agency agreement, contract with an employee, etc.

An auditor should have a clear and precise knowledge of legal provisions under which the concern was registered or is functioning, as well as those which constitutes the basis of various transactions entered into, more particularly the provisions as regards maintenance and audit of its accounts. He should also study the rules, if any, framed for regulating the internal management of the entity; these may be embodied in some of the documents mentioned above. If he has any doubt on any legal point, by way of guidance, he should call for legal opinion. However, unless he is convinced of the reasonableness of the legal opinion, he should not act on it. In the case of Republic of Bolivia Exploration Syndicate Ltd. [1914], it was held that auditors are *prima facie* responsible for *ultra vires* payments made on the faith of their balance sheet but whether, and to what extent, they are considered responsible for not having discovered them in their audit would depend upon the circumstances of each
case. An auditor is responsible for detecting payments that are ultra vires the company (Leed Estate Building & Investment Society v. Shepherd).

(vi) Disclosure in the Final Accounts: The object of audit ultimately is that the statements of account prepared from books of account which have been checked should present a true and fair picture of the financial position of the entity. This particular objective should be kept in view while checking the grouping of accounts. The auditor must see that not only items of a like nature be grouped together but also the description of each account truly reflects the nature of the amounts accumulated therein. Unless this is verified, the classification of income and expenditure and that of assets and liabilities would be misleading. For example if director’s fee and salaries to staff have been added together or advances to directors have been covered up by being amalgamated with book debts, the nature of these payments would be obscured. Fundamentally, care should be taken to ensure that no material fact is suppressed or stated in a manner that it may mislead anyone. If it is found that owing to costing or managerial requirements, certain items of expenditure or receipts have not been classified by the company in the way as would meet the requirements of the Companies Act, 2013 the client’s staff at the end of the year should be required to re-classify them. Nevertheless such a re-classification of expenditure should be checked by the assistant of the auditor to confirm that it has been correctly made and that no item requiring re-classification has been left out. In the case of a company, Schedule III to the Companies Act, 2013 has laid down requirements in regard to the disclosure.

5.1.2 Casting or Totalling: Sometimes the totals of a wage bill are inflated by over totalling the column in which the wages payable are entered. Such a fraud can be detected only if the totals of the wage bill are checked. Similarly, a cashier may misappropriate receipts from account receivables by under-totalling the receipts column of the cash book. At times, shortages in cash have been also covered up by over totalling. Such frauds can be detected only if the totals of the cash book and the general ledger are checked. On these considerations, where totals of the cash book or the ledger are found to have been made in pencil, the book keeper should be asked to ink the totals before their verification is commenced. This would deter him from altering the totals on the totalling mistakes being discovered.

Sometimes a fraud is committed in the following manner:

(a) under casting the receipt side of the cash book;
(b) Over casting the payment side of the cash;
(c) fictitious entries being made in the cash column to show that amounts have been deposited in the account when, in fact, no deposit has been made;
(d) posting an amount of cash sale to the credit of a party and subsequently withdrawing the amount; and
Students are expected to think several other devices where amounts can be misappropriated either by making wrong entries or by failing to make an entry in the accounts.

5.1.3 Bank Reconciliation Statement: Bank reconciliation is an important accounting control. It is expected the students will be familiar with the method of preparing Bank Reconciliation Statement. A copy of the statement duly signed by the accountent of the client after it has been checked should be kept in record by the auditor along with other working papers, for future reference. The position of cheques and other remittances shown in the statement as outstanding should be ascertained on a reference to the Bank Pass Book. Where it is found that a number of cheques have been deposited in the bank immediately before the close of the year, which subsequently were dishonoured, it should be investigated whether these were fictitious which had been deposited merely to inflate the bank balance or to show parties’ balances outstanding against whom were fact irrecoverable. Generally, it is advisable that the position of all amounts deposited in the bank, which were outstanding for realisation at the close of the year, should be ascertained.

5.2 Audit of Payments

Under the Indian Stamp Act, 1899, instruments whereby payment is acknowledged, should bear a revenue stamp. An auditor, therefore, should see that the receipts produced in evidence of payments, shown to have been made are properly stamped. The date of issue of a stamp paper from the stamp office is entered on its back. The design on revenue stamp also is changed from time to time. Such information sometimes may provide a clue leading to the discovery that a receipt has been forged or agreement has been ante-dated. It is the practice with some big companies to have a receipt form printed on the back of their cheques, so that the endorsement on the cheque may be accepted as an evidence of payment. Such cheque forms are specially printed by the bank under an agreement with the account receivable. The system has a drawback from the point of view of the auditor in so far as that such a receipt is only an evidence of the fact that the amount has been paid by the bank; but not that of the identity of the party to whom the payment is purported to have been made. As a safeguard, the auditor should see that adequate precautions to prevent payments being made to wrong persons were being taken by the client’s office (One precaution could be that all cheque forms should have “Account payee only” printed on them). It would also be advisable for him to refer other connected documents, viz., invoices, debit notes, etc. against which payments have been made before accepting such receipts as evidence of payment of money. In such cases, the auditor would be well advised to obtain confirmation of balances of personal accounts and, wherever practicable, these should be obtained directly by him.

5.2.1 Purchase of Goods: Cash purchases should be verified by reference to cash memos or receipted invoices by suppliers. Payments made against credit purchases should be vouched with the receipts issued by the suppliers and the credit to their accounts on the basis
of invoices entered in the Purchases Day book. There must be also evidence of the goods having been received through an entry in the Goods Inward Books or inventory ledger.

It is necessary, however, to make a distinction between a payment for goods and an advance against supplies to be made in future; the latter should be classified as advance recoverable in cash or in kind or for value to be received. Since the amount shown as an advance paid against goods may be only a camouflage for assistance to a party, it is necessary for the auditor to confirm that the advance was paid pursuant to a normal trade practice and supplies were, subsequently, received with a reasonable period of the advance.

Certain concerns issue invoices in duplicate. In such a case, there can be a possibility of an invoice being paid twice; first by its being entered in the Purchase Day Book and the account of the supplier being credited and the second time by the duplicate copy of the invoice being paid as a cash purchase. On this account, on noticing a receipted invoice, the auditor should verify that neither the original nor the duplicate thereof has been already entered in the Purchase Day Book. In the case of goods purchased at the end of year, it should be further verified that even though not received or entered in inventory before the close of the year, they have been included in the closing inventory. To confirm that all the goods, payment for which have been made, have been received and entered in inventory, all invoices for purchases made during one week preceding the close of the year should be traced into the Goods Received Book maintained by the Receiving Section, also it should be verified that every purchase invoice is stamped with the date of receipt of goods in inventory and the ledger folio at which invoice has been entered.

For a more detailed discussion on vouching of credit purchases, students may refer to Audit of Trading Transactions.

5.2.2 Transactions with Related Party: As per Section 188 of the Companies Act, 2013 read with Rule 15 of the Companies (Meetings of Board and its Powers) Rules, 2014, no company shall enter into any contract or arrangement with a related party except with the consent of the Board of Directors given by a resolution at a meeting of the Board with respect to:-

(a) sale, purchase or supply of any goods or materials;

(b) selling or otherwise disposing of, or buying, property of any kind;

(c) leasing of property of any kind; availing or rendering of any services;

(d) appointment of any agent for purchase or sale of goods, materials, services or property;

(e) such related party’s appointment to any office or place of profit in the company, its subsidiary company or associate company; and

(f) underwriting the subscription of any securities or derivatives thereof, of the company.
The above provision is subject to the following conditions, namely:

(1) The agenda of the Board meeting at which the resolution is proposed to be moved shall disclose:

(a) the name of the related party and nature of relationship;
(b) the nature, duration of the contract and particulars of the contract or arrangement;
(c) the material terms of the contract or arrangement including the value, if any;
(d) any advance paid or received for the contract or arrangement, if any;
(e) the manner of determining the pricing and other commercial terms, both included as part of contract and not considered as part of the contract;
(f) whether all factors relevant to the contract have been considered, if not, the details of factors not considered with the rationale for not considering those factors; and
(g) any other information relevant or important for the Board to take a decision on the proposed transaction.

(2) Where any director is interested in any contract or arrangement with a related party, such director shall not be present at the meeting during discussions on the subject matter of the resolution relating to such contract or arrangement.

(3) Where a member of the company is a related party, he shall not vote on such special resolution to approve any contract or arrangement which may be entered into by the Company.

Prior approval of the company by a special resolution is required for entering into contract or arrangement with any related party in case of:

(i) a company having a paid-up share capital of ten crore rupees or more;
(ii) sale, purchase or supply of any goods or materials directly or through appointment of agents exceeding twenty five percent of the annual turnover;
(iii) selling or otherwise disposing of, or buying, property of any kind directly or through appointment of agents exceeding ten percent of net worth;
(iv) leasing of property of any kind exceeding ten percent of the net worth or exceeding ten percent of turnover;
(v) availing or rendering of any services directly or through appointment of agents exceeding ten percent of the net worth;
(vi) appointment to any office or place of profit in the company, its subsidiary company or associate company at a monthly remuneration exceeding two and half lakh rupees;
(vii) remuneration for underwriting the subscription of any securities or derivatives thereof of the company exceeding one percent of the net worth.

Note: The Turnover or Net Worth referred above shall be on the basis of the Audited Financial Statement of the preceding financial year. In case of wholly owned subsidiary, the special resolution passed by the holding company shall be sufficient for the purpose of entering into the transactions between wholly owned subsidiary and holding company.

Proviso to Section 188(1) of the Companies Act, 2013 provides that no provision to this section shall apply to any transactions entered into by the company in its ordinary course of business which are on an arm’s length basis.

Such consent or approval should be ratified by a resolution at a Board Meeting or by a special resolution in the general meeting before the contract is entered into or within three months thereof. In case compliance is not undertaken, then such contract or arrangement shall be voidable at the option of the Board.

It is also necessary to refer in the Board's report to the shareholders about every contract or arrangement entered into under sub-section (1) of section 188 with the justification for entering into such contract or arrangement.

Further, every director of a company who is in any way, whether directly or indirectly, concerned or interested in a contract or arrangement entered into or one proposed to be entered into by the company, must disclose the nature of his concern or interest to the company at the Board Meeting (Section 184). An interested director is also restrained from taking part in such meeting. If the director of the company, who is concerned or interested in any way, whether directly or indirectly, does not disclose his interest or, participate in Board meeting in which the contract or arrangement is discussed, the contract or arrangement entered into by the company shall be voidable at the option of the company. There are certain exceptions to these provisions contained in sub-section (5) of Section 184 of the Companies Act, 2013.

5.2.3 Remuneration paid to Directors: The following points must be considered while vouching the directors’ remuneration in case of a public company—

(i) Examine the Entitlement: The directors are not automatically entitled to remuneration. It is paid either according to the terms of articles of association or in accordance with a resolution of the general meeting.

(ii) Examine Adherence to Legal Provisions: The auditor should examine adherence to relevant sections of the Act such as—

- Section 197(6) which deals with manner of payment of managerial remuneration.
- Section 197(5) which deals with payment of listing fees.
- Section 197(1), which has prescribed the overall limit to managerial remuneration.
Schedule V to the Act that has laid down conditions for payment of remuneration for companies having no profits or inadequate profits and companies having negative effective capital.

Proviso to Section 197(1) which provides for increase in remuneration with the approval of the Central Government.

5.2.4 Payment for Acquisition of Assets: The purchase of an asset must be duly supported by the receipt for the amount paid. In case of an immovable property the auditor must also inspect the title deeds. The title of an immovable property passes only on registration. It is therefore essential for an auditor to see that property has been registered in the purchaser’s name as required by the Transfer of Property Act, 1882 and also that the title of the transfer to sell property has been verified by a solicitor or an advocate.

In the case of movable property requiring registration of ownership, e.g., a car or a ship, it must be verified that such a registration has been made in favour of the purchaser. It is necessary for the auditor to satisfy himself generally as regards existence, value and title of the assets acquired. It must also be verified that the assets were purchased only by a person who had the authority to do so. Section 179 of the Companies act, 2013 provides that only the Board of Directors can invest the funds of the company. Thus the Board alone can sanction the purchase of a fixed asset. If the benefit of an item of expense has been acquired by the purchaser along with the asset, its value should be debited to a separate account, e.g., when a motor car has been purchased on which certain taxes and insurance charges were paid by the seller for a period that had not expired. In the case of an asset constructed or manufactured by the client himself, e.g., where a building has been constructed or a plant or machinery manufactured by the concern with its labour and materials, it must be verified that the cost of labour, materials and other direct expenses incurred has been charged as cost of the asset on a proper allocation of the total expenditure debited under these heads. This is because, if a larger sum is capitalised than warranted in the circumstances, it would inflate the profit and if a smaller amount is debited, it would have the effect of unduly reducing the profit. Also corresponding values of assets would not be properly recorded. It must also be seen that neither expenses on repairs and maintenance have been capitalised nor the cost of additions to assets charged off as revenue expenses.

5.2.5 Payments controlled by the Companies Act, 2013:

(a) Under sub-section (1) of section 143, Clause (e) whether personal expenses charged to the revenue account of a company should be reported.

(b) Under section 180, the Board of Directors of a company except with the consent of the company by a special resolution exercises the following powers.

(i) to sell, lease or otherwise dispose of the whole or substantially the whole of the undertaking of the company or where the company owns more than one undertaking, of the whole or substantially the whole of any of such undertakings.
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(ii) to invest otherwise in trust securities the amount of compensation received by it as a result of any merger or amalgamation;

(iii) to borrow money, where the money to be borrowed, together with the money already borrowed by the company will exceed aggregate of its paid-up share capital and free reserves, apart from temporary loans obtained from the company’s bankers in the ordinary course of business:

Provided that the acceptance by a banking company, in the ordinary course of its business, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise, shall not be deemed to be a borrowing of monies by the banking company within the meaning of this clause.

(iv) to remit, or give time for the repayment of, any debt due from a director.

(c) Under section 181, the Board of Directors of a company except with the prior permission of the company in general meeting, contribute to the bonafide charitable and other funds any amount in any financial year, the aggregate of which exceeds 5% of its average net profits for the three immediately preceding financial years.

(d) Section 182 deals with prohibition and restriction regarding political contributions. According to this section, a government company or any other company which has been in existence for less than three financial years cannot contribute any amount directly or indirectly to any political party. In other cases, contribution in any financial year should not exceed 7½ % of average net profits during the three immediately preceding financial years.

(e) Section 183 permits the Board and other person to make contributions to the National Defence Fund or any other Fund approved by the Central Government for the purpose of National Defence to any extent as it thinks fit.

5.2.6 Assets acquired on Hire Purchase Basis

(i) Examine the Board’s Minute Book approving the purchase on hire-purchase terms.

(ii) Examine the hire-purchase agreement carefully and note the description of the machinery, cost of the machinery, hire purchase charges, terms of payment and rate of purchase.

(iii) Assets acquired under Hire Purchase System should be recorded at the full cash value with corresponding liability of the same amount. In case cash value is not readily available, it should be calculated presuming an appropriate rate of interest.

(iv) Hire purchased assets are shown in the balance sheet with an appropriate narration to indicate that the enterprise does not have full ownership thereof. The interest payable along with each installments, whether separately or included therein should be debited to the interest account and not to the asset account.
5.2.7 Assets Acquired on Lease

(1) Examine the terms and conditions of the lease deed.

(2) If a part of the leasehold property has been sublet, examine the tenant’s agreements.

(3) Verify relevant document to check the cost of property.
   
   i. In case of *acquisition of an asset is on* operating lease, lease payment should be recognized as an expense in the *Statement of Profit and Loss* on a straight line basis over the lease term, *in case of operating lease*;

   ii. In case of *acquisition of an asset is on* finance lease, *ensure* all the substantial risks and rewards incidental to ownership are transferred, considering the indication as prescribed in AS-19, the lessee should recognize the lease as an asset and as a liability. Such recognition should be at an amount equal to the fair value of the leased asset at the inception of the lease. Ensure contingent rents are recognised as expense in the statement of profit and loss for the period in case of Finance Lease;

(4) Ensure assets acquired under finance lease are segregated from the assets owned.

(5) Ensure that the assets under lease have been properly disclosed as per the requirements of Schedule III to the Companies Act, 2013.

5.2.8 Payment of Expenses: Normally, every item of expenditure has to be written off in the year in which it is incurred. But, considering the requirement of AS 10 and AS 26, the expenses relating to tangible and intangible assets can be capitalized if recognition criteria are met. It may be noted that with the issuance of AS 26, "Intangible Assets", the concept of deferred revenue expenditure is no more in existence.

If the provision for outstanding expenses made in a past year turns out to be insufficient and the amount is material, proper disclosure of such a fact should be made in the accounts of the year in which any further amount is charged on that account. This is done either by showing the amount separately in the inner column and explaining its nature or by including it in the Appropriation Section of the Statement of Profit and Loss.

Only expenses incurred for the purpose or for the benefit of business are chargeable to it. The auditor therefore, should make certain, as far as practicable, that no personal expenses are charged to the business. In the case of a company, as has been stated earlier, personal expenses, if charged, have to be reported, particularly those which are not covered by commercial practices or contractual obligation.

It should be verified that all expenses incurred, whether paid or payable, have been included in the accounts and that where any part of an item of expenses relates to the period that extends beyond the close of the year, a proportionate amount thereof has been adjusted as prepaid expense.

Where some of the expenses are found to have been adjusted in a lump-sum especially at the
close of the year, these might be fictitious items introduced merely to reduce profits. These, therefore, should receive special attention of the auditor.

Requirements as stated in Schedule III to the Companies Act, 2013, related to disclosure of expenses in case of Companies are:

(i) A Company shall disclose aggregate of the following expenses separately on the face of the Statement of Profit and Loss:

   **Item IV. Expenses:**
   (a) Cost of Materials Consumed
   (b) Purchases of Stock-in-trade
   (c) Changes in Inventories of Finished Goods, Work-in-progress and Stock-in-trade:
   (d) Employee Benefits Expense
   (e) Finance Costs
   (f) Depreciation and amortization expense
   (g) Other Expenses

(ii) A Company shall disclose separately by way of notes on the face of the Statement of Profit and Loss additional information regarding aggregate expenses as under:

   (a) Consumption of stores and spare parts;
   (b) Power and fuel;
   (c) Rent;
   (d) Repairs to buildings;
   (e) Repairs to machinery;
   (f) Insurance;
   (g) Rates and taxes, excluding, taxes on income;
   (h) Miscellaneous expenses

5.2.9 Payment of Taxes: Payment on account of income-tax and other taxes consequent upon a regular assessment should be verified by reference to the copy of the assessment order, assessment form, notice of demand and the receipted challan. Payments or advance payments of income-tax should also be verified with the notice of demand and the receipted challan acknowledging the amount paid. The interest allowed on advance payments of income-tax should be included as income and penal interest charged for non-payment should be debited to the interest account.

Nowaday, electronic payment of taxes is also in trend. Electronic payment of taxes means payment of taxes by way of internet banking facility or credit or debit cards. The
assessees can make electronic payment of taxes also from the account of any other person. However, the challan for making such payment must clearly indicate the Permanent Account Number (PAN) of the assessees on whose behalf the payment is made. It is not necessary for the assessees to make payment of taxes from their own account in an authorized bank. While vouching such E Payment the auditor should cross verify the payments of taxes through the receipted challan along with PAN No/TAN No. etc.

5.2.10 Customs and Excise Duties: The audit procedures for custom duties are listed below:

(i) *Examine Cash Book:* Examine the payment of custom duties in the cash book with reference to bill of entry.

(ii) *Examine the Bill of Entry:*

- Check the amount of custom duty was calculated correctly, i.e., in accordance with the applicable rate for dutiable goods.
- If the duty has been paid by dealing and forwarding agent, examine bill of entry with reference to agent’s bill.
- If the duty has been paid by the client directly, examine bill of entry together with receipt evidencing payment of customs duty.

(iii) *Examine Disputed Cases Carefully:* In case of a dispute about the amount of duty payable, a provisional payment may have been made. The auditor should determine the duty payable and ensure any additional duty to be paid or refund expected should have been adjusted.

(iv) *Verify for Duty Drawback:* Duty drawback refers to a scheme under which central excise and customs duties paid for raw-materials and other inputs used in the manufacture of the product prior to its export are refunded to the exporter. The auditor should verify the claim of duty drawback with reference to acknowledgement issued by the Directorate of duty drawback.

Excise duty becomes payable at the time of releasing of excisable goods from the factory/godown to the manufacturer. Normally, the excise duty payable is deposited with the designated bank to the credit of the controller of excise and one copy of the challan is forwarded to him for obtaining the permit and another copy is sent to the dispatch department evidencing payment of required duty. The auditor may adopt the following procedures to vouch the payment of excise duties:

(i) *Verify payment of excise duties by examining the duly paid as per Challans with reference to the quantity of goods in respect of which issue permits have been received.*

(ii) *Test check the accuracy of the amount of duty paid by multiplying the rate of excise duty with the value of goods issued as per the client’s inventory register.*

(iii) *In respect of excisable goods manufactured but remaining to be released, ensure that*
necessary provision for unpaid excise duty has been made.

(iv) Ensure that in every case CENVAT credit has been adjusted and only net excise duty has been paid.

5.2.11 Travelling Expenses: Travelling expenses are normally payable to staff according to rules approved by directors or partners. Where no rules exist, the auditor should recommend that these be framed for controlling the expenditure. In the absence of T.A. Rules, the expenditure should be vouched on the basis of actual expenditure incurred. A voucher should be demanded for all items of expenses incurred, except those which are capable of independent verification.

As regards travelling expenses claimed by directors the auditor should satisfy himself that these were incurred by them in the interest of the business and that the directors were entitled to receive the amount from the business.

The voucher for travelling expenses should normally contain the under mentioned information:

(i) Name and designation of the person claiming the amount.
(ii) Particulars of the journey.
(iii) Amount of railway or air fare.
(iv) Amount of boarding or lodging expenses or daily allowance along with the dates and times of arrival and departure from each station.
(v) Other expenses claimed, e.g., porterage, tips, conveyance, etc.

If the journey was undertaken by air, the counterfoil of the air ticket should be attached to the voucher; this should be inspected. For travel by rail or road, the amount of the fare claimed should be checked from some independent source. Particulars of boarding and lodging expenses and in the case of halting allowance the rates thereof should be verified. The evidence in regard to sundry expenses claimed is generally not attached to T.A. bills. So long as the amount appears to be reasonable it is usually not questioned. All vouchers for travelling expenses should be authorised by some responsible official. In the case of foreign travel or any extraordinary travel, the expenses, before being paid, should be sanctioned by the Board. The travelling advance taken, if any, should be settled on receipt of final bills. At the year end, the amount not settled should be shown appropriately in the Balance Sheet.

Unless the articles specifically provide or their payment has been authorised by a resolution of shareholders, directors are not entitled to charge travelling expenses for attending Board Meetings.

5.2.12 Repairs to Assets: Since the line demarcating repairs from renewals is slender, usually it is not a simple matter to determine the amount of the expenditure, if any, included as charges for repairs, which should be considered as that incurred for renewal of an asset and added to its cost. It may sometimes be possible to determine this on a consideration of the nature of repairs carried out. The proportion of the charges which had the effect of increasing
the value of an asset or enhancing its capacity or life should be treated as capital expenditure. Where, however, it is not possible to form an opinion accurately on the basis of evidence as regards the nature of repairs, a certificate from the engineer under whose supervision the repairs were carried out, confirming the classification of expenditure should be obtained. It should be ensured that Repairs to ‘Certain Assets’ like Building and Machinery have been separately disclosed as per the requirements of Schedule III.

5.2.13 Preliminary Expenses: The expenditure incidental to the creation and floating of a company includes stamp duties, registration fees, legal costs, accountant’s fees, cost of printing, etc. The contracts relating to preliminary expenses should be examined. If preliminary expenses incurred by promoters have been reimbursed to them by the company, the resolution of the Board of Directors and the power in the Articles to make such reimbursement should be seen. The bills and statements supporting each item of preliminary expenses should be checked. It should be seen that no expenses other than those which constitutes preliminary expenses are booked under this head. The auditor can cross check the amount of preliminary expenses with that disclosed in the prospectus, statutory report and the balance sheet. Any amount paid in excess of the amount disclosed in the prospectus should have been approved by the shareholders. **Expenditure in connection with the preliminary expenses should be treated as an expense in the year of incurring and not to be carry forwarded for writing off in future years as per the compliance of AS 26.** Underwriting commission and brokerage paid for shares and debentures should not be included under the head preliminary expenses.

5.2.14 Salaries and Wages: Payments on account of salaries and wages need to be vouched carefully, since amounts which were either not due or in excess of those due may have been paid by the client. The evidence in support of such payments generally is internal. It can, therefore, be relied upon only if it has been produced in the normal course of business and there exists an efficient system of internal control which could be expected to prevent it from being fabricated.

Therefore, before proceeding to verify payment made on account of salaries and wages, the auditor should examine the internal control procedure as regards the following:

(a) Appointment, promotion, transfer and discharge of employees.

(b) Recording attendance of workers engaged on the time basis, as well as particulars of jobs performed by piece workers.

(c) Arrangement for the preparation of wages and salaries bills and their analysis.

(d) Sanctioning the disbursement of wages and salaries.

(e) Arrangement for disbursement of wages and salaries for workers and employees not present on the pay day.
(f) Custody of the wages records.

He should also verify that the system of internal control provides for the following matters:

(a) Mechanical recording of attendance of workmen by time recording clocks installed at the factory gate, as well as in each department and the reconciliation of the total labour force with the total of workmen in different departments; also the recording of attendance of the staff departmentally in separate registers.

(b) Preparation of wages and salary bills by members of the staff, who are not connected with maintaining a record of engagement of workers, recording of their attendance or fixation of their wages.

(c) Rotation of duties of different clerks employed for preparation of wages and salaries bills so that calculations, additions and extensions are not carried out by the same clerk every month. Also, signing of the statement by persons who have prepared them and indication by each person so employed of the nature of work carried out by him.

(d) Verification of salaries and wages bills in case of newly appointed persons by reference to orders for appointment, promotions or transfer made during each month and of those payable to old employees by reference to old records and on reference to the record of attendance.

(e) Verification of the amount of total wages paid with the amount adjusted in the costing record.

(f) Checking and authorising the overtime and piece work payment by officers who are not associated with the Wages Department.

(g) Withdrawal by a single cheque from the bank of the exact amount of wages and salaries payable as are entered in the wages and salaries bill, depositing in the bank the undisbursed amounts.

(h) Recording of unclaimed wages and salaries immediately in the Unpaid Wages and Salaries Register, and their subsequent payment on the employee's claim to them.

(i) Payment of advances in lieu of wages and salaries to persons who go on leave on short notice before the end of the month through the Petty Cash.

(j) Disbursement of wages in the presence of an official who is in a position to identify the worker and ensure that wages are not being paid to persons other than the workmen except under a proper authority.

Provided that the system of internal control has built-in safeguards against payments being made in excess, the auditor should check the wages and salaries bills for one month as follows:

(a) Check the bill in detail by reference to the record of attendance, schedule of rates, sanctioned by the management for different classes of workers and employees and the sanction for their payment.
Check the computation of wages and salaries payable to different workers and employees by taking into account the deduction and other factors on a consideration of the following:

(i) Absence;
(ii) Leave with pay;
(iii) Loans and advances;
(iv) Increments;
(v) Fines and penalties;
(vi) Deduction on account of Provident Fund and Income-tax;
(vii) Deduction on account of contribution towards Employees’ State Insurance, etc.

Verify the addition, extension and classifications of wages and salaries for distributing them among different accounts.

Confirm that all payments to workers and other employees have been acknowledged and amounts which have remained undisbursed have been deposited back in the bank and credited to the Unpaid Wages and Salaries Account. Also, check disbursement of unpaid wages and salaries made during the month.

See that wage sheets are signed by the persons who have prepared wage sheets and disbursed wages; also that they have indicated precisely the nature of work carried out by them.

Test the correctness of the amount paid by reference to the Annual Return of Salaries, etc., submitted to the Income-tax Authorities and that of wages with Employee’s State Insurance Cards.

Trace recoveries out of loans and advances, outstanding against employees into the Employees Loans and Advances Register.

See that names of the same persons do not always appear on the list of unpaid wages if their wages are not, from time to time, adjusted against their loans and advances to prevent their absence being noticed at the time wages are paid. It might provide a clue that the workmen are dummies.

If the aforementioned checking does not disclose significant mistakes, either in the preparation of wages and salaries bill or in their disbursements, the auditor could verify the wages and salary bills for the rest of the period by the application of the following checks:

(a) Test checking the amount of wages and salaries, shown as payable in the bill, to a selected list of employees by reference to their attendance record as well as Employees Insurance Cards; also verifying the rate of wages and salaries at which the amount due have been computed on an inspection of the authority under which they were engaged.

(b) Verifying the disbursement of all wages and salaries by reference to receipts furnished
by employees or their authorised representatives on the salaries and wages bill.

(c) Verifying the amounts withdrawn each month from the bank for payment of the salaries and wages bill.

(d) Reconciling the amounts deposited in the bank each month with that undisbursed shown in the relevant bill.

(e) Vouching all payment made on account of wages and salaries that had remained unclaimed on the pay day.

5.2.15 Schedule III - Disclosure requirement to the Statement of Profit & Loss:

A Company shall disclose separately by way of notes on the face of the Statement of Profit and Loss additional information regarding aggregate expenditure on Employee benefits expenses as under:-

Employee Benefits Expense
- Salaries and Wages
- Contribution to Provident and Other Funds
- Expenses on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP)
- Staff Welfare Expenses

5.2.16 Petty Cash: Payments from petty cash should be verified as follows:

(i) Trace the amounts advanced to the petty cashier for meeting petty office expenses from the Cash Book in the Petty Cash Book.

(ii) Vouch payments with docket vouchers which must be supported, wherever possible, by external evidence e.g., payee’s receipted bill or invoices, cash memo, etc.

(iii) Trace payments made for the purchase of postage stamps recorded in the Postage Book. The totals of the Postage Book should be test checked. The amounts of postage stamps in hand, at the end of the year, should be credited to Postage Account by debiting the amounts to Postage in Hand Account. It should be seen that the amount paid for postage stamps is not unduly large and the Postage Book is normally checked by the petty cashier from time to time before the amount of imprest is reimbursed. Confirm that the postage expenses for the year are reasonable as compared with that in the postage expenses from month to month.

(iv) See where a columnar Petty Cash Book is maintained, that the extension have been carried forward into appropriate amount columns.

(v) Check the column totals and cross totals.

(vi) Trace posting of the various columns in which payments are classified to the respective ledger accounts.
(vii) Verify the cash balance in hand.

(viii) Auditor should also verify whether the amount of petty cash imprest is fixed. Is this amount reasonable considering the total amount of petty cash payments made during a month or so?

### 5.2.17 Advertisement Expenses:

The advertisement expenses will be vouched in the following manner:

(a) Ascertain the nature of advertisement expenses to ensure that the same have been charged properly.

(b) Obtain the complete list of advertisement, media wise, i.e., newspapers, slides, hoardings, magazines, television, radio, etc. showing the dates, exact location, timings, etc., along with the amounts paid in respect of each category.

(c) See that advertisement expenses relate to the client’s business.

(d) Ascertain whether there is a regular contract with an advertising agency. See that regular statements are obtained from the agency showing the advertising media and amounts debited to the client. Discounts, if any, should be properly adjusted and disclosed in the bills.

(e) Check the receipts for amounts paid for the advertising expenses incurred.

(f) See that outstanding advertising expenses have been properly disclosed on the liabilities side of the balance sheet.

### 5.2.18 Payment of Dividends

(a) Examine special provisions, if any, in the Memorandum and Articles of Association regarding payment of dividends.

(b) See that in declaring dividends, provisions of the Companies (Transfer of Profits to Reserves) Rules, 1975 have been complied with.

(c) Examine the Board’s minutes regarding rate of dividends.

(d) Examine the company’s procedure for payment of dividends including unclaimed dividends and ensure that they are not paid without adequate safeguards as to identification of the payee, checking of the payee’s claims etc. In this connection, internal control of the company should be examined.

(e) Verify the shareholders’ register and ensure that the names of all shareholders who are entitled to receive dividends have been included.

(f) Check the computation of dividends with reference to rate of dividends and number of shares held.

(g) See counterfoils of cheques for amounts paid to shareholders.

(h) Examine, whether all the conditions for payment and source of dividend as specified on
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section 123 and 124* of the Companies Act, 2013, have been complied with.

5.2.19 Retirement Gratuity to Employees

(a) Examine the basis on which the gratuity payable to employees is worked out. The liability for gratuity may either be worked out on actuarial rules or agreement or on the presumption that all employees retire on the balance sheet date.

(b) Ensure that the basis of computing gratuity is valid.

(c) Verify computation of liability of gratuity on the aggregate basis.

(d) Check the amount of gratuity paid to employees who retired during the year with reference to number of years of service rendered by them.

(e) See that the annual premium has been charged to Statement of Profit and Loss in case the concern has taken a policy from LIC.

(f) Ensure that the accounting treatment is in accordance with AS-15 (Revised), “Retirement Benefits”.

5.3 Cash Receipts

The function of audit in respect of cash receipts being much the same as that in the case of cash payments, the procedure stated at the beginning of this Chapter should be applied for their verification. But the internal check in respect of cash receipts should be closer and stricter, primarily because these have to be verified generally only by reference to the internal evidence which, if it is not in existence or is manipulated, would not be of any assistance for the detection of incomes that either have not been credited or have been credited only partially. For example, if in respect of sale proceeds of goods or an item of miscellaneous income no bill or voucher has been prepared, audit would not disclose that the amount has been misappropriated. Similarly, if the amount on the copy of a cash memo has been cleverly altered from ₹ 50 to ₹ 5 and the latter amount only has been entered in the Cash Book, unless the alteration is detected and the fact that it has been altered is established, it would not be possible for the auditor to know that part of the cash sales has been misappropriated.

On this account, it is essential that the auditor before starting the audit of cash receipts should examine the internal check in operation and bring to the attention of the management any weakness therein, as well as to the possible consequence that might follow if it is not removed. If he fails to do so, he may be held responsible at some later date for not having detected a defalcation or misappropriation in cash, the cause of which was the absence/inadequacy of the internal check.

Cash receipts are usually checked with counterfoils of the receipts issued. But the issue of receipts with counterfoils in respect of amounts collected by it would not ensure that all the amounts collected have been fully accounted for or have been correctly adjusted. For

* Section 124 of the Companies Act, 2013 not yet enforced
instance, a receipt might be issued for a larger amount than entered on its counterfoils. Again, only one receipt might have been issued for two or more amounts collected from a party while the counterfoils may show that separate receipts have been issued in respect of each amount collected and the one or more receipts forms, thus saved, may have been used for issuing a receipt of another amount collected which have been misappropriated. Therefore, before accepting counterfoils or receipts as evidence or the correctness of the amount collected, the auditor should satisfy himself that there exists an efficient system of internal check which would prevent any receipt from being misappropriated. For the purpose, the auditor should make the following enquiries:

(i) Who opens letter, what record is kept, and whether all cheques and postal orders are immediately endorsed to bankers and crossed 'Account Payee Only'?

(ii) Whose duty is to enter cash, cheques and other forms of remittance in the Pay-in-Slip and who deposited it in the bank?

(iii) Are receipts banked daily?

(iv) Who prepares receipts and who countersigns the same before these are issued to the parties from whom the amounts have been received?

(v) Whether printed receipts with counterfoils, numbered serially by a machine, are used and who maintains the inventory of unused receipts?

(vi) Are the receipt books kept in safe custody and are they issued only when the current receipt book has been used up?

(vii) What internal check is being exercised over the collection of cash sales and miscellaneous income?

(viii) Are travelling salesmen allowed to collect any advance against orders booked and what control exists over such collections?

(ix) How often are the bank statements checked and compared with the Cash Book?

(x) Who controls the preparation and dispatch of monthly statements of account to account receivables?

(xi) Are ledgers posted by the cashier or some other person?

There are certain firms which insist upon a receipt furnished to them on their own forms. In such a case, this fact should be noted on the counterfoil of the receipt which has been issued and the unused receipt form cancelled, as an additional precaution, balances in such account receivable's account should be get confirmed periodically.

While vouching cash receipts, it should be seen that the date of each receipt as it is entered in the cash memo or the counterfoil of the receipt issued in respect thereof corresponds with the date on which it is entered in the Cash Book. If there is a time lag between them, it is possible that the person who had collected the amount had failed to deposit it with the cashier immediately thereafter. When such a discrepancy is observed, the cause thereof should be ascertained.
5.3.1 **Cash Sales**: Primarily, the system of internal check should be examined with the objective of finding out loopholes therein, if any, whereby cash sales could be misappropriated. Further, the practice followed in the manner cash memos are issued should be ascertained. Because in case, cash memos are issued not only for cash sales but also for credit sales, the amount whereof if collected long after, there would be no guarantee that all the amount of cash sales has been collected before the close of year or that some of the amounts collected have not been misappropriated.

Cash sales usually are verified with carbon copies of cash memos. If sales are quite voluminous then a Cash Sales Summary Book is maintained and the cash memos are traced into it; the totals of the Summary Book are verified and the daily totals of the Summary book traced into the Cash Book. One of the matters, to which attention of the auditor should be paid in the process, is that the dates on the cash memos should tally with those on which cash collected in respect thereof has been entered in the Cash Book.

To verify that price of goods sold has been calculated correctly; the computation of the sales should be ascertained. If a cash memo has been cancelled, its original copy should be inspected, for it could be that the amount thereof has been misappropriated.

5.3.2 **Receipts from Account receivables**: Receipt of cash from the account receivables against price of goods sold are checked with the counterfoils of receipt issued to them. At the same time, it is also verified that there is a system of internal check in operation which acts as a safeguard against amounts collected being misappropriated.

One of the common devices for misappropriating cash collections from account receivables is the one known as *Teeming* and *Lading*. Such a fraud, usually, remains undetected for long since the cashier is able to make good the amounts misappropriated before the cash balance is checked. At times, the cashier who has committed such a fraud may cover up the amounts misappropriated, by raising a fictitious debit in an expense account.

When such a fraud is suspected, the first step in its investigation should be making comparison of the entries of amounts deposited in the bank account with those on counterfoils of the Pay-in-Slip Book. If the composition of the deposits is different from that shown on the counterfoils of the Pay-in-Slip Book, it would be a *prima facie* evidence of the fact that the amounts collected were not deposited as soon as these were received. Another evidence of the existence of such a fraud can be the fact that debits in account receivables’ accounts, which ought to have collected in whole, are cleared in small instalments.

If such evidence exists, the matter should be investigated further. This can be done by all the account receivables being requested to send statements of account from their books, for the period during which the fraud is suspected to have been in progress. On comparing items in each statement, with the entries in the account receivable’s accounts, it would be possible to locate amounts which were not deposited on the day these were collected, but subsequently.
5.3.3 Income from Investments: If the investments are many, the client generally would have an Investment Register. In such a case, the dividend income is first vouched by reference to the counterfoils of Dividend Warrants and the interest on securities by reference to the tax-deduction certificates, issued by the Reserve Bank. Afterwards the amounts collected are traced into the Investment Register; it is scanned to find out whether interest or dividend, relating to any investment, has remained unrealised. If so, the reasons thereof are ascertained. In order that the gross amount of interest are disclosed in the Statement of Profit and Loss, the tax deducted out of interest is debited to the Income-tax Account and credited to Interest Account. The auditor should verify that this has been done.

The auditor should examine the separate ledger accounts kept for each investment or loan given. The dates on which dividends or interest payments generally fall due should also be noted. The counterfoil of dividend warrants should be seen. These should be tallied with the records of investment. Where investments are sold ex-dividend, it should be seen that the dividends are subsequently received. Similarly when a purchase is on cum dividend basis, the receipt of dividend should be checked. In case of interest on deposit with banks, verification should be done by reference to the bank statement and the agreed rate of interest. The receipts of dividends and interest should be addressed to the bank statement for encashment. It should be ensured that the interest and dividend received are credited to the respective account in full i.e., before deduction of tax at source and the tax deducted at source should be debited to an appropriate account. It should be further seen that the certificate for tax deducted at source exists in each case.

5.3.4 Rental Receipts: Before proceeding to vouch rental receipts, copies of bills issued to tenants should be test checked by reference to copies of tenancy agreements and bills of charges paid by the landlord on behalf of the tenants, i.e., house tax, water tax, tax deducted at source, electricity consumed, etc. The entries in the Rental Register in respect of rents accrued afterwards should be verified by reference to copies of rental bills. The amounts collected from tenants on account of rent should be checked by reference to receipts issued to them. These afterwards should be traced into the Rental Register.

At the end, the register should be scrutinized to find amount or rents which have not been recovered and are considered bad or irrecoverable, for deciding whether these should be written off or as provision against the same should be made.

An overall check over rental receipts is also necessary. For this purpose, particulars of total accommodation available for being let out, in different buildings, belonging to the client, should be ascertained. It should be verified that every available accommodation has been let out and rental income has been duly accounted for. If it is reported that one or more tenements have remained vacant a certificate in respect thereof should be obtained from the client.

5.3.5 Bankruptcy Dividends: When a account receivable has been sued for bankruptcy it is necessary to prove that the debt is due from him to the Official Receiver or Assignee before
any amount can be recovered from his estate. The amounts of claim admitted are received subsequently, usually in parts, which are referred to, somewhat euphemistically, as dividends.

For the verification of these part amounts, it is necessary to refer to the correspondence with the Official Receiver or Assignee to find particulars of part amounts already collected and the balance outstanding at the beginning of the year. The advice, if any, received from the same authority along with the payment should be referred to.

5.3.6 Sale of Investments: Only the person who is authorised to purchase an investment can sell an investment. Thus, in the case of a company, an investment can be sold only by the Board of Directors and in the case of a trust by the trustees acting together. The normal method of selling investment is through Stock Broker, either directly or through a bank; the sale proceeds of investments are vouched by reference to Brokers’ Sold Note. On disposal of an investment, the difference between the carrying amount and the disposal proceeds, net of expenses, is recognised in the Statement of Profit and Loss. When disposing of a part of the holding of an individual investment, the carrying amount to be allocated to that part is to be determined on the basis of the average carrying amount of the total holding of the investment. AS-13 requires disclosures of amounts included in Statement of Profit and Loss for:

- interest, dividends (showing separately dividends from subsidiary companies), and rentals on investments showing separately such income from long term and current investments. Gross income should be stated, the amount of income tax deducted at source being included under Advance Taxes Paid;
- profits and losses on disposal of current investments and changes in the carrying amounts of such investments; and
- profits and losses on disposal of long term investments and changes in the carrying amount of such investments.

5.3.7 Loans: Primarily, the authority under which a loan has been raised should be verified. An unauthorised loan cannot be treated as a liability of the concern. The copy of the loan agreement should be referred to find out the rate of interest, the terms of repayment and the conditions as to security agreed to by the client. If any guarantee has been provided for the repayment of the loan the particulars thereof should be ascertained for the purpose of disclosure in the balance sheet.

5.3.8 Bills Receivable: The amount collected in respect of bills receivable are verified by reference to Bills Receivable Book. When bills are purchased, a provision for the amount of the discount, not earned till the close of the year is made in the accounts, in the case of bank. If the bills have been discounted, the contingent liability in respect of the discounted bill is disclosed in the balance sheet; also bills which have since been paid off are shown separately. Enquiries should be made from the client as regards the position of a bill or bill receivable dishonoured and if it is suspected that the amount due on a bill may not be
recovered, a provision thereof should be made.

5.3.9 Sale of Assets: In this case also, as in the case of sale of investments, the authority for sale is most important. It is, therefore, a matter which should receive the attention of the auditor. Another important aspect which requires consideration is the basis of sale, whether by auction or by negotiation, for determining that the asset was sold at the maximum price that could be contained for it and that the sale proceeds of the asset have been fully accounted for. It should further be confirmed that sale proceeds have been credited to an appropriate head of account and the amount of profit arising out of it has been segregated between revenue profits and capital profits, if any, accordingly appropriate accounts are credited, where there is a loss, the same should be written off.

5.3.10 Royalties received: The auditor should see the relevant contract and examine the important provisions relating to the conditions of payment of royalty. In particular, the rate of royalty, mode of calculation and the due dates should be noted. The periodical statements received from the publisher and the calculation of the royalty should be checked. If there is any deduction on account of recoupment of royalty for the past period, the records for earlier royalty receipts should be seen to ensure that the amount of deduction is as per the contract. Royalties due but not yet received should have been properly accounted for.

5.3.11 Insurance Claims: Insurance claims may be in respect of fixed assets or current assets. While vouching the receipts of insurance claims, the auditor should examine a copy of the insurance claim lodged with the insurance company. Correspondence with the insurance company and the insurance agent should also be seen. Counterfoils of the receipts issued to the insurance company should also be seen. The auditor should also determine the adjustment of the amount received in excess or short of the value of the actual loss as per the insurance policy. The copy of certificate/report containing full particulars of the amount of loss should also be verified. The accounting treatment of the amount received should be seen particularly to ensure that revenue is credited with the appropriate amount and that in respect of claim against an asset, the Statement of Profit and Loss is debited with the shortfall of the claim admitted against the book value. If the claim was lodged in the previous year but no entries were passed, entries in the Statement of Profit and Loss should be appropriately described.

5.3.12 Sale Proceeds of Junk Materials

(a) Review the internal control on junk materials, as regards its generations, storage and disposal and see whether it was properly followed at every stage.

(b) Ascertain whether the organisation is maintaining reasonable records for the sale and disposal of junk materials.

(c) Review the production and cost records for the determination of the extent of junk materials that may arise in a given period.
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(d) Compare the income from the sale of junk materials with the corresponding figures of the preceding three years.

(e) Check the rates at which different types of junk materials have been sold and compare the same with the rates that prevailed in the preceding year.

(f) See that all junk materials sold have been billed and check the calculations on the invoices.

(g) Ensure that there exists a proper procedure to identify the junk material and good quality material is not mixed up with it.

(h) Make an overall assessment of the value of the realisation from the sale of junk materials as to its reasonableness.

5.3.13 Recovery of Bad Debts written off: Recovery of bad debts written off is verified with reference to relevant correspondence and proper authorisation.

(a) Ascertain the total amount lying as bad debts.

(b) Ensure that all recoveries of bad debts have been properly recorded in the books of account.

(c) Examine notification from the Court or from bankruptcy trustee. Letters from collecting agencies or from account receivables should also be seen.

(d) Check Credit Manager’s file for the amount received and see that the said amount has been deposited into the bank promptly.

(e) Vouch acknowledgement receipts issued to account receivables or trustees.

5.3.14 Refund of General Insurance Premium paid: The refund of insurance premium may be because of earlier provisional payment of premium or may be a policy might have been cancelled at a later date. The auditor should take following steps while vouching such refunds:

(a) Ascertain the reasons for refund of insurance premium.

(b) Examine insurance policy or cover note to find out the amount of premium.

(c) Verify advice of refund received from the insurance company. When refund is admitted, the insurance company sends the advice. This will be evidence as a covering letter to the cheque for the refund. Sometimes, a cheque is issued after a receipt is sent in advance to the insurance company.

(d) Scrutinise correspondence between the insurance company and the client.

(e) Check entries in the bank book or the bank statement. If necessary, the counterfoil of the pay-in-slips can also be verified.
5.3.15 Discounted Bills Receivable Dishonoured

(a) Obtain the schedule of discounted bills receivable dishonoured.
(b) Check the entry in bank statement regarding the amount of bills dishonoured and see that the bank has debited the account of client.
(c) Verify the bills receivable returned by the bank along with bank’s advice.
(d) See that the dishonoured bills have been noted and protested by following the proper procedure and the account of the drawee or the account receivable is also debited.
(e) Check that bank commission, if any, charged by the bank has been recovered from the party.

5.3.16 Schedule III- Disclosure requirement to the Statement of Profit & Loss:

(i) A Company shall disclose separately by way of notes on the face of the Statement of Profit and Loss-
   Item II. Other Income
   Classification of Other Income into:
   - Interest Income (except for a finance company)
   - Dividend Income
   - Net gain / loss on sale of Investments
   - Other Non-Operating Income (net of expenses directly attributable to such income)

(ii) A Company shall disclose separately by way of notes on the face of the Statement of Profit and Loss additional information regarding aggregate income as under:-
   - Adjustments to the carrying amount of investments
   - Net gain on foreign currency transactions and translations (other than considered as Finance Costs)
   - Interest Income
   - Dividend Income
   - Net gain on sale of investments
   - Any item of income which exceeds 1 % of the revenue from operations or ` 1 lakh, whichever is higher.

5.4 Verification of Bank Balance and Cash-In-Hand

5.4.1 Verification of bank balance: Apart from comparing the entries in the cash book with those in the Pass Book the auditor should obtain a certificate from the bank confirming the balance at the close of the year as shown in the Pass Book. If the bank account is
overdrawn, the auditor should obtain from the bank particulars of assets on which a charge has been created to secure the overdraft. The auditor should examine the bank reconciliation statement prepared as on the last day of the year. He may also examine the reconciliation statement prepared as on the last day of the year. He may also examine the reconciliation statements as at other dates during the year. It should be examined whether (i) cheques issued by the entity but not presented for payment, and (ii) cheques deposited for collection by the entity but not credited in the bank account, have been duly debited/credited in the subsequent period. For this purpose, the bank statements of the relevant period should be examined. If the cheques issued before the end of the year have not been presented within a reasonable time, it is possible that the entity might have prepared the cheques before the end of the year but not delivered them to the parties concerned. In such a case, the auditor should examine that the entity has reversed the relevant entries. Where the auditor finds that post-dated cheques are issued by the entity, he should verify that any cheques pertaining to the subsequent period have not been accounted for as payments during the period under audit. The auditor should pay special attention to those items in the reconciliation statements which are outstanding for an unduly long period. The auditor should ascertain the reasons for such outstanding items from the management. He should also examine whether any such items require an adjustment/write-off. The auditor should be alert to the possibility that even though the balance in an apparently inoperative account may have remained stagnant, transactions may have taken place in that account during the year.

Where a large number of cheques have been issued/deposited in the last few days of the year, and a sizeable proportion of such cheques have subsequently remained unpaid/uncleared, this may indicate an intention of understating account payables/account receivables or understating/overstating bank balances. In such a case, it may be appropriate for the auditor to obtain confirmations from the parties concerned, especially in respect of cheques involving large amounts. The auditor should also examine whether a reversal of the relevant entries would be appropriate under the circumstances. In relation to balances/deposits with specific charge on them, or those held under the requirements of any law, the auditor should examine that suitable disclosures are made in the financial statements. In respect of fixed deposits or any type of deposits with banks, the relevant receipts/certificates, duly supported by bank advices, should be examined. Remittances shown as being in transit should be examined with reference to their credit in the bank in the subsequent period. Where the auditor finds that such remittances have not been credited in the subsequent period, he should ascertain the reasons for the same. He should also examine whether the entity has reversed the relevant entries in appropriate cases. The auditor should examine that suitable adjustments are made in respect of cheques which have become stale as at the close of the year. Where material amounts are held in bank accounts which are blocked, e.g., in foreign banks with exchange control restrictions or any banks which are under moratorium or liquidation, the auditor should examine whether the relevant facts have been suitably disclosed in the financial statements. He should also examine whether
suitable adjustments on this account have been made in the financial statements in appropriate cases. Where the auditor finds that the number of bank accounts maintained by the entity is disproportionately large in relation to its size, the auditor should exercise greater care in satisfying himself about the genuineness of banking transactions and balances. The following areas may also be considered by the auditor:

(i) In relation to balances/deposits with specific charge on them, or those held under the requirements of any law, the auditor should examine that suitable disclosures are made in the financial statements.

(ii) In respect of fixed deposits or any other type of deposits with banks, the relevant receipts/certificates, duly supported by bank advices, should be examined.

(iii) Remittances shown as being in transit should be examined with reference to their credit in the bank in the subsequent period. Where the auditor finds that such remittances have not been credited in the subsequent period, he should ascertain the reasons for the same. He should also examine whether the entity has reversed the relevant entries in appropriate cases.

(iv) The auditor should examine that suitable adjustments are made in respect of cheques which have become stale as at the close of the year.

(v) Where material amounts are held in bank accounts which are blocked, e.g., in foreign banks with exchange control restrictions or any banks which are under moratorium or liquidation, the auditor should examine whether the relevant facts have been suitably disclosed in the financial statements. He should also examine whether suitable adjustments on this account have been made in the financial statements in appropriate cases.

(vi) Where the auditor finds that the number of bank accounts maintained by the entity is disproportionately large in relation to its size, the auditor should exercise greater care in satisfying himself about the genuineness of banking transactions and balances.

5.4.2 Verification of Cash-in-hand: The auditor should carry out physical verification of cash at the date of the balance sheet. However, if this is not feasible, physical verification may be carried out, on a surprise basis, at any time shortly before or after the date of the balance sheet. In the latter case, the auditor should examine whether the cash balance shown in the financial statements reconciles with the results of the physical verification after taking into account the cash receipts and cash payments between the date of the physical verification and the date of the balance sheet. Besides physical verification at or around the date of the balance sheet, the auditor should also carry out surprise verification of cash during the year.

All cash balances in the same location should be verified simultaneously. Where petty cash is maintained by one or more officials, the auditor should advise the entity to require the officials concerned to deposit the entire petty cash on hand on the last day with the cashier. The auditor should enquire whether the cashier also handles cash of sister concerns, staff societies, etc. In such a case, cash pertaining to them should also be verified at the same time.
so as to avoid chances of cash balances of one entity being presented as those of another.

If IOUs (‘I owe you’) or other similar documents are found during physical verification, the auditor should obtain explanations from a senior official of the entity as to the reasons for such IOUs/other similar documents remaining pending. It should also be ensured that such IOUs/other similar documents are not shown as cash-on-hand.

The quantum of torn or mutilated currency notes should be examined in the context of the size and nature of business of the entity. The auditor should also examine whether such currency notes are exchanged within a reasonable time.

If, during the course of the audit, it comes to the attention of the auditor that the entity is consistently maintaining an unduly large balance of cash-on-hand, he should carry out surprise verification of cash more frequently to ascertain whether the actual cash-on-hand agrees with the balances as shown by the books. If the cash-on-hand is not in agreement with the balance as shown in the books, he should seek explanations from a senior official of the entity. In case any material difference is not satisfactorily explained, the auditor should state this fact appropriately in his audit report. In any case, he should satisfy himself regarding the necessity for such large balances having regard to the normal working requirements of the entity. The entity may also be advised to deposit the whole or the major part of the cash balance in the bank at reasonable intervals.

Where postdated cheques are on hand on the balance sheet date, the auditor should verify that they have not been accounted for as collections during the period under audit.

### 5.5 Audit of Trading Transactions

#### 5.5.1 General Considerations:
In addition to matters which are listed in the audit of cash transactions, certain other principal matters that should be taken into account while vouching trading transactions are:

(i) **Correctness of book-keeping record**: The auditor should also take steps to verify that the amount of profit has not been overstated, e.g., by the inflation of sales or closing inventory, by the understatement of purchase and expenses or by omission to credit account receivables accounts with the value of goods returned by them, etc. The figure of profit can also be inflated by the failure to provide for losses and depreciation or reduction in their value for instance, by not making an adequate provision for bad debts, for discounts payable on the recovery of book debt, for any fall that has taken place in the value of investments or inventory. In such a case, the final accounts would not disclose a ‘true and fair’ stage of affairs of the business.

(ii) **Observance of accounting principles**: Students are already aware of the implications of all these requirements; nevertheless, there is a necessity for a fresh look into these with a view to knowing how trading results can be upset if any of these are not properly followed. If the distinction between capital and revenue is not kept in mind in recording transactions, the profit or loss would be wrongly stated; as a consequence, there would
not be a true statement of assets in the balance sheet. For example, if an amount representing installation cost of a machine, has been wrongly treated as a revenue expense charged off in the year’s account, the profit for the year would be understated to the extent of the charge and the value of machine also would be understated. If the benefit of an expense incurred in a given period is not fully realised within that period, it would be proper to carry forward the appropriate proportion of the expense in the books of account without charging that amount wholly to revenue. For example, if annual insurance premium is paid at the end of third quarter of the financial year of the concern, it would be appropriate that only 1/4th of the total premium should be charged in that year’s account and the rest carried forward to be charged off in the next year when the benefit from the premium would be exhausted.

Similarly, if commission has been earned by salesmen for effecting sale within the year, the same should be provided in the accounts irrespective of whether a bill for commission has been received or not within the year. It is a common knowledge that the value of fixed assets depreciates due to efflux of time, use and obsolescence. The diminution of the value represents an item of cost to the concern for earning revenue during a given period. Unless this cost is charged to the accounts, the profit or loss would not be correctly ascertained and the values of fixed assets would be shown at higher amounts. Likewise, current assets, if they are stated at more than the realisable value, the year’s profit or loss would not be fairly stated.

Also, fictitious assets like a worthless patent, trade mark or developmental expense should be written off at the earliest so that the net value of the business can be really known and the infructuous expenses are absorbed by the revenue earned by the business and the true surplus is reflected in the books as profits.

Inventory-in-trade stands on a slightly different footing in as much as no running account in the financial record is generally maintained for inventory. At the year end, the physical quantities of the inventories in hand are noted and values are applied to them to arrive at the value of the closing inventory. Often the inventory records also provide the basis for ascertaining quantities in hand on the closing day. This being an asset, representing a part of the inventory purchased or acquired in the year or earlier needs to be brought into books of account for a fair ascertain ment of the profit or loss. Closing inventory is adjusted in “change in inventories” in the Statement of Profit and Loss for giving effect to the adjustment required in the Profit or Loss and for bringing the inventory as an item in the accounts. It is therefore obvious that any mistake, error or fraud in the aforesaid process of bringing inventory into financial books will have considerable impact on the year’s trading results and assets position. To obtain a true and fair view of the accounts, the correctness, appropriateness and consistency of the verification and valuation bases and methods are of great significance.

Students, no doubt, are aware that except for any physical losses that the goods may suffer during the manufacturing process or due to some extra-ordinary factors, e.g., fire
or pilferage, there should be no difference in the quantities of opening inventory and the quantities purchased being equal to the quantities of goods sold and those held in inventory at the close of the year. It is the duty of the auditor to verify that there has not been any loss or leakage of goods in the process of trading. He should, therefore, reconcile the closing inventory with the opening inventory on taking into account the quantities of goods purchased and sold. If there is a discrepancy, he must locate the cause thereof. Some of the factors which give rise to discrepancy in the inventory are stated below:

(a) Inclusion in the closing inventory of goods that should have been returned to suppliers and non-inclusion of goods returned by account receivables.
(b) Inclusion in the closing inventory of goods received for sale on approval or on a consignment basis and, conversely, non-inclusion in the closing inventory of goods sent out for sale on approval or on consignment basis.
(c) Failure to adjust the quantities of inventories lost by fire or given away as samples.
(d) Failure to adjust any sales, the proceeds whereof have been misappropriated, or purchases, the bills in respect of which had not been received from the suppliers.
(e) Failure to include goods purchased that were in transit at the close of the year and to exclude goods which had been sold but not delivered.
(f) Non-adjustment of the losses in weight of material in the process.

In this connection, it is necessary to mention that since the closing inventory of one period becomes the opening inventory of the next, it is essential that the inventory should be valued consistently from year to year; otherwise a part of profit or loss of one period will be transferred to the next. On this consideration, Students may also refer to AS-2 on Valuation of Inventories for disclosure of accounting policies in this regard. As a matter of general principle, AS-1 “Disclosure of Accounting Policies” also states that consistency is one of the fundamental accounting assumptions. The change in accounting policy, if any, requires appropriate disclosure.

(iii) Checking of inventory and record: The inventory accounts are an integral part of the financial accounts. Therefore, any inaccuracy in one affects the other. It is necessary; therefore, that while checking entries of purchases and sales in the financial books, corresponding entries in the inventory accounts also should be checked. In a large concern, this is a stupendous task, on account of the large volume and variety of inventories purchased and sold. In the circumstances, it is practicable for the auditor to only test check the inventory entries. In case no mistakes are found, he can accept the correctness of entries not checked provided there exists an efficient system of internal check. He must, however, reconcile the quantities of goods purchased and sold with the balance at the close of the year.
5.5.2 Internal Control in Respect of Trading Transactions: Trading is a chain of business process of buying, taking delivery of goods bought, making proper arrangements for their storage and issuing them on sale, etc. The function of audit, in this background, is to ensure that there is no leakage of goods or cash; also that the goods that are purchased have been received and are of the type dealt in by the firm, the prices are normal and the goods have been duly accounted for. It is, therefore, the duty of the auditors to see that the trading establishment, the accounts of which he is called upon to audit, has devised a system of internal control as a safeguard against the losses that may arise out of the foregoing. This he performs by reviewing the system. The principal features of such a system are briefly outlined below:

**Buying:** Buying should be a function independent of receiving, storage and dispatching. There should exist a proper a procedure for buying, as regards who shall authorise a purchase, on what basis purchases are to be made, from whom to buy and in what quantity, etc.

The goods, if possible, should be purchased by a separate Purchase Department. The department should be constantly receiving information as regards prices prevailing in different supply centres and have knowledge as regards the allowance, if any, that should be made, the price of every commodity prevailing in one centre as compared to that in another on consideration of freight, quality and other allied factors. The buying department should maintain an up-to-date list of suppliers and manufacturers of various commodities, dealt in by the concern with a note on their usual terms of trade and past performance. In respect of commodities or brands which are not so well known in the market, it is desirable that the view of the Sales Department should be obtained before an order is placed for purchase of such commodities or brands. It would also be prudent to avoid bulk purchase of such commodities/brands until consumer acceptance is evident. For purchasing such commodities, there should be a system of inviting quotations from a number of suppliers or manufacturers.

When the purchase department decides to place an order for the purchase of commodities or goods, a purchase order, preferably standardized, should be prepared in quadruplicate; it should specify the name of the supplier, the goods ordered with specifications as to quantity, quality, source, etc., the date of supply and the price agreed to. It should also specify the other terms about delivery, freight, insurance, etc. One copy of the Purchase Order should be forwarded to the Accounts Department and another to the Receiving Department. If the order has been placed on the basis of a sample, the sample should also be forwarded to the Receiving Department. The purchase order forms should be pre-numbered and the internal reference number should be given to identify the purchase indent sent by the Inventory Department. Any purchase which is initiated on indent of any section other than the Inventory Section should be authorised by the concerned departmental head and manager.

**Receipt of goods:** The responsibility for the receipt of all incoming goods should be centralised in a separate department. The responsibilities of the Receiving Department should be the following:

(a) Verifying all receipts as to the quality and quantity by comparison with the copy of the purchase order issued by the Purchase Department and the forwarding challan of the
suppliers. The goods should be checked for damage, leakage, etc.

(b) Entering the goods immediately on receipt in the Goods Inward or Goods Received Book.

(c) Drawing up in quadruplicate a Goods Received Note for each consignment.

(d) Transmitting the material in the Inventory Department along with a copy of the G.R. Note as aforementioned and obtaining a receipt for the goods for constituting the record of the department.

Before accepting the goods, the Inventory Department sends a note to the Inspection Department for checking the quality and specification. Only on getting a clearance from this department, the goods are accepted. A copy of the Inspection Note is usually attached to the Goods Received Note.

The original copy of G.R. Note should be retained in the Receiving Department as a permanent record of receipt, preferably bound up in the numerical sequence of receipts. One copy of the note should be handed over to the supplier for being enclosed with the invoice he would be sending for the supply made. The second copy should be forwarded to the Inventory Department along with the goods and the third copy to the Purchase Section to enable it to follow up any non-supply or short supply made by the supplier. It would be a good internal check if the Accounts Section, before passing any invoice for supplies made, compares the suppliers’ copy of the note as enclosed with the invoice with that in the Inventory Department because it is from that copy that entries in the inventory records have been made.

Storage:

(a) No sooner the quantity of any article in the godown reaches the ordering level specified on the Bin Stock Card then the inventory-keeper should prepare an indent, stating the particulars of goods to be purchased, the quantity required, the date and quantity of goods which was last ordered, the name of the party from whom the goods were obtained and other particulars considered relevant. The indent should be forwarded to the Purchase Department.

(b) The goods should be stored in a manner to ensure that:

(i) they are easily accessible and at no time are obscured from view;

(ii) they do not suffer any deterioration during storage;

(iii) they occupy the minimum amount of space;

(iv) necessary segregation has been made in the matter of storage of fast moving and relatively slow moving items and easier accessibility has been arranged for the former type.

Also, it should be ensured that the goods are adequately insured against fire, theft, etc. and that conditions of the insurance policy are complied with.
**Issues:**

(a) All deliveries from the sales-godown under all circumstances should be made on delivery notes signed and authorised by the Sales Department. Where credit is to be allowed to the account receivable, the Sales Department should obtain the prior approval of the Accounts Departments.

(b) The requisition slip should be prepared in quadruplicate. The original copy should be retained by the Sales Department as a permanent record of the sale made. Two copies should be forwarded to the Inventory Department. This department in turn should retain one copy in its record as evidence of goods having been issued, after it has been acknowledged by the Despatch Department and surrender the other to the Despatch Section along with the goods. The fourth copy should go to the Accounts Department. It will be the basis on which the Accounts Department shall prepare the bill for the account receivable on receiving a copy of the despatch note from the Despatch Department.

(c) The Inventory Department, on releasing the goods, should make an entry on the Bin/Stock Card.

(d) The goods on release from the sale godown should be sent to the Despatch Department, along with both the copies of the requisition slip; one should be obtained back duly signed in acknowledgement of the fact that the goods have been received for despatch. It should be placed on the file in the Inventory Department.

(e) After the goods have been despatched, the Despatch Department should prepare a despatch note in quadruplicate. One copy of the note should be forwarded to the Accounts Department and another to the Sales Department for reporting to it that the goods sold have been despatched; from the third an entry would be made in the Goods Outward Book; and the fourth is to accompany the goods.

(f) The requisition slip forms should be pre-numbered and the control over them should be kept by the Sales Department. All forms that are spoiled should be kept in the file.

Students may note that the person who has got finished inventory in his custody is described as the inventory-keeper and the department dealing with the goods as the inventory department. Likewise, the person who has in his custody the stores of raw materials, manufacturing stores, etc. is described as the store-keeper and the department is referred to as the stores department.)

The provision of service also constitutes trading, e.g., those rendered by a contractor, estate agent, repairer of motorcars, etc. In those cases, the internal check should provide for the regulation of the charges for the services rendered, either according to an agreement entered into with the parties to whom the services have been provided or on the basis of costs incurred in providing the service a record in respect whereof is maintained. For instance, the charge for a construction job should be regulated according to the agreement entered into with the party; and in case any subsequent modification has been made therein, involving additional work, the charge should be modified accordingly. A motor repairing workshop or an estate agency office should regulate its charges according to the time taken and the expenses
incurred in rendering the services. Similarly, a solicitor should charge for the specific item of work handled for the client. A record of work done should be maintained in the time sheets or in diaries which should be posted regularly, to obviate the possibility of the client being undercharged.

It is the duty of the auditor to verify that an appropriate internal check exists in respect of different types of transactions entered into by the client to ensure that all the income receivable has been properly accounted for and adequate precautions have been taken to control expenses.

### 5.6 Audit of Purchases

The purchases on credit should be verified by reference to the suppliers invoices to which generally copies of delivery notes, disclosing the dates and particulars of goods received and acknowledged by the Receiving Department, are also attached. While vouching entries for purchases with the invoices, the following points should be specially observed:

(a) that the date of invoice falls within the accounting period;
(b) that the invoice is made out in the name of the client;
(c) that the supplier’s account has been credited with the full amount of the invoice and that the deduction in the amount of the invoice, if any, has been made on a proper basis;
(d) that the goods purchased are those that are regularly dealt in by the concern or required for the process of manufacture carried on by it and that the price payable has been correctly arrived at;
(e) that the cost of purchases has been debited to an appropriate nominal account or accounts;
(f) that the invoice is signed by the accountant to show that he has verified it as well as the store-keeper to indicate that the delivery of goods have been taken by him. If the invoice relates to the purchase of a technical store or a chemical, the price whereof is dependent on its quality, a copy of the report of a technical person showing that the article purchased is of the specification for which the order has been placed; and
(g) that the manager or some other official, competent to sanction payment, has authorised its payment.

**Classification of purchases:** For controlling expenditure on purchases it is essential that these should be classified under the following heads:

1. Purchases of raw material, for each material separately.
2. Purchases of finished goods.
3. Purchases of consumable stores, fuel etc.
4. Purchases of packing materials, etc.
5. Purchases of articles like stationery for office use.
6. Purchases for making additions to assets.
5.6.1 Special Precautions in Verification of Purchase Invoices

(a) When an invoice runs into several pages and the total of each page has been carried forward to the next or where the amount of an invoice has been distributed over several accounts, it should be confirmed that the amounts relating to different parts of the invoice have been adjusted together. When the total amount of the invoice has been adjusted in separate accounts, the entire amount so adjusted should be added together to confirm that there has not been error under adjustment.

(b) At times, invoices are received in duplicate and even triplicate. In such cases, payment usually is made on the basis of the original invoice. Sometimes, however, the original is kept in record and the price is adjusted on the basis of the duplicate. In such a case, it should be confirmed that the original invoice has also been paid or adjusted separately.

(c) Often supplies are received on certain special conditions. In such cases, it should be verified that these are the same as were agreed to at the time the order was placed, e.g., payment of freight and insurance charges of goods while in transit, etc. If the amount of an invoice was payable after the lapse of some time, subsequent to the receipt of goods, it should be ascertained that it has not been paid earlier and the benefit of cash discount, if any, has been obtained. Where a trade discount has been deducted from the amount of the invoice, it should be seen that only the net amount has been credited to the supplier.

(d) Where goods have been purchased for the use of an officer or a subordinate but the invoice is made out in the name of the concern for obtaining the benefit of trade discount, it should be seen that the cost has been charged to the person concerned and not to the Purchases Account.

(e) Purchases of goods from the allied and associated concerns can be made only under an appropriate sanction.

(f) If the case of an invoice addressed to an individual, particular care should be taken when vouching such an item, since the individual may have attempted to procure goods for his own use while allowing the company to pay for them. The system of internal check for purchases should be such as to preclude such a possibility. Nevertheless, it should be seen whether the goods are of a type which the company usually requires, and whether the invoice has been duly checked by someone other than the individual to whom it was addressed.

   The delivery note and the goods inward note should be examined and it should be seen that the goods were inspected on arrival. Further evidence should also be sought to establish whether the goods were actually received into inventory. The original order for goods should have been duly authorised by a responsible official. The firm supplying the goods should be requested not to submit invoices addressed in this way.

(g) If materials are bought for delivery direct to a account receivable, the exact circumstances of the transaction should be ascertained and the reasons for the goods having been delivered direct to the account receivable. The auditor should make appropriate inquiries in order to establish that the transaction was appropriately authorised by a responsible official. A copy of
the delivery note signed by the account receivable on delivery of the goods should be examined, and it should be ascertained whether the account receivable is a regular purchaser of the company’s goods and not an employee of the company wishing to take advantage of a weakness in the system. The original order should also be seen to have duly authorised by the appropriate official, and if this practice is a regular feature of the company’s mode of transacting business, the system of internal check should be such as to ensure that no fraud may by perpetrated as a result of this practice. The payment for the goods, if it has been received, should be vouched to the cash book and bank statement.

(h) Though it is not practicable for an auditor to verify that every item of goods purchased has been entered in inventory, he should trace into the inventory record at least purchases of goods during the opening and closing months and accept the correctness of the rest only if he is satisfied that there exists a system of internal control which prevent payment being made for any goods not received in inventory.

5.6.2 Failure to Check Inventory: Some of the frauds which audit may fail to disclose unless inventories are checked are the following:

(a) Suppose there are two cotton mills: Alfa and Beta, and have a common managing director. The mill Alfa closes its accounts on December 31, and mill Beta, on March 31. Further, suppose that when the accounts of Mill Alfa for the year ended December 31, 2013 are prepared in January 2014, the managing director of the mill decides to transfer a part of the profits earned to mill Beta.

To give effect to such a design, mill Alfa enters into an agreement in February 2014, with mill Beta but ante-dates the agreement to November, 2013. It provides that mill Alfa shall purchase 5,000 bales of cotton at ₹ 195, per bale from mill Beta. On the basis of this agreement a book entry showing that 5,000, bales have been purchased in November, 2013, is recorded in the books of the mill Alfa for the year ended 31st December, 2013, and their price is credited to the account of mill Beta, corresponding entries are recorded in the books of account of mill Beta. In pursuance of the entry 5,000 bales of cotton are included in the closing inventory of mill Alfa valued at ₹ 190 per bale, the supposed market price. As a result the profit of mill Alfa is reduced by ₹ 25,000.

Subsequently on 28-2-2014 another contract is entered into by mill Alfa to sell 5,000 bales of cotton to mill Beta ₹ 185 per bale. The corresponding entries are duly recorded in the books of mill Beta. The net effect of both of these entries is that the profits of mill Beta are increased by ₹ 50,000 for the year ended 31-3-2014 and those of mill Alfa, for the year ended 31-12-2013 are reduced by ₹ 25,000 and by the same amount those of the year ended 31-12-2013 also. In fact, neither any bales of cotton are received by the mill Alfa from mill Beta nor they are sold back to Beta. Also neither any price is paid by mill Beta on purchasing neither the bales nor any sale price is received on the bales being sold back.

Students will observe that the foregoing transactions have been represented merely by book entries, as contemplated by clause (b) of Sub-Section (1) of Section 143 of the
Companies Act, 2013. Such a fraud may not be discovered, unless the auditor checks entries of purchases and sales of the bales of cotton in the inventory books of the respective mills or carefully takes note of the associated nature of the companies and diligently scrutinizes transactions of the subsequent period.

(b) A commercial concern dealing in mill stores enters in its accounts several invoices showing that it has purchased mill stores from a number of suppliers. All the purchases have been made for cash and the entries are duly supported by printed invoices showing the names and addresses of the suppliers that are false. All the payments have been duly acknowledged by the parties. The auditor of the concern, not suspecting any mala fides, accepts the invoices as correct without tracing the purchases into the inventory book. In fact, no mill stores had been purchased and the transactions entered into merely to reduce profits. The fraud remained undetected due to the failure of the auditor to trace the purchases into the inventories of the concern and preparing a inventory-tally of goods purchased and sold.

(c) There have been several cases in the past wherein it has been found during liquidation proceedings that the management has overvalued its closing inventory to show a profit larger than what the company has actually earned. In all these cases, fraud would have been detected if the auditor had verified the quantities and value of inventories at the close of the year.

All these cases related to the period before the Companies Act was amended in 1956. Therefore, the auditor escaped liability for professional misconduct. Until then it was possible for the auditor to accept the value of inventory declared by the management. But this is not possible now. Under the present circumstances, a duty is cast on the auditor to verify the closing inventory in the manner stated in Chapter 6.

5.6.3 Gross Profit

(i) Factors which increase the gross profit:

(a) Undervaluation of opening inventory; it may be either the effect of non-inclusion of certain items of inventories or that of valuation of the inventory at a rate lower than that warranted by the basis of valuation adopted or miscalculation of the value of one or more items of inventory. In such a case, the increase in the rate of gross profit would be preceded by a fall in the rate of gross profit in the previous year.

(b) Overvaluation of closing inventory, either by the inclusion therein of fictitious items of inventory or over-statement of values of some of them.

(c) Alteration of the basis of valuation of closing inventory, e.g., where the opening inventory was valued at cost or market rate whichever was lower, valuing the closing inventory at the market price which is higher than cost.

(d) Increase in the values of some of the items included in the opening inventory (which were valued at market rate which was lower than cost) above cost, on account of
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which the unsold inventory of these items at the close of the year is valued at cost.

(e) Under-statement of opening inventory or over-statement of closing inventory, due to adjustment of the amount of sales, when goods sold but not delivered are included in the closing inventory or when goods were delivered and taken out of inventory last year, but sales invoices is raised in the current year.

(f) Inclusion in the closing inventory of goods returned awaiting despatch to supplier, the cost of which has been debited to them or goods returned by account receivables, the cost whereof has not been credited to parties.

(g) Inclusion in the closing inventory of goods received for the sale on approval or on a consignment basis.

(h) Treatment of goods sent out for sale on consignment basis as regular sales.

(i) No provision or under-provision in the expenses accounts included in the Trading Account. For example, purchase may be understated; provision for outstanding wages or carriage inward may not have been made.

(j) Wrong allocations of expenses, e.g., carriage inwards either in whole or in part may be wrongly taken to the Statement of Profit and Loss.

(ii) Factors which decrease the gross profit:

(a) Over valuation of the opening inventory or undervaluation of closing inventory either due to mistakes made in taking inventory or in its valuation.

(b) Alteration of the basis of valuation of inventory, e.g., closing inventory having been valued at cost, which is below the market price, when the opening inventory was valued at market price above cost.

(c) Inclusion in the year of the amount of goods purchased in the previous year, that were received and where taken in the same year.

(d) Reversal of the fictitious sale entries recorded in the previous year to boost up profit.

(e) Entry of sales returns twice or failure to account for purchase returns when the goods in question have been sent back.

(f) Excessive provisions have been made for wages or direct expenses.

(g) Failure to include in closing inventory goods sent out for sale on approval or on a consignment basis.

(h) Omission to adjust the value of unused inventory of consumables stores, such as fuel and packing material or inclusion in Trading Account expenses which should have been included in the Profit in the Loss Account.

(i) Failure to take credit for the amount of an insurance claim in respect of a consignment of goods lost in transit or destroyed by fire.

(j) Failure to account for goods sold or destroyed or given away as samples.
From the aforementioned statement of factors affecting gross profit, it would be evident that it is affected by every failure to properly account for values receivable and payable at the time a benefit accrues or is given away. Such a position can arise in a multiplicity of situations, only some of which have been listed above.

The auditor must also take steps to verify that the amount of profit has not been overstated, e.g., by the inflation of sales or closing inventory, by understatement of purchases and expenses or by omission to credit account receivables’ accounts with the value of goods returned by them, etc. The figure of profit can also be inflated by the failure to provide for losses and depreciation or reduction in their value, for instance, by not making adequate provisions for bad debts, for discounts payable on the recovery of book debts or for any fall that has taken place in the value of investments or inventory accounts would not disclose a true and fair state of affairs of the business.

Likewise it should be verified that profits have not been understated.

5.6.4 Purchases Returns: If a part or whole of a consignment of goods found to be defective or of a poor quality, the goods sometime are returned to the supplier and his account is debited. The debit is raised in the Purchase Returns Books, on the basis of Debit Note. The supplier, on receiving the Debit Note, issues Credit Note indicating his acceptance of the debit. Thus, on receipt it is attached to Debit Note. All these entries should be verified by reference to the record kept in the Goods Outwards Book or the Stores Record. The original invoices through which the purchases were made also should be referred to for confirming that the nominal account, which was originally debited on the purchases being made, has been subsequently credited on a part or whole of the goods contained in the consignment having been returned. Where the purchase returns are large, either at the beginning or at the close of the year, these might be fictitious, entered to cover bogus purchases recorded earlier. On such a consideration the nature thereof should be ascertained. The rebate in price and allowances granted by the suppliers should be adjusted through the journal on the basis of Credit Notes received from the suppliers. These should be verified by reference to the original invoices.

5.6.5 Schedule III- Disclosure requirement to the Statement of Profit & Loss:

A Company shall disclose separately by way of notes on the face of the Statement of Profit and Loss additional information regarding aggregate expenditure and income as under:-

(a) In the case of manufacturing companies,—

(1) raw materials under broad heads.

(2) goods purchased under broad heads.

(b) In the case of trading companies, purchases in respect of goods traded in by the company under broad heads.
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(c) In the case of companies rendering or supplying services, gross income derived from services rendered or supplied under broad heads.

(d) In the case of a company, which falls under more than one of the categories mentioned in (a), (b) and (c) above, it shall be sufficient compliance with the requirements herein if purchases, sales and consumption of raw material and the gross income from services rendered is shown under broad heads.

(e) In the case of other companies, gross income derived under broad heads.

5.7 Sales

The student should refer to Spicer and Pegler’s book for the details in the matter of internal check on sales that should be exercised and the extent to which checking of individual entries in the Sales Day Book can be dispensed with when it is proper and effective. The credit sales should be verified by reference to copies of invoices issued to account receivables and, in the process, attention should be paid to the following matters:

(a) that each item of sales relates to the period of account under audit;

(b) that the goods are those that are normally dealt in by the concern.

(c) that the sale price has been correctly arrived at and the copy of the requisition slip issued by the Sales Department and the copy of the Despatch Note showing the date and mode of despatch of goods are attached with the invoice.

(d) that the amount of the invoice has been adjusted in an appropriate account; and

(e) that the sale has been authorised by a responsible official and in token thereof he has initialed the invoice; also that any alteration in the invoice has been attested by the same person.

It should be generally verified that the sales have been made at a uniform rate, and on identical terms as regards payment of freight, sales-tax, packing, forwarding charges, etc. The additional charges recovered along with the sale price should be credited to separate accounts, appropriately headed, and not to the Sales Account. When a trade discount is allowed, the amount thereof should be deducted from the sale price. Where any special trade discount has been allowed, the reason thereof should be ascertained. The different types of sales should be classified under the following heads:

(1) Sale of raw materials.

(2) Sale of finished goods.

(3) Sale of empties and other packing materials.

(4) Sale of assets.

Small concerns generally do not have well organised Sales and Despatch Departments. In such cases, for verifying sales the auditor should trace a small proportion of sales invoice into the Inventory Book, especially of goods sold at the beginning and at the close of the year.
Such a step is essential for verifying that the sales of goods issued in the previous year or years have not been adjusted in the accounts of the year under audit, also that the goods sold during the year have not been erroneously included in the closing inventory. This would also disclose any bogus sales debited to the accounts of fictitious account receivables for which payments have not been received. In the case of sales to directors as well as to associate concerns, it should also be verified that these have been made at market rates. The sale of goods on hire-purchase basis of the goods sent out on sale or return basis or on consignment basis should be separately recorded. When credit sales are not adjusted in the accounts at the time they are made but at the time the sale proceeds are collected, there can be no guarantee that any amount collected in such sales has not been misappropriated. The auditor should, therefore, draw the attention of the management to the risk involved in adopting such practice; also in such a case he should not certify the correctness of any amount outstanding for recovery shown in the Balance Sheet in the absence of confirmation of the balance by the account receivables.

5.7.1 Schedule III- Disclosure requirement to the Statement of Profit & Loss:

A Company shall disclose separately by way of notes on the face of the Statement of Profit and Loss-

(i) In respect of a company other than a finance company:
   Item I. Revenue from Operations
   Revenue from—
   (a) Sale of products;
   (b) Sale of services;
   (c) Other operating revenues;
   Less:
   (d) Excise duty.

(ii) In respect of a finance company:
   Item I. Revenue from Operations
   Revenue from—
   (a) Interest; and
   (b) Other financial services.

The auditor should see that a separate record in respect of these items has been maintained for purposes of disclosure.

5.7.2 Goods Sent Out on Sale or Return Basis: A record of goods sent out on sale or return basis should preferably be kept in a specially ruled Day Book. In this book first memoranda entries are made; and only after the goods have been sold entries are made
debiting the party and crediting the Sales Account. The auditor should refer to the memoranda record to confirm that on the receipt of acceptance from each party, his account has been debited and the sales account correspondingly credited, also that the goods in respect of which the period of approval has expired at the close of the year either have been received back subsequently or account receivables’ accounts have been debited. Further, that the inventory of goods sent out on approval, the period of approval in respect of which had not expired till the close of the year, has been included in the closing inventory.

5.7.3 Sales Returns and Allowances: From time to time accounts of account receivables are credited with the value of goods returned and the rebates and allowances sanctioned on one account or another. The entries are passed on the basis of credit notes issued to account receivables. The credit note contains complete particulars of the credit allowed and the basis on which it has been allowed. In each such case the auditor should verify that credits for goods returned have been allowed on the basis of the record maintained in the stores in respect of goods received back in the Goods Returned Book; also that rebates and allowances have been allowed in accordance with the policies and practices of the business. To verify credits in respect of goods returned, the auditor must check entries in the Goods Inward Book kept at the factory gate. He must further verify, on a reference to the memo prepared when the goods were returned, that the goods in fact were defective and the defect was not one which occurred subsequent to the case on which the goods had left the factory premises. If such a memo is not on record, the management should be advised that a responsible official should examine the goods on their return and prepare such a memo.

When there is long time lag between the dates of the sale and that of return of the goods, the reasons for the same as well as the conditions, in which the goods have been received back, should be ascertained. For it could be that the account receivable had returned the goods on its price having fallen, on one or the other pretext with the connivance of the sales staff. The credit given to allied or associated concerns on account of goods returned by them should be specially examined to verify that the goods have been returned due to some valid reasons and the credit does not represent the reversal of fictitious sales earlier entered in their account. Allowances are granted to account receivables of a number of reasons; goods having been supplied short or goods having suffered damage while they were in transit, some defect in their quality, etc. The auditor should verify that these have been granted under a proper authority and on a due consideration of a claim and of the policies of the business in these matters. If considered necessary, correspondence with the party, the quantities and value of goods supplied and those returned out of them also should be verified.

We have considered earlier how a dishonest book-keeper might misappropriate the amounts received from account receivables by entering false credits in their accounts on account of rebates and allowance on the return of goods. This possibility should be kept in view while verifying the aforementioned credits.
5.7.4 Empties: When the empties or containers in which goods necessarily have to be supplied are costly, the manufacturers normally agree to purchase them back at a reduced price as compared to the one charged for them. In such a case, it is necessary to keep a separate account of the empties “issued and received” and the number of them held by the account receivables, which they may return after the close of the year. The auditor should see that this has been done and also that a provision has been made against the contingency of the containers being returned by account receivables and that for the wear and tear which they would suffer in the process.

5.7.5 Consignment Sale: Where the number of consignments sent out in a year is large, usually a separate consignment Sales Day Book and Ledger are kept. In that case, the entries in the Day Book in respect of price of goods sent out and expenses incurred on their transport and insurance should be verified with copies of proforma invoices and other relevant documents; the sale price of goods sold and expenses incurred by the consignee should be verified from the Account Sales.

The balances in the Consignment Ledger, at the end of the year in such a case, would represent the cost of unsold goods, including a proportion of non-recurring expenses incurred on their transport and insurance. These balances should agree with those shown in the respective account sales received from the consignees.

If the goods sent out for sale on consignment have been charged at the invoice price, the difference between the cost and the invoice price would be credited to the Consignment Stock Adjustment Account. The appropriate part of the amount credited in this account attributable to the inventory remaining unsold at the year end, should be reversed so that credit can be taken for the net amount representing the difference for the part actually sold.

5.8 Cut-Off Arrangement

Accounting is a continuous process because the business never comes to halt. It is, therefore, necessary that transactions of one period would be separate from those in the ensuing period so that the results of the working of each period can be correctly ascertained. The arrangement that is made for the purpose is technically known as “Cut-off arrangement”. It essentially forms part of the internal check of the organisation. Accounts, other than sales, purchases and inventory are not usually affected by the continuity of the business and, therefore, this arrangement is generally applied only to the aforesaid accounts. The auditor satisfies by examination and test checks that the cut-off procedures adequately ensure that:

(i) goods purchased, property in which has passed to the client, have in fact been included in the inventories and that the liability has been provided for in case of credit purchase; and

(ii) goods sold have been excluded from the inventories and credit has been taken for the sales; if the value of sales is to be received, the concerned party has been debited.

The auditor may examine a sample of documents evidencing the movement of inventories into
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and out of stores, including documents pertaining to period shortly before and after the cut off date and check whether inventories represented by those documents were included or excluded as appropriate during inventory taking.

5.9 Audit of Ledgers

5.9.1 General Considerations: The audit of ledgers generally involves the under mentioned steps:

(i) Testing the strength and quantity of internal check;
(ii) Tracing the opening balances from the previous year’s records;
(iii) Checking the postings from subsidiary books and, if they are kept on the self-balancing system, also tallying the totals of balances in subsidiary ledgers with those in the total of control account;
(iv) Checking the closing balances of individual accounts on the balance schedules afterwards from the schedules on to grouping schedules and then into the final accounts;
(v) Checking the totals of ledger accounts, trial balance, schedules and groupings;
(vi) Verifying the balances in personal accounts, either with the statements of account or confirmation of balances obtained from the parties; verifying the balances in impersonal accounts, viz., those of fixed assets, bank balances, etc. with the schedules containing details of assets and liabilities as well as those of nominal accounts (featuring various items of income and expense by reference to the documentary evidence which may exist in a variety of forms to ensure that all the outstanding amounts, both receivable and payable have been properly adjusted);
(vii) Scrutinizing the accounts generally and, in particular, examining the composition of final balances; and
(viii) Ascertaining the extent of clearance of the balances brought forward from the previous year particularly those relating to receivables and payables, sale or disposal of fixed assets and of inventories.

The audit of ledgers is thus an important step in the process of verification of the correctness of Final Accounts. It is an occasion to review the transactions entered during an accounting period, duly classified, in the totality; also that of studying the relationship which exists between different sets of figures. Ledgers, therefore, should be examined carefully and comprehensively. The composition of the balance of each account should be scrutinised and, if a doubt arises, the transaction or the set of transactions, which have given rise to the doubt should be examined in depth.

When a comprehensive and effective system of internal control exists, it is possible to limit the routine checking of ledgers by the application of test checks as stated below:

(i) verifying the postings into the ledgers from the various books of prime entry;
(ii) verifying the totals of the account;

(iii) tracing the balances of the personal and nominal accounts from the ledgers into the schedule of balances;

(iv) comparing schedules totals with the balances in the Control Accounts; and

(v) checking the position of the daily entries into Control Accounts.

The foregoing audit tests are applied to a selected group of entries in the ledgers. Alternatively, steps (i) to (iv) should be applied to accounts for parts of the year determined on a selection. However, the posting of the Control Accounts should be verified for the whole year. In selecting the period or periods of verification of posting and totals, preference should be given to the accounts the composition whereof is not clear or in which items on either side cannot be correlated. Moreover, instead of certain periods being selected for the application of test checks, a few accounts could be selected for being test checked for the whole of the year.

If, however, the system of internal control on application of procedural tests is found to be ineffective, it would be necessary for the auditor to extend the programme of verification of balances of the accounts in the ledgers as aforementioned. In doing so, the auditor should take into account the existence of possibilities of frauds being committed through manipulation of entries in the ledgers, for example, the possibility of the ledger clerk colluding with others for misappropriating amounts collected from the account receivables and subsequently covering up misdeeds by adjusting fictitious credit in the account receivable accounts.

Such a fraud in a ledger would not be disclosed merely on extracting balances from the ledger and agreeing their totals with the balance in the respective Control Accounts, since the balances, despite the fraud, would agree. It would be discovered either on postings being checked in detail, or on obtaining detailed statements of account from account receivables and comparing them with those stated in the books of account.

### 5.9.2 Ledger Keeper and Frauds:

For studying the various avenues which are open to a ledger-keeper to commit a fraud, the auditor should find out whether the ledger-keeper extracts balances of account receivables and account payables from the ledgers and agrees their totals with their balances in the Total Accounts; also whether the balances when they have been extracted, are subsequently checked by some other official; further, whether he has access to the account receivables and account payables; also if he meets them, does he do so on his own or in the presence of responsible official?

Some of the frauds which may be committed by a ledger-keeper are stated below:

(i) **In the Bought Ledger:**

   (a) Credit the account of a supplier on the basis of a fictitious invoice, showing that certain supplies have been received from the firm, whereas in fact no goods have been received or on the basis of duplicate invoice from a supplier, the original amount whereof has already been adjusted to the credit of the supplier in the Bought Ledger, and subsequently misappropriating the payment made against the...
credit in the supplier’s accounts.

(b) Suppressing a credit note issued by a supplier in respect of return or an allowance and misappropriating an amount equivalent thereto out of the payment made to him. For if a credit note issued by a supplier either in respect of goods returned to him or for an allowance granted by him, is not debited to his account, the balance in his account in the Bought Ledger would be larger than the amount actually due to him. The ledger-keeper thus will be able to misappropriate the excess amount standing to the supplier’s credit.

(c) Crediting an amount due to a supplier not in his account but under a fictitious name and misappropriating the amount paid against the credit balance.

(ii) In the Sales Ledger:

(a) Teeming and lading method. This method has been explained in Chapter 3.

(b) Adjusting an unauthorised credit or fictitious rebate, allowance, discount, etc. in the account with a view to reduce the balance and when payment is received from the account receivable, misappropriating an amount equivalent to the credit.

(c) Writing off the amount receivable from a account receivable’s bad debt account and misappropriating the amount received in payment of the debt.

(iii) In the Nominal Ledger:

(a) Allocating an item of income or expenditure wrongly, e.g., an item of capital expenditure being charged as revenue and vice versa; and

(b) Understating or overstating the value of inventories, amount of prepaid expenses or liability.

Verification of Posting:

(a) The selection of accounts for checking postings should be made on the same consideration as that accounts, the balances whereof require to be confirmed directly as stated hereinafter. Moreover, either all postings should be checked for only a part of the period covered by the audit or only a few accounts selected for the whole period.

(b) Subsequently, when the closing balances in a ledger are checked, it should be confirmed that postings in the ledger to the extent specified in the Audit Programme have been checked; also that the totals of the balances have been checked. If there is any item in any account in a ledger, the posting whereof has not been checked indicated by absence of the relevant tick against the item, the reason thereof should be ascertained.

(c) Each ledger account should be seen through to confirm that all the entries therein are posted in a chronological order; no entry has been made in between two entries and the figures of an entry have not been altered; also that there is no entry which has been posted directly into the ledger before being recorded in a book of original entry. In each such case, the genuineness of the entry or entries should be verified, for these could be the results of attempts made by the ledger-keeper with an ulterior motive.
Finally, it should be confirmed that all the ledger balances are inked. As a safeguard against
the ledger-keeper making an entry in a ledger after the same has been checked, it is usually
advisable that until the audit has been completed all the ledgers should remain in the custody
of the auditor. The opening balances should be checked, wherever practicable, with the
balances shown in the auditor’s own copy of trial balance, schedules and groupings of the
previous year. Alternatively, these should be checked with the balances shown in the Balance
Sheet, as at the end of the year.

While checking the closing balances or the groupings of balances, a memo should be
prepared as regards particulars of various balances which need to be disclosed in the Balance
Sheet, as well as of matters in respect of which either sanction has to be obtained or adjusting
entries have to be passed.

5.9.3 Scrutiny of Ledgers

(i) Bought Ledger: The structure of every account in the Bought Ledger is: opening
balance, credits on account of goods purchased and debits raised in respect of returns,
allowances and discount receivable, advances paid against goods, payments and transfers.
Usually, it is possible to link up each amount on one side of the account, with one or more
accounts on the other side; only the amounts which cannot be correlated require a detailed
scrutiny. Generally, it should be verified that payments for goods have not been made long
before they were due; nevertheless, they have been made within the period of credit, to take
advantage of the cash discount allowed by the supplier. The scrutiny of the accounts would
show that payments for goods normally have been credited in the order in which their costs
have been credited in the accounts. Therefore, if in any case no payment has been made
against the opening balances or against any particular item of credit, the reasons thereof
should be ascertained. Likewise, credit entries which cannot be correlated with those on the
debit side should be enquired into to confirm that they are not fictitious.

It should be further seen whether full payments for purchases have been made at a time or in
parts. In the cases where payments have been made in parts, the reasons for such a practice
having been followed should be ascertained. Further, when payments to a supplier are usually
made by accepting Bills of Exchange but one or more amounts have been paid in cash, the
reasons therefore should be ascertained. It would be observed that in respect of goods
returned back, as well as allowances allowed by the supplier, either separate payments have
been received or the amounts therefore have been deducted out of subsequent payment
made for goods purchased. Where this has not been done, the reasons should be
ascertained.

The accounts in the Bought Ledger, usually, are in credit. The composition of the balance of
each amount should be scrutinised. If it is not clear, reference should be made to the account
of the party as shown in the ledger for the previous year or in the one for an earlier year. The
composition of each balance will indicate the group in which the balance in the account should
be included for statement in the Balance Sheet. When the amount of the opening balance of
the account of the cost of goods purchased earlier has not been paid but the goods purchased
subsequent thereto have been paid, the reasons for the non-payment of the amount or amounts should be enquired into. It could be that the liability to pay the amount is disputed or is totally denied. The auditor should examine these claims to assess the liability of the client and may then have the balances adjusted and disclosed accordingly. If the liability is totally denied, the amounts should be written back. But when it is partially admitted, these should be reduced to the extent admitted.

If the account of a supplier has been credited at the end of the year with large sums of money, the basis of the credit should be enquired into as it might be a fictitious credit with a view to suppressing profits. If certain goods purchased from a party have been subsequently sold back to him, enquiries should be made to find out if the transactions of the purchase and sale are not mere book entries, hit by Clause (b) of sub-section (1) of section 143 of the Companies Act, 2013. When a balance in an account has been outstanding for payment for an inordinately long time, enquiry should be made to confirm whether the balance in fact is payable.

An account in the Bought Ledger may be in debit. The balance may represent the amount receivable on account of goods returned, rebate allowed by the supplier or advance paid against an order. The auditor should confirm that the advance against the order had been paid in pursuance of a recognised trade practice, also that subsequently goods have been received against the advance or will be received, for such an advance may represent a disguised loan to accommodate a business associate. The book balance also may represent the cost of goods purchased wrongly debited to the account of the supplier, instead of the Purchase Account.

In each such case, it should be ascertained that the book balance is good and recoverable and if it is not considered recoverable, a provision against the same has been made. The book balances should be appropriately classified for purposes of disclosure in the Balance Sheet.

If the debit balance represents a loan to a director or officer of the company, either jointly or severally with another person or it is a debit due by a firm or a private company in which the director is a partner or a member, the same should be separately disclosed in the Balance Sheet in accordance with the provisions contained in Schedule III to the Act. Students may note that in view of section 185 of the Companies Act, 2013 a loan or an advance paid to a director, represented by a book debt which from its inception was in the nature of a loan, is to be regarded as a loan.

(ii) Sales Ledger: The structure of each account in the Sales Ledger is opening balance, debits representing values of goods sold, payments made for goods returned and transfers. The credits represent amounts received for goods sold, advances received against orders, discounts and allowances allowed, value of goods returned back and debts written off. If amounts on either side of each account are checked with the corresponding amounts on the other side, the discrepancy, if any, would be discovered.

It should be seen that the account receivables’ balances are being collected promptly, otherwise the capital of the client would be locked up unproductively; also the risk of bad debts and misappropriations would be greater. Therefore, when the examination reveals such a position the auditor should bring this fact to the notice of the management.
If, during the course of examination, it is found that the opening balance in an account or an amount of sales has not been collected, while the amount of sales made subsequent thereto have been duly recovered, it could be that the account receivable is disputing the liability to pay the amount or that the cash collected in payment of the amount has been misappropriated. It may also be found that the debit balance in an account has been collected in parts. It could be the result of misappropriation practiced by the teeming and lading method. All these matters, when noticed, should be fully investigated.

When the payments for sales to a account receivable have been received in parts, it would be beneficial for the client to adjust the amounts received against amounts which have been outstanding the longest. The auditor should confirm that the client is aware of it and has acted accordingly.

Where it is discovered that the returns out of sales, made in the year or years, have been adjusted in the accounts during the year under audit, the justification for such a delayed adjustment should be enquired into, for it could be that the account receivable has been allowed to return the goods, only as a matter of favour. Likewise credit balances resulting from the allowance of discounts and rebates should be scrutinised to confirm that these have been availed of within a reasonable time. If any allowance has been adjusted against an amount recoverable for the goods sold, it should be verified that the allowance is not fictitious, for it could be one which has been adjusted by a dishonest book-keeper with a view to covering up a fraud committed by an employee, by misappropriating the cash collected from the account receivable.

While checking the account receivable's balances, the auditor shall have an opportunity to comprehensively review all the transactions entered into with each of them. If, in the process, he finds that there are any old balances which have not been collected, the possibilities of an amount collected having been misappropriated should be investigated. For the purpose, the auditor should obtain from the account receivable either confirmation of the balances or copy of his statement of account, admitting that the amount is infact payable by him.

If a sale has not been recorded, though the ledger account would not contain an entry in respect thereof, it may contain an entry showing that a credit for the goods returned or an allowance has been adjusted in his account which has been paid to him in cash. This would show that the original sale has not been recorded. Such a discovery may lead to the unearthing of an organised scheme of fraud.

A clever employee who has misappropriated an amount paid by a account receivable might attempt to adjust the debit in the account receivable's account before the close of the year by paying in a bogus cheque. The cheque, no doubt, would be received back unpaid in the beginning of the next year. But the non-payment of the cheque would not be detected until the bank account is reconciled. Therefore, when the bank reconciliation statement shows that the cheque of a party has been received back unpaid, the auditor should find out whether the amount due from him has been or will be recovered.

If the amount paid by a account receivable has been misappropriated, though the balance in
the account would be outstanding for payment, it would not be recoverable. It is only on this consideration that there exists an audit practice according to which confirmation of balance is obtained from account receivables and account payables directly at the close of each period.

If the balance in an account has been settled for a smaller sum, the nature of the dispute and the amount which the client has agreed to forego should be ascertained. In case the dispute has been settled by arbitration, the award should be referred to.

All transfers of balances from one account to another should be checked to confirm that these have been made under proper authority in the normal course of the business.

If the scrutiny of the account in the Sales Ledger shows that any of the book debts is not recoverable, the auditor should confirm that an adequate provision has been made against the same.

To verify the adequacy of provision against bad and doubtful debts, usually the client is asked to prepare a list of debts which are irrecoverable either wholly or partially. All the balances in the list afterwards are scrutinised by the auditor to confirm that these are in fact so, also that adequate steps have been taken by the client for their recovery but without success or that they are time-barred for recovery. It is necessary to remember in this connection that debts can be written off only under the authority of a person who is empowered to give up a claim, e.g., board of directors, partners or the proprietor.

When any bad debt is written off, the client should be advised that a record thereof should be kept in the Bad Debts Register in order that if subsequently any recovery is made out of it, may be possible to identify the amount.

Finally, the composition of all balances outstanding of recovery should be examined. Normally, the debit balances in an account should be the total of the amount of sales not collected. In every case, where the composition of a balance is not clear, the copy of the statement of account received from the party should be referred to. If in respect of a particular account receivable, copies of a number of invoices are not in record, his balance should be confirmed by sending out statement of account.

While checking the closing balances which are required to be included under certain specific heads of account, those required to be separately disclosed (e.g., amounts due from Directors, Managers, or concerns in which they are interested) should be listed up separately.

For the tests, which must be applied and the enquiries which should be made for ascertaining which of the account receivable’s balances are bad and irrecoverable; students may refer to the next chapter.

**Self-balancing and sectional balancing ledgers:** When in an organisation a number of ledgers are maintained, it is usual to find the system of self-balancing or sectional balancing of ledgers in operation. Sectional balancing, as any student of accountancy knows, is just the system of maintaining a total account in the general ledger in respect of each sectional ledger like account receivables, account payables, nominal accounts. The self-balancing system is a further improved system which enables the preparation of independent trial balances for each of the separate
ledgers by means of contra-adjustment accounts. This, as part and parcel of the system of internal check, is of great assistance to the auditors for localizing errors. It should however be borne in mind that the only reliable verification of balances of various adjustment accounts in the general ledger lies in the thorough verification of the various personal ledger balances. As regards the routine checking aspects, no special technique is involved. The postings to the individual ledgers and to general ledger account maintained for control purpose should be appropriately checked. Also the castings and balancing should be tested.

(iii) General Ledger: The general ledger contains all the balances which are ultimately included in the Statement of Profit and Loss and the Balance sheet. Its examination, therefore, is undertaken last of all. It should be carried out with great deal of care inasmuch as it is the final review of balances which, on inclusion in Final Accounts, cumulatively reflect the financial position of the concern.

Entries in the General Ledger usually are posted in a summary form from the Cash Book, Journal, and from other subsidiary books like Purchases Book, Sales Book, etc. As such before starting its examination, it should be confirmed that all the postings in various accounts have been verified, totals have been checked and the final balances have been linked.

It should also be ascertained that balances in all the income and expense accounts have been adjusted: (i) according to standard accounting practices, and (ii) on a consideration of the legal provisions which are applicable to the concern. Each ledger balance finally should be examined on a consideration of its position in the Final Accounts to see how the financial position of the concern would be affected by the inaccuracy in the balance.

Wherever practicable, the balances in the General Ledger should be traced simultaneously on to the trial balance, the groupings schedules and the Final Accounts. At the same time, by way of a comparison, the corresponding balances in the previous year’s Final Accounts also should be referred to.

It should be confirmed that the accounts have been kept according to accepted accounting principles and the Balance Sheet and the Statement of Profit and Loss have been drawn up on the same basis as in the previous year.

Consistency is also one of the fundamental accounting assumptions as stated in AS-1 on “Disclosure of Accounting Policies”. Usually, the accounts of a commercial concern are kept on the mercantile basis. It demands that all the liabilities in respect of goods purchased or expenses incurred before the close of the year that were outstanding for payment should be provided for; amounts paid as advances should be included as an asset, the proportion of expense relevant to the period that extends beyond the close of the year should be excluded by the amount being debited to the prepaid Expenses Account. Further, on the same consideration, the income which had accrued before the close of the year, but had not been collected should be taken credit for and correspondingly, income relating to the period, following the close of the year, which has been received in advance should be adjusted as a liability. Thus, unless accounts are adjusted in this manner, neither the Statement of Profit and Loss nor the Balance Sheet would disclose a true and fair state of the business.
The valuation of assets and verification of liabilities are other important steps in the ascertainment of profit earned by the business inasmuch as only under or overvaluation thereof would either depress or boost up profits.

Conventionally, current assets are valued at their cost or net realisable value whichever is lower, fixed assets are valued at cost reduced by the amount of depreciation that they have suffered, calculated on any accepted basis, and followed consistently.

(iv) Main Journal: Both the closing and adjusting entries as well as other entries which cannot be accommodated in any other Journal are recorded in the Main Journal. The evidence in support of entries in this Journal usually exists in a large variety of forms. It may consist of correspondence, contracts, minutes of Board of Directors or the shareholders, statements of account, etc. All the statements attached to support adjusting entries, since these would be prepared by the internal staff, should be verified very carefully, and where possible, some independent evidences in confirmation thereof should be obtained.

The correcting entries will contain references to vouchers which have already been checked by the auditor. He ordinarily, therefore, will have a record thereof in his audit notes. It should be referred to while verifying them. One form of adjusting entries is the one recorded to provide for expenses accrued till the date of the Balance Sheet but not paid, e.g., those in respect of rent, electricity, income-tax, etc. as well as for taking credit for the income accrued but not received, e.g., interest accrued which is not matured for receipt, lease rent accrued which is not due for payment, etc. In all such cases, it is possible that by the time that audit is undertaken, some of the liabilities, a provision for which has been made, may have been paid off; also that the amounts adjusted as not recoverable may have been collected. As a result, in actual practice, it may be found that amount paid or received were larger than those adjusted. But so long as these were estimated on a reasonable basis, it is not necessary for the auditor to reopen accounts to adjust the difference between the amounts of income or expense estimated and those collected or paid.

The opening entries should be verified by reference to the balance sheet or other similar documents for the previous year.

The auditor should specially note that neither any accounting principles nor practices followed in the past have been contravened or altered during the year under audit. If a departure has been made, its effects should be disclosed on the face of the Statement of Profit and Loss. For example, when the basis of valuation of closing inventory or that for providing depreciation on fixed assets has been altered, their effect on profit should be disclosed.

### 5.10 Outstanding Liabilities

1. **Purchases:** In some instances, invoices relating to purchases of goods that have been taken into inventory are received too late to be included in the Purchase Day Book of the closing month. As a result, those will be included in the accounts of the succeeding period. In such a case, a schedule of such invoices should be prepared and their total debited to Purchases Account and carried down as an outstanding liability. If the precise amount of li-
ability on account of such purchases cannot be ascertained, an estimate made by a responsible official might be accepted.

2. **Wages, Salaries, etc.** The amounts debited to these accounts should represent the amount actually chargeable for the year. Thus, if the amount payable at the close of the year has been paid in the succeeding period, a provision therefore should be made. While doing so, it should also be verified that the corresponding provision made at the end of the previous year has been brought in as a credit, for arriving at the amount chargeable for the year.

3. **Rent and Taxes**: The amount charged towards the rent should be the annual rent as provided for in the lease. If any rent for the year was outstanding at the close of year or has been paid in advance, the amount outstanding or paid in advance should be adjusted as a liability or asset respectively.

Municipal taxes usually are payable in advance. As a result a proportion of last payment is usually carried forward as unexpired to the next period. By scanning the account, it should be ascertained that the charge only for the full has been included in the account.

4. **Directors’ and Managing Directors’ Fees or Salaries**: It should be verified that after making necessary provisions for account outstanding the total amount to be debited to the account agrees with the resolution of the Board of Directors or shareholders under which the payments have been paid at the rates authorised by the articles in respect of meeting attended by the Directors and it should be noted that the working directors of a public company are not expected to receive any such fee pursuant to the guidelines issued by the Company Law Board.

5. **Freight**: Carriage and freight account may not be rendered till some time after the period to which they relate. In such a case a provision for the amount outstanding may be made on an estimate and while doing so the amount provided in the earlier year may be taken into account.

6. **General Expenses**: Entries in the various accounts should be carefully examined and analysed to make certain that no item has been debited in this account which should have gone elsewhere. Quite often, donations and subscriptions, bank charges, conveyance and other petty expenses are included under this head. Wherever possible, the use of such omnibus account for these debits should be avoided and, in any event, where the total of items in any individual class of transactions is considerable to warrant a separate account being opened for it, the same should be segregated and recorded in a separate account. When this is not possible, as a precaution an analysis of the account should be prepared at the end of the year and the total under the various headings compared with the corresponding totals in the previous period. Schedule III to Companies Act, 2013, requires that every company must show under distinct heads the expenses that exceed 1% of the revenue from operations of the company or ₹ 1,00,000, whichever is higher. Henceforth, it would be improper to include any such expense under the heading “other expenses”.

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5.11 Outstanding Assets

There are two classes of outstanding assets the adjustment whereof has to be examined; first, items accruing but not recorded in books and second, expenditure already incurred, a part or whole of which relates to a period subsequent to the date of the Balance Sheet.

The following are some of the accounts in which adjustment of outstanding assets could be made:

1. **Rent receivable**: All rents receivable due or accrued to the date of the Balance Sheet should be calculated and brought into account, after a provision has been made for doubtful or irrecoverable arrears of rent, allowance for repairs, etc.

2. **Interest and dividend**: Interest receivable on loans accrued to the date of the Balance Sheet should be brought into accounts in all cases where the interest is being regularly received on the dates. If the interest is in arrears, the amount accrued should either be omitted or brought into account and a corresponding provision made against it. Interest on debentures and other securities, receivable on fixed dates accrued and payable before the close of the year should be brought into account and adjustment on account of dividend on shares should be made with reference to the dividend accounting policy followed by the management. This would be in order if the same is accounted for on the basis of declarations during the audit year. It is also possible to account for dividends declared after the close of the year, provided the period in respect of which the same was declared fell within the accounting period of the client. However, accounting of dividend purely on receipt basis would not always be in order for companies. Finally, it should be ensured that the methods in this regard have been consistently followed.

3. **Insurance charges paid in advance**: Insurance premiums are always paid in advance; and, in case of a large business, the amount paid, the benefit of which will arise in the succeeding period, may be considerable. The proportion thereof applicable to the period subsequent to the date of the Balance Sheet should be calculated and included as an outstanding asset.

4. **Advertisement**: Sometimes payments under advertising contracts are made in advance. In such a case, the proportion thereof relating to any period subsequent to the date of the Balance Sheet should be adjusted as an outstanding asset.

5.12 General Scrutiny of Expense Accounts

The structure of each expense account should be thoroughly scrutinised and the distribution of the total expense over different methods comprised in the period under audit. Where there are significant variations between different months, the cause thereof should be ascertained. At times, it may be found that an expense account has a few credit entries. These may represent recovery of the share of common expenses from one or more participants, refund of rebate obtained from a supplier of an entry made to exclude the expense relating to the succeeding period. All these entries should be verified.
Some entities maintain an Outstanding Book, for keeping a record of expenses which were outstanding at the close of the year that have been paid in the succeeding years. From a reference to the entries therein, it is usually possible to have an explanation for the difference that there is an amount of expenditure paid out in the closing month as compared to that in the earlier months. The book is of much assistance also in the verification of the accuracy of the provision made for expenses which were outstanding at the close of the year.

While verifying the adjustment of liabilities, outstanding at the close of year, it should be observed that the liabilities, a provision for which was made in earlier years, have been paid off during the year, and if any amount has not been paid, reasons thereof should be ascertained, as it may not all be payable.

Where certain common expenses have been divided between two or more activities carried on by the same concern or between two sister concerns, it should be ascertained that the basis adopted for the division is reasonable.

Where there has been a change in the basis of accounting, as compared to that in the previous year, the reasons thereof should be ascertained and if any item is shown in the Statement of Profit and Loss has been affected by any change in the basis of accounting, the amount of the difference should be shown separately by way of a note.

The different elements of cost (material, labour and manufacturing expenses) generally are known as direct expenses. Normally, there exists a direct relationship between the cost of each element and total cost of manufacture of the article. Therefore, where there has been a significant variation in the relationship the reasons thereof should be ascertained. It may be due to some of the expenses having been left out or having been included in excess. This could be ascertained on a verification of the entries relative to adjustments of different types of expenses. The causes of variation in the proportion of direct expenses usually can be readily ascertained but this is not practicable in the case of indirect expenses, for these often are the results of a variety of factors unconnected with manufacturing process.

For instance, the change in indirect expenses may be the effect of the change in the rate of turnover or that in the structure of the management. Quite often office expenses increase with that in the rate of turnover, but they may not do so in proportion thereto. For example, if a business owned by a partnership is taken over by a company or machines are introduced to perform certain routine functions which were previously carried out manually, the cost of administration may increase. Small variations therein may also take place due to substitution of one form of expenditure by another either as a measure of economy or on consideration of good management. For example, a company may decide to raise a part of its working capital by issuing debentures and to pay off its overdraft account on which it was paying a higher rate of interest. The management may otherwise decide that local letters should be delivered by hand even though the cost of peon delivery is greater.

Normally, every increase in an expense is accompanied by that in income, e.g., an increase in selling commission, freight and packing charges is usually the outcome of an increase in sales. At times, however, an item of expense may not immediately result in revenue. For
example, the trip of managing director abroad to find a foreign market for the articles manufactured by the company may not start showing results until some time has passed.

The provision for liability that has been incurred, the amount whereof cannot be ascertained accurately, is generally made on the basis of an estimate. But where the existence of the liability is contested, the amount thereof is only disclosed as a contingent liability. Where, in the previous year, provision for an item of expenditure was either not made or was short and the difference in the amount was subsequently paid and the amount of provision is material, the fact should be disclosed by the amount being shown below the line or the amount being shown separately in a bracket against the amount of expenditure of which it forms a part.

5.13 Income Accounts

It is comparatively an easy matter to verify different forms of income earned by the client during the year in totality. In respect of some of the incomes which are collected regularly, *e.g.*, rents on lockers in the case of Safe Deposit Vault, dividends on shares, subscription in case of clubs, advertisement revenue in case of publishers of newspapers, a record of income the basis on which it has been collected and the particulars of the party through whom it has been received are contained in a Demand Register; there is a separate Demand Register for each such form of income. For the verification of such an income, it should be seen that the Demand Register has been checked and the balance that was outstanding for collection at the close of the year has been adjusted as an asset. In cases where the income earned represent charges for services rendered, the particulars of services rendered by the client to different account receivables would generally be recorded in a separate statistical register, *e.g.*, Job Register in case of the printer and Repairs Register in the case of a workshop, Patients Register in case of a doctor, Clients Register in the case of solicitors, etc. By reference thereto it should be verified that the amount receivable in respect of services rendered before the close of the year have either been called or adjusted as an outstanding asset.

The sale proceeds of goods which have been sold at a uniform rate of profit, *e.g.*, boxes of tea, petrol, vanaspati, ghee, etc. can be verified by computing the amount of profit, which the firm should have earned on quantities of goods sold during the year comparing it with the amount actually earned.

In case of a manufacturing concern, the system of invoicing finished goods should be examined to confirm that the system of internal check in operation ensures that goods would be despatched only after they have been either paid for or the account of the purchaser have been debited. Also, the quantities of raw materials consumed during the period should be reconciled with the quantities of finished products manufactured. The rate of wastage, if any, should be compared with that in the earlier period. It should be verified that quantities of goods sold but not delivered in respect of which bills were not prepared before the close of the year, have been adjusted in the books.

For ascertaining the trading profit of a year, it is also necessary that profits from trading transactions which were not completed before the close of the year should be brought into ac-
count by allocating the total profits on a reasonable basis over the different accounting periods in which these will be completed. The auditor should therefore see that discounting charges of bills of exchange earned on such sales, profits on contracts not completed, etc., have been distributed over their periods of accrual on a “reasonable basis”.

Capital profit e.g. profit arising on sale of assets, reissue of forfeited shares, etc., not available for distribution as dividend, are credited to the Capital Reserve. Any transfer to Capital Reserve out of amounts credited to the Statement of Profit and Loss should be separately disclosed. Similarly, income of an extraordinary and non-recurring character should be separately shown in the Statement of Profit and Loss [Part II of Schedule III].

### 5.14 Asset Accounts

The general make up of fixed asset account is: opening balance, additional adjustment of profit or loss on sale and on account of depreciation.

Every entry which does not conform to this pattern should be inquired into. It should be observed that expenses on current repairs have not been added to the value of the fixed asset but charged to Statement of Profit and Loss and conversely those on additions to or renewal of assets have not been charged to Statement of Profit and Loss. It should also be verified that purchase of assets or addition to them have been duly sanctioned by the concerned sanctioning authority. Where the entire undertaking of a business had been taken over, the value placed by the management on different assets and particularly the amount debited to Goodwill Account or that credited to Capital Reserve Account should be verified by reference to the vendors’ agreement. The debit to the Goodwill Account would be necessary only when the amount paid for the business is in excess of the total value of asset taken over reduced by the amount of liabilities taken over. On the other hand, if the last mentioned amount is in excess, it shall be credited to the Capital Reserve Account.

The values of various current assets held at the close of the year and their composition should be compared with those held at the end of the previous year and if there is material change in their amounts or the basis of their valuation, the reasons thereof should be ascertained. If they appear to be unduly large, e.g., when the value of inventory in hand has doubled but the sales have not increased, the fact should be brought to the notice of the management.

It should be also verified that interest at reasonable rate has been charged on loans advanced to directors, managers, and all concerned; also that loans were advanced under appropriate authority either that of directors or shareholders.

The balance in the Suspense Account, if any, should be analysed and the constituent amount included under appropriate heads of the Balance Sheet.

Finally, it should be confirmed that assets have been properly grouped under different heads for purpose of disclosure in the Balance Sheet and the method of valuation of each asset is shown as required by the form in which the Balance Sheet is required to be presented.
5.15 Liabilities

The auditor should obtain a certificate from the client that all the liabilities which had accrued due till the close of the year have been taken into account and contingent liabilities, if any, have been fully disclosed.

It should be verified that the liabilities have been appropriately grouped under different heads for the purpose of disclosure in the Balance Sheet; secured and unsecured liabilities have been segregated; and against the first, nature of security and its amount have been stated.

5.16 Balance Sheet Audit

Until recently, test checks were applied only for confirming balances in a few nominal accounts; those of inventories and stores, amount of sale and other similar records relevant to trading transactions, which were voluminous but of similar nature. Now a days on account of increase in the size of business units, but more so due to mechanization of accounting, the test checks are being applied widely for the verification of income and expense accounts as well as assets and liabilities. This has crystallized into a form of audit known as Balance Sheet audit.

A Balance Sheet audit consists of the verification of all includible Balance Sheet items, together with the examination of expense and income accounts which are so closely related to these items that it cannot be properly verified without such analysis and test. Records, vouchers, books and accounts are examined; capital and revenue accounts are analysed. The concept of Balance Sheet audit has been developed along with the development of formal internal control system. In outline form, a Balance Sheet audit will include the following:

1. An examination of partnership agreement, the memorandum and articles of association, minutes of the board of directors, and the system of accounting in force, (depending upon the type of entity).
2. The establishment of ownership of all assets included in the Balance Sheet.
3. Proof that all owned assets are included.
4. The inclusion of the asset in the Balance Sheet is in accordance with the accepted principles of accounting.
5. Proof that all liabilities are included and at proved amounts.
6. The examination of adjusting and closing entries or any other entries necessary to the preparation of the Balance Sheet.
7. Evidence that the distinction has been made in recording transactions between capital and revenue; and that capital and revenue have been created on the basis of accepted accounting principles.
8. Proof that the share capital issues have been made in compliance with the requirements of law and they are correctly recorded in the financial books.
9. An analysis of the charges and credit to the revenue accounts and the inclusion of the resultant balance in the Balance Sheet.

Given below are some of the overall tests which may be applied for verification of balance in the Statement of Profit and Loss.

**Expenses Accounts:**

(a) Check direct expense such as customs duty, excise duty with the value of purchases and quantity of goods for sales; verify adjustment of regular expenses e.g. rent, managerial salaries, insurance charges, postage, stationery, etc.

(b) Compare the total of each expense account comprised in the Statement of Profit and Loss with the corresponding amount in the same account for the previous year and if there is any material variation in any one of them, find out the reason therefore.

(c) Determine whether increases or decreases in wages, material consumed and variable expenses appear to be proportionate to the increase or decrease in the turnover.

(d) Investigate the causes of any material change in the rate of gross profit.

(e) Enquire into extraordinary expenses, e.g., donations paid to charities or item of a non-recurring nature, like expenses of foreign tours, those on an advertisement campaign and others which have resulted in changes of material amount on the revenue of the period.

(f) Ascertain whether there have been any changes in the basis of accounting which have resulted in significant increase or decrease in the amount of expenses included in the Statement of Profit and Loss e.g. due to non-provisions of closing inventory of stationery or advertisement material, non-provisions of bonus or gratuity payment to staff, etc.

(g) Compare schedules of outstanding expenses and provision with those for the previous period and ascertain causes of any material changes therein; check in detail the provisions for depreciation and taxation.

**Income Account:**

(a) Verify different types of income in respect of which separate Demand Registers are maintained, by reference to them and confirm that amounts outstanding have been properly adjusted.

(b) Examine the system of invoicing goods to ensure that goods cannot be issued without the sale price thereof being received or the amount being debited to the account receivable’s account.

(c) Reconcile the quantity of raw material consumed with quantities of finished products manufactured and compare the rate of wastage with that in the earlier period.

(d) Compare the total of each income account comprised in the Statement of Profit and Loss with the corresponding amount in the same account in the previous year and, if there is any material variation, find out reasons therefore.
5.64 Auditing and Assurance

Account payables:
(a) The account payables’ ledger trial balance should be extracted by the client and agreed with the Control Account, if any, before the balances for confirmation are selected.
(b) The outstanding liability in respect of goods received, within the last week of the close of the year, should be verified by comparing entries in the Goods Inward Register with those in the Purchase Journal. In verifying this, due attention should be paid to the cut-off arrangement made by the client.
(c) A certificate should be obtained from the client that all the liabilities which had accrued upto the date of the Balance Sheet have been taken into account.

Account receivables:
(a) The trial balance of the account receivables’ ledger should be extracted by the client and agreed with the Control Account, if any, before the balances for confirmation are selected.
(b) The amount of sales made during the week before the close of the year should be verified on comparing the entries in the Goods Outward Register with those in the Sales Journal. Here also, due attention should be paid to the cut-off arrangement.
(c) A certificate should be obtained from the client that all the book debts are good and recoverable and that a provision has been made against those considered bad or doubtful.

5.17 Analytical Procedures

Nature and Purpose: Since routine checks cannot be depended upon to disclose all the mistakes or manipulation that may exist in accounts, certain other procedures also have to be applied. These collectively are known as overall tests. As stated earlier, with the passage of tests, analytical procedures have acquired lot of significance as substantive audit procedure. SA-520 on Analytical Procedures discusses the application of analytical procedures during an audit. “Analytical procedures” means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

Analytical procedures include the consideration of comparisons of the entity’s financial information with, for example:

- Comparable information for prior periods.
- Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
- Similar industry information, such as a comparison of the entity’s ratio of sales to
accounts receivable with industry averages or with other entities of comparable size in the same industry.

Analytical procedures also include consideration of relationships, for example:

- Among elements of financial information that would be expected to conform to a predictable pattern based on the entity’s experience, such as gross margin percentages.
- Between financial information and relevant non-financial information, such as payroll costs to number of employees.

Various methods may be used in performing the above procedures. These range from simple comparisons to complex analyses using advanced statistical techniques. Analytical procedures may be applied to consolidated financial statements, financial statements of components (such as subsidiaries, divisions or segments) and individual elements of financial information. The auditor’s choice of procedures, methods and level of application is a matter of professional judgement.

Analytical procedures are used for the following purposes:

(a) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and

(b) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor’s understanding of the entity.

For instance, establishing the relationship that exists between certain balances included in the Balance Sheet and the Statement of Profit and Loss and comparing them with those that existed between the same set of balances in the previous years reconciling the physical balances of assets with the relevant financial record; obtaining of account from the bankers, account receivables and account payables and reconciling with relevant balances in books of account; confirming amounts of outstanding income and expenses by preparing reconciliation statements, etc. These are helpful in the detection of unusual state of affairs and mistakes in accounts. For example if on comparison of the gross profit ratio with that of the previous year, it is discovered that there has been fall in the ratio, it would be necessary for the auditor to make further enquiries. These may reveal that this was the result of pilferage of inventories, misappropriation of a part of the sale proceeds or a change in the cost of sales without a corresponding increase in the sales price.

Likewise, on verifying the balances of sundry account receivables and account payables by obtaining the confirmation of their statements of account, it will be possible for the auditor to find out whether the discrepancy in the balance of a account receivable is due to the failure to debit his account with the cost of goods supplied to him or is the result of non-adjustment of a remittance received from him. Also whether in the case of a account payable, the discrepancy is due to failure to afford him credit for one or more consignments of goods supplied by him or failure to debit him with an amount of remittance.
Similarly, by taking inventories of raw materials and stores at the end of the year any excesses or shortages therein shall be detected. The investigation of their causes might disclose that the shortages were the result of a misappropriation of inventory or that the excesses were due to requisitions having been entered before the inventories were issued.

Similarly, by reconciling the amounts of interest and dividends collected with the amounts which had accrued due and that which are outstanding for payment, the mistake, if any, in the adjustment of such an income would be detected.

The overall tests can be extended for making a inter-firm and intra-firm comparison of trading results. For example, if balances included in the Statement of Profit and Loss of an entity are compared with those contained in the Statement of Profit and Loss for the same period of another entity engaged in the same trade and working under similar circumstances, it would be possible to find out the cause of the variation in the rate of profitability that exists. Similarly, it would also be possible to compare the balances on the Statement of Profit and Loss with that of the previous period, it would be possible to find out the reasons for increase or decrease in the amount of profits of those years. By setting up certain expenses ratios on the basis of balances included in the Statement of Profit and Loss, for the year under audit, comparing them with the same ratios for the previous year, it is possible to ascertain the extent of increase or decrease in various items of expenditure in relation to sales and that of trading profit in relation to sales. If differences are found to be material, the auditor would ascertain the reasons thereof and assess whether the accounts have been manipulated to inflate or suppress profits.

An abnormal fall in the cost of manufacture or that in the administrative cost, apart from economy in expenses, there could be no provision or less provision for expenses incurred in the year. When it is suspected, the auditor should compare the entries in the outstanding book with those in the previous year. He must also check the vouchers for one month immediately before the close of the following years. To verify that none of the expenses in the accounts under audit have been charged to the accounts of the following years.

Often it is possible to independently verify the correctness of some of the items of expenses included in the Statement of Profit and Loss. For instance the cost of importing goods which are subjected to an ad valorem duty at uniform rate can be verified from the amount of duty paid. Similarly, a quantity of sugar sold by sugarmill can be verified independently from the amount of excise duty paid. Similarly, the amount of any income or expenses which has a direct relationship with the amount of profits or that of sales can be verified independently, e.g., commission paid to a manager calculated on the basis of net profits, commission paid to a selling agent as percentage of sales, etc. Such calculation of ratios, trends and comparisons is also termed as analytical review.

**Analytical procedures in planning the audit** - In the planning stage, analytical procedures assist the auditor in understanding the client’s business and in identifying areas of potential risk by indicating aspects of and developments in the entity’s business of which he was previously unaware. This information will assist the auditor in determining the nature, timing
and extent of his other audit procedures. Analytical procedures in planning the audit use both financial data and non-financial information, such as number of employees, square feet of selling space, volume of goods produced and similar information.

**Analytical procedures used as substantive tests** -

When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with SA 330\(^1\), the auditor shall:

(a) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions;

(b) Evaluate the reliability of data from which the auditor’s expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation;

(c) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and

(d) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation.

Matters relevant to the auditor’s evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated, include:

- The accuracy with which the expected results of substantive analytical procedures can be predicted. For example, the auditor may expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.

- The degree to which information can be disaggregated. For example, substantive analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.

- The availability of the information, both financial and non-financial. For example, the auditor may consider whether financial information, such as budgets or forecasts, and non-financial information, such as the number of units produced or sold, is available to design substantive analytical procedures. If the information is available, the auditor may also consider the reliability of the information.

**Extent of reliance on analytical procedures** - The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained.

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\(^1\)SA330, paragraph 20.
Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:

(a) Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity;

(b) Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;

(c) Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and

(d) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.

The auditor may consider testing the operating effectiveness of controls, if any, over the entity’s preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor generally has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over non-financial information may often be tested in conjunction with other tests of controls. For example, in establishing controls over the processing of sales invoices, an entity may include controls over the recording of unit sales. In these circumstances, the auditor may test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing of sales invoices. Alternatively, the auditor may consider whether the information was subjected to audit testing. SA 500 (Revised) establishes requirements and provides guidance in determining the audit procedures to be performed on the information to be used for substantive analytical procedures.

**Analytical Procedures that Assist When Forming an Overall Conclusion:** The conclusions drawn from the results of analytical procedures designed and performed in accordance with paragraph 6 are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements. This assists the auditor to draw reasonable conclusions on which to base the auditor’s opinion.

The results of such analytical procedures may identify a previously unrecognised risk of material misstatement. In such circumstances, SA 315 requires the auditor to revise the auditor’s assessment of the risks of material misstatement and modify the further planned audit procedures accordingly.

The analytical procedures performed in accordance with paragraph 6 of “SA 520 Analytical Procedure” may be similar to those that would be used as risk assessment procedures.

**Investigating Results of Analytical Procedures:** If analytical procedures performed in

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2SA500(Revised),paragraph 10.
3SA315,paragraph 30.
accordance with SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

(a) Inquiring of management and obtaining appropriate audit evidence relevant to management’s responses; and

(b) Performing other audit procedures as necessary in the circumstances.

5.18 Direct Confirmation of Balances

If the trial balance of the General Ledger agrees to the inclusion of the balance in the total accounts governing the Bought Ledger and the Sales Ledger (instead of individual balances of accounts contained therein), it would not necessarily prove that the balances in the account of the Bought and Sales Ledgers are correct. For example there could still be compensating errors in the ledgers which would not affect the agreement of the trial balance. Therefore, it is essential that the individual balances of account receivables and account payables should be verified on obtaining either confirmation of balance from them or detailed statements of account.

SA505, “External Confirmations”, lays down standards for external confirmation of balances. As per the Standard, External Confirmation means audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium. The objective of the auditor, when using external confirmation procedures, is to design and perform such procedures to obtain relevant and reliable audit evidence.

SA 500 (Revised) indicates that the reliability of audit evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained. That SA also includes the following generalisations applicable to audit evidence:

- Audit evidence is more reliable when it is obtained from independent sources outside the entity.
- Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference.
- Audit evidence is more reliable when it exists in documentary form, whether paper, electronic or other medium.

Accordingly, depending on the circumstances of the audit, audit evidence in the form of external confirmations received directly by the auditor from confirming parties may be more reliable than evidence generated internally by the entity. SA 505 is intended to assist the auditor in designing and performing external confirmations procedures to obtain relevant and reliable audit evidence.

External confirmation is the process of obtaining and evaluating audit evidence through a direct communication from a third party in response to a request for information about a
particular item affecting assertions made by management in the financial statements. In deciding to what extent to use external confirmations, the auditor considers the characteristics of the environment in which the entity being audited operates and the practice of potential respondents in dealing with requests for direct confirmation.

External Confirmation Procedures: When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:

(a) Determining the information to be confirmed or requested;
(b) Selecting the appropriate confirming party;
(c) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and
(d) Sending the requests, including follow-up requests when applicable, to the confirming party.

Selecting the items for which confirmations are needed. External confirmations are frequently used in relation to account balances and their components, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements or transactions an entity has with third parties. The confirmation request is designed to ask if any modifications have been made to the agreement, and if so, the relevant details thereof. Other examples of situations where external confirmations may be used include the following:

- Bank balances and other information from bankers.
- Accounts receivable balances.
- Inventories held by third parties.
- Property title deeds held by third parties.
- Investments purchased but delivery not taken.
- Loans from lenders.
- Accounts payable balances.
- Long outstanding share application money.

The reliability of the evidence obtained by external confirmations depends, among other factors, upon the application of appropriate procedures by the auditor in designing the external confirmation request, performing the external confirmation procedures, and evaluating the results of the external confirmation procedures. Factors affecting the reliability of confirmations include the control which the auditor exercises over confirmation requests and responses, the characteristics of the respondents, and any restrictions included in the response or imposed by management.

The following procedures should be followed for confirmation of the balances of account receivables and account payables at the close of the year:
(a) Confirmatory letters, in respect of the balance, either as at the date of the Balance Sheet or as at another selected date before the close of the year, should be sent out within a period of 15 to 21 days after the end of the year even when the audit is taken up much later.

(b) If the number of accounts is large, letters may be issued only in respect of balances in the accounts of principal account receivables and account payables, selected according to some system, which would ensure that the accounts selected would constitute a representative sample of all accounts of account receivables and account payables. After the size and the contents of the sample have been determined, the client should be requested to prepare confirmatory letters requesting the parties to confirm the balances in their accounts as on a specified date.

(c) The balances shown in the confirmatory letters should be compared by auditors with the book balances of the account receivables and account payables before the letters are despatched. He should also take control of the copies of these balances to prevent these being erased subsequently. The letters should be posted by the auditor. In case these are being posted by the client, there should be adequate check by the auditor that all the letters prepared have been duly posted.

(d) Each confirmatory letter should show the balance in the account of the account receivable or account payable and the address of the auditors at which the confirmation under the signature of the party is to be sent. It should be signed by the client or the auditor, as has been mutually agreed upon. Also a stamped envelope containing the auditor’s name and address should be enclosed. The envelope containing the letter of confirmation should have the address of the auditor as the sender.

(e) The account receivables or account payables who fail to reply within a reasonable time should be reminded. Also, letters received back undelivered should be sent again at the correct address.

(f) On the confirmations being received, the auditor should verify that in each case either the balance has been confirmed or it can be satisfactorily reconciled. In case the balance in the account differs from that confirmed by the party, the client should be requested to prepare a reconciliation statement.

(g) In every case, where a reconciliation statement has been prepared, it should be verified that the difference in the amount confirmed and that shown by the books of account is not the result of an omission to credit any amount received from the party or failure to debit him with any amount of sales or to credit him with the value of goods received with a view to suppressing or inflating profits.

(h) If the difference is the result of some dispute or claim for an allowance or return, etc. not granted to the party, it should be confirmed that a provision equal to the difference which ultimately have to be credited to the party has duly been made.
Selection of accounts for direct verification: A few suggestions as regards selection of accounts for obtaining direct confirmation from parties are given below:

(a) **Credit Balances**: Balance in the accounts of suppliers, depositors, employees, securities deposited by account payables.

(b) **Sundry account receivable balances**: Balances of advances to suppliers, balances recoverable for goods sold, securities deposited, etc. especially when the balances are in round figures have been continually increasing. It is usually not possible to obtain confirmation of amounts outstanding against Government Departments. These, thus, should be left out.

(c) (i) A certain percentage of total number of accounts should be selected: some on the basis of largeness of their balances and others according to numerical or alphabetical order. For example, all accounts having balances above ₹ 10,000 may be included in the list of balances prepared for obtaining confirmations. Also accounts of parties with names beginning with, say “B” and “M” may be included in the list.

(ii) A few amount with no unpaid items, as well as those the balance whereof have been written off during the period under review should be specially included. Furthermore, accounts wherein payments or other credits have been adjusted subsequent to the confirmation date should not be omitted.

(iii) Accounts of parties, any cheque whereof has been received back unselected and accounts which are ‘dead’, i.e., wherein there has been no operation during the year should also be included.

The group of accounts selected in the foregoing manner for obtaining confirmation of the account receivables and account payables balances would be representative sample of all the accounts of account receivables and account payables.

Unless there is evidence that the difference in the amounts confirmed and those shown by the respective accounts in the books is the result of some omission of fictitious entries, the position as revealed by direct verification of a sample of accounts could be accepted.