

## **BCOM -4<sup>TH</sup> SEMESTER**

### **IX- Auditing and Corporate Governance**

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#### **Unit I: Introduction to Auditing**

Introduction –Meaning -Definition –Objectives –Differences between Accountancy and Auditing –Types of Audit -Advantages of Auditing –Preparation before commencement of new Audit – Audit Notebook –Audit Working Papers –Audit Program, Recent Trends In auditing: Nature & Significance of Tax Audit –Cost Audit -Management audit.

Internal Control: meaning and objectives. Internal Check: meaning, objectives. Internal Check as regards: Wage Payments, Cash Sales, Cash Purchases. Internal Audit: Meaning -Advantages and Disadvantages of Internal Audit –Differences between Internal Check and Internal Audit.

#### **Introduction –AUDITING**

Auditing is a cornerstone of modern business, acting as a "watchdog" to ensure that financial records are accurate, reliable, and compliant with laws.

#### **1. Introduction to Auditing**

The term "audit" is derived from the Latin word "**Audire**," which means "**to hear**." In ancient times, when a business owner suspected fraud, they would hire an "auditor" to listen to the oral accounts read by the accountant to verify their correctness.

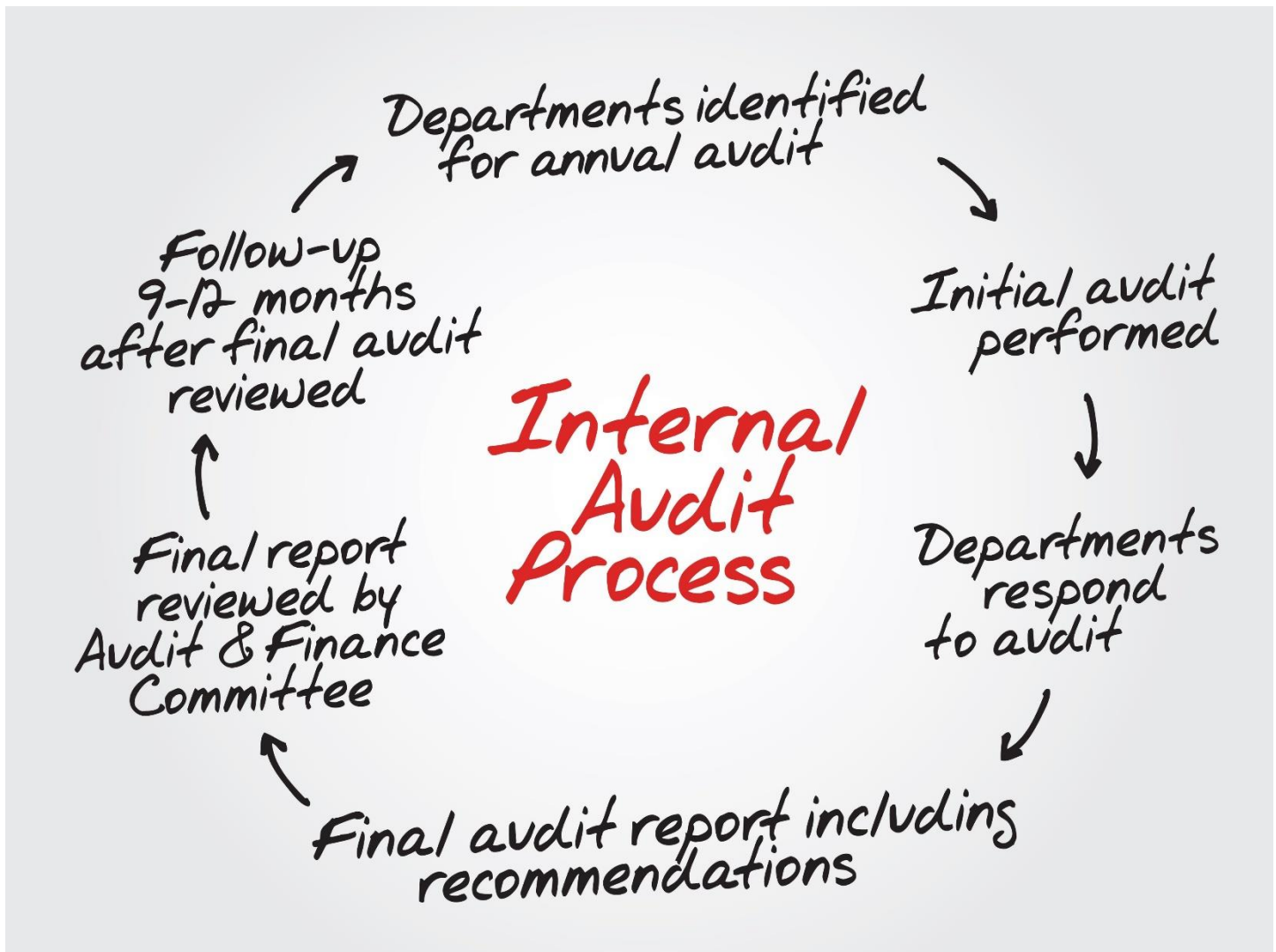
Today, it has evolved from a simple "hearing" to a complex, systematic investigation. As businesses grew and ownership (shareholders) became separated from management (directors), the need for an independent third party to verify the accounts became essential for maintaining trust.

#### **2. Meaning of Auditing**

Auditing is the **intelligent and critical examination** of the books of accounts of a business. It involves a systematic review of vouchers, documents, and financial records by an independent person (the auditor) to confirm that the financial statements represent a "true and fair view" of the company's financial health.

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### 3. Definition of Auditing

Several authorities have defined auditing. Two of the most widely accepted definitions are:

- **As per ICAI (SA 200):** > "An audit is the independent examination of financial information of any entity, whether profit-oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon."
- **According to Spicer and Pegler:** > "Auditing is such an examination of books of accounts and vouchers of business, as will enable the auditors to satisfy himself that the balance sheet is properly drawn up, so as to give a true and fair view of the state of affairs of the business."

### 4. Objectives of Auditing

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The objectives of auditing are generally classified into two main categories: **Primary** and **Secondary (Subsidiary)**.

### **A. Primary Objectives**

The main goal of an audit is to provide assurance to stakeholders.

1. **To Examine Accuracy:** To check the arithmetical accuracy of the books of accounts and ensure that transactions are recorded correctly.
2. **To Verify Financial Statements:** To verify that the Profit & Loss Account and Balance Sheet are prepared according to accounting standards.
3. **To Express an Opinion:** To state whether the financial statements present a "**True and Fair View**" of the company's profit/loss and its assets/liabilities.
4. **Verification of Assets & Liabilities:** To confirm that the assets shown in the balance sheet actually exist and are valued correctly.
5. **B. Secondary (Subsidiary) Objectives-**These objectives are incidental to the primary examination.
  1. **Detection and Prevention of Errors:** Identifying unintentional mistakes like:
    - *Errors of Omission:* Forgetting to record a transaction.
    - *Errors of Commission:* Recording an amount incorrectly.
    - *Errors of Principle:* Violating accounting rules (e.g., treating an expense as an asset).
  2. **Detection and Prevention of Fraud:** Identifying intentional misrepresentations, such as:
    - Misappropriation of cash or goods.
    - Manipulation of accounts (window dressing) to show more profit than actually earned.
  3. **Moral Check:** The knowledge that an audit will take place acts as a deterrent for employees, preventing them from being negligent or dishonest.

**Differences between Accountancy and Auditing-**While accounting and auditing are closely related and both deal with financial records, they are distinct functions. A common way to remember the relationship is: "**Where Accounting ends, Auditing begins.**" Think of the **Accountant as the "Author"** of the company's financial story and the **Auditor as the "Editor"** who reviews that story for accuracy.

### **Key Differences at a Glance**

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Basis	Accountancy (Accounting)	Auditing
<b>Meaning</b>	The process of recording, classifying, and summarizing financial transactions.	The independent examination and verification of books of accounts.
<b>Objective</b>	To determine the financial performance (profit/loss) and financial position of a business.	To verify the accuracy and reliability of financial statements and express an opinion.
<b>Timing</b>	A <b>continuous</b> process carried out daily year-round.	A <b>periodic</b> process, usually done after the financial year ends.
<b>Start Point</b>	Begins where bookkeeping ends.	Begins where accounting ends.
<b>Performed By</b>	Performed by an <b>Accountant</b> (usually an employee of the firm).	Performed by an <b>Auditor</b> (usually an independent external professional).
<b>Scope</b>	Broad: involves day-to-day entries, ledger preparation, and final accounts.	Specific: involves checking the records that the accountant has already prepared.
<b>Reporting</b>	Accounts are reported to the <b>Management</b> .	The Audit Report is submitted to the <b>Shareholders</b> or Owners.
<b>Remuneration</b>	Accountants receive a regular <b>Salary</b> .	External auditors receive an <b>Audit Fee</b> .

### Key Nuances to Note

- **Relationship:** Accounting is constructive in nature (building the records), while auditing is analytical and critical in nature (tearing them down to see if they hold up).
- **Standards:** Accountants follow **Accounting Standards** (like GAAP or IFRS), whereas auditors follow **Standards on Auditing** (SAs).
- **Detection of Fraud:** An accountant's primary job is not to find fraud but to record transactions. An auditor, while not a "bloodhound," has a duty to look for material misstatements, which include errors and fraud.
- **Independence:** An accountant is generally subordinate to the company management. An auditor must be **independent** of the management to provide an unbiased opinion.

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**Types of Audit**-Auditing can be classified into various types based on its purpose, the authority that mandates it, and the time at which it is conducted.

### 1. Classification Based on Authority

This determines whether the audit is required by law or performed voluntarily.

- **Statutory Audit:** Mandated by law. For example, all companies registered under the **Companies Act** must undergo an annual audit to protect shareholders.
- **Government Audit:** Conducted for government departments and public sector undertakings (PSUs) to ensure public money is used efficiently.
- **Voluntary (Private) Audit:** Not required by law but performed at the request of the owners (e.g., sole traders or partnership firms) to ensure their records are accurate or to secure bank loans.

**2. Classification Based on Scope & Objective**-This looks at "what" specifically is being examined.

Type	Focus
<b>Financial Audit</b>	Verifies the accuracy of the Balance Sheet and Profit & Loss Account.
<b>Internal Audit</b>	Done by employees or external experts to review internal controls and risk management.
<b>Cost Audit</b>	Verifies cost records to ensure the cost of production is calculated correctly.
<b>Tax Audit</b>	Ensures compliance with tax laws and checks the accuracy of tax returns.
<b>Management Audit</b>	Evaluates the performance of the management and the efficiency of their decisions.
<b>Forensic Audit</b>	A specialized investigation used to gather evidence for legal proceedings or to detect fraud.

### 3. Classification Based on Timing

This refers to "when" the audit takes place during the year.

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- **Continuous Audit:** The auditor visits the client regularly (weekly or monthly) throughout the year. It is ideal for large businesses with many transactions.
- **Final (Periodic) Audit:** Conducted only at the end of the financial year once the accounts are fully prepared.
- **Interim Audit:** Performed in the middle of the year, usually to check the profit before declaring an interim dividend.

#### 4. Specialized Audits

- **Operational Audit:** Checks if the business operations (like production or HR) are running efficiently.
- **Compliance Audit:** Ensures the business is following specific rules, such as environmental regulations or labor laws.
- **IT Audit:** Examines the security and integrity of the company's computer systems and data.

### Advantages of Auditing

Auditing provides significant value not just to the business owners, but also to the management, investors, and even the government. It transforms raw financial data into a verified "seal of quality." The advantages can be categorized based on who benefits from the audit:

#### 1. Advantages to the Business & Management

- **Detection of Errors and Frauds:** The most direct benefit is the identification of unintentional mistakes (errors) and deliberate misappropriations (frauds) that might otherwise go unnoticed.
- **Operational Efficiency:** Auditors often provide a "Management Letter" at the end of an audit, highlighting bottlenecks in processes and suggesting ways to improve business productivity.
- **Moral Check on Employees:** The mere knowledge that an independent auditor will examine the books acts as a powerful deterrent against negligence or dishonesty by the staff.
- **Better Internal Controls:** An audit evaluates the company's internal systems. If the "checks and balances" are weak, the auditor recommends improvements to protect assets.
- **Evidence in Disputes:** Audited accounts are considered reliable evidence in legal disputes, such as settling accounts during a partner's retirement or resolving wage/bonus conflicts with employees.

## 2. Advantages to Owners & Shareholders

- **Assurance of "True and Fair View":** Shareholders, who are often not involved in daily operations, get peace of mind that the directors are not mismanaging funds and that the profits reported are real.
- **Protection of Interests:** For small partners or minority shareholders, an audit ensures their financial interests are being looked after and that they are receiving their fair share of profits.

## 3. Advantages to Third Parties

- **Easy Access to Loans:** Banks and financial institutions almost always require audited financial statements before approving loans. It serves as proof of the business's creditworthiness.
- **Settlement of Insurance Claims:** In the event of fire, theft, or flood, insurance companies rely on audited figures to determine the exact value of the loss and settle claims quickly.
- **Tax Assessments:** Tax authorities (Income Tax, GST/VAT) generally accept audited statements as the basis for calculating tax liability, leading to fewer disputes and smoother assessments.
- **Attracting Investors:** Potential investors are more likely to put money into a company that has a history of "clean" audit reports, as it reduces their investment risk.

## Summary of Key Benefits

Benefit	Impact
<b>Credibility</b>	Financial statements become reliable for the public and the market.
<b>Compliance</b>	Ensures the business follows the Companies Act and Accounting Standards.
<b>Financial Health</b>	Identifies "leaks" in the business where money is being wasted.
<b>Goodwill</b>	Regularly audited firms enjoy a higher reputation in the industry.

**Preparation before commencement of the new audit:** When an auditor takes on a new assignment, they cannot simply walk in and start checking vouchers. A systematic preparation phase is required to ensure the audit is efficient, legal, and thorough.

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This preparation is generally divided into **Preliminary Engagement Activities** and **Audit Planning**.

## 1. Preliminary Engagement Activities

Before the official "start," the auditor must clear certain legal and ethical hurdles.

- **Verify Appointment:** The auditor must ensure their appointment is valid under the law (e.g., the Companies Act). This involves checking the resolution passed at the Annual General Meeting (AGM).
- **Communicate with the Previous Auditor:** Professional ethics require the new auditor to communicate with the outgoing auditor to ask if there are any professional reasons (like unpaid fees or disagreements on principles) why they should not accept the position.
- **Acceptance & Engagement Letter:** Once satisfied, the auditor sends an **Audit Engagement Letter**. This contract defines the scope of work, management's responsibilities, and the auditor's reporting obligations to avoid future misunderstandings.
- **Confirm Independence:** The audit team must sign declarations confirming they have no financial interest or personal relationship with the client that could bias their judgment.

## 2. Technical Preparation (Understanding the Client)

The auditor must "get to know" the business to identify where risks might hide.

- **Study Legal Documents:** For a company, this means reading the **Memorandum of Association (MOA)** and **Articles of Association (AOA)**. For a firm, it's the **Partnership Deed**. These define what the business can and cannot do.
- **Knowledge of Business (KOB):** The auditor visits the factory or office to understand the production process, the types of products, and the industry environment (e.g., specific tax laws or economic trends).
- **List of Books & Officers:** The auditor asks for a list of all accounting books maintained and a list of principal officers (Directors, Managers) along with their powers and specimen signatures.

## 3. Evaluating Internal Controls-The auditor tests the client's own "defense systems."

- If the company has a strong **Internal Control System** (e.g., software that requires two people to approve a payment), the auditor can do "Test Checking."
- If the controls are weak, the auditor must perform a much more detailed and deep examination.

**4. Developing the Audit Program-**The final step in preparation is creating a "battle plan" known as the **Audit Program**.

- **Step-by-Step Instructions:** A detailed list of audit procedures to be followed by the audit staff.
- **Allocation of Work:** Assigning specific tasks (e.g., "Junior A checks cash," "Senior B verifies fixed assets") based on the team's skills.
- **Timeline:** Setting deadlines for each phase of the audit to ensure the report is issued on time.

### **Summary Checklist for a New Auditor**

1. [ ] Check Validity of Appointment.
2. [ ] Send "No Objection" letter to the previous auditor.
3. [ ] Obtain Signed Engagement Letter.
4. [ ] Study MOA/AOA and previous year's Financial Statements.
5. [ ] Evaluate the Internal Control System.
6. [ ] Finalize the Audit Program and Staffing.

**Audit Notebook, Audit Working Papers, Audit Program-**To ensure an audit is thorough and legally defensible, auditors use three primary tools to document their work: the **Audit Program** (the plan), the **Audit Notebook** (the diary), and **Audit Working Papers** (the evidence).

**1. Audit Program (The Battle Plan)-**An Audit Program is a detailed, written list of specific audit procedures to be followed by the audit staff. It serves as a "to-do list" to ensure no important area is overlooked.

- **Contents:** Steps for checking cash, bank balances, inventory, and vouchers; allocation of work to specific assistants; and the estimated time for each task.
- **Advantages: \* Fixes Responsibility:** You know exactly which assistant checked which record.
  - **Uniformity:** Ensures the audit is conducted consistently every year.
  - **Progress Tracking:** The auditor can see at a glance how much work is finished.
- **Disadvantage:** It can become "mechanical," and staff may stop using their own initiative if they only follow the checklist.

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**2. Audit Notebook (The Auditor's Diary)**-The Audit Notebook is a bound register where the audit staff records difficulties, irregularities, and points that require further clarification from the management.

- **Key Contents:**

- List of books of accounts maintained by the client.
- Technical queries and their explanations.
- List of missing vouchers or receipts.
- Important dates (start and end of audit).
- Points to be included in the final Audit Report.

- **Importance:** It is a vital **legal evidence** in court if the auditor is ever charged with negligence. It proves that the auditor was diligent and raised questions where necessary.

**3. Audit Working Papers (The Evidence)**-Working papers are the link between the client's records and the auditor's report. They include all the documents collected or prepared by the auditor during the engagement.

They are typically organized into two files:

1. **Permanent File:** Contains documents of long-term importance (e.g., Memorandum of Association, Partnership Deed, Internal Control manuals).
2. **Current File:** Contains documents related only to the current year's audit (e.g., Bank Reconciliation Statements, Trial Balance, letters of confirmation from debtors).

### Summary Comparison

Tool	Purpose	Ownership
<b>Audit Program</b>	To guide and supervise the audit staff.	Auditor
<b>Audit Notebook</b>	To record queries and daily observations.	Auditor
<b>Working Papers</b>	To provide evidence for the audit opinion.	Auditor

**Note on Ownership:** Legally, the Audit Notebook and Working Papers are the **property of the auditor**, not the client. However, the auditor must maintain their confidentiality.

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## Recent Trends in Auditing: Nature & Significance of Tax Audit

The field of auditing is undergoing a significant transformation driven by technological change and a shift toward non-financial accountability. Simultaneously, **Tax Audit** remains a critical regulatory pillar for financial integrity.

### 1. Recent Trends in Auditing (2024–2025)

The modern audit is moving away from "looking at the past" toward "predictive and real-time" insights.

- **The Year of AI and Data Analytics:** Auditors are shifting from **sampling** (checking 1 in 100 transactions) to **full population testing**. AI tools can now scan 100% of a company's transactions to flag anomalies, potential fraud, or outliers in seconds.
- **Continuous (Real-Time) Auditing:** Instead of a "year-end scramble," more firms are adopting continuous auditing. By integrating with a client's cloud software, auditors can test controls and verify transactions as they happen throughout the year.
- **ESG Auditing (Environmental, Social, and Governance):** This is the fastest-growing trend. Stakeholders no longer just care about profit; they want verified data on a company's **carbon footprint**, diversity, and ethical supply chains. Many regulators (like SEBI in India or the CSRD in the EU) now mandate "Sustainability Audits."
- **Remote Auditing:** Accelerated by the pandemic, digital communication tools and virtual site visits (sometimes using drones for inventory counting) have made remote audits a standard practice, allowing for global collaboration.
- **Cybersecurity Audits:** As data breaches become more common, auditors are increasingly tasked with verifying that a company's IT defenses and data privacy protocols (like GDPR) are robust.

### 2. Tax Audit: Nature and Significance

A **Tax Audit** is a specialized audit conducted to verify that a taxpayer has complied with the tax laws of the country (e.g., Section 44AB of the Income Tax Act in India).

#### A. Nature of Tax Audit

- **Regulatory Requirement:** It is not voluntary. It is mandatory for businesses or professionals whose turnover/gross receipts exceed a specific threshold (e.g., ₹1 Crore or ₹10 Crore depending on cash transactions).
- **Independent Certification:** It must be performed by a qualified **Chartered Accountant (CA)** who is independent of the business.

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- **Compliance-Focused:** Unlike a regular audit which checks if accounts are "true and fair," a tax audit checks if the accounts are "**compliant with tax laws.**" For example, it checks if expenses like entertainment or travel were deducted correctly according to tax rules.
- **Specific Reporting:** The auditor submits specific forms (like **Form 3CA/3CB and 3CD**) which detail disallowances, depreciation, and tax-related information.

## B. Significance of Tax Audit

1. **Ensures Accurate Tax Reporting:** It prevents tax evasion by ensuring that the income and expenses reported to the government are accurate and substantiated by vouchers.
2. **Facilitates Easy Assessment:** Since a CA has already certified the books, tax authorities can process returns faster and with more confidence, reducing the likelihood of a "scrutiny" notice.
3. **Detects Fraud and Discrepancies:** The systematic examination of tax-deductible items often reveals internal errors or intentional frauds that were missed during regular bookkeeping.
4. **Acts as a Deterrent:** The legal requirement of a tax audit encourages taxpayers to maintain proper, up-to-date books of accounts throughout the year.
5. **Standardizes Reporting:** It forces businesses to follow uniform accounting standards and tax provisions, making the economic system more transparent and comparable.

### Summary Checklist: Is a Tax Audit Mandatory? (Typical Criteria)

- **Business:** If turnover exceeds **₹1 Crore** (or **₹10 Crore** if more than 95% of transactions are digital).
- **Profession:** If gross receipts exceed **₹50 Lakhs**.
- **Presumptive Taxation:** If a taxpayer claims their profit is lower than the government-prescribed percentages.

**Cost Audit AND Management audit-** While financial auditing focuses on the accuracy of balance sheets, **Cost Audit** and **Management Audit** look deeper into the "gears" of the business to see how money is being spent and how the company is being run.

### 1. Cost Audit

Cost Audit is the verification of cost accounts to ensure that the cost of production for a product or service is calculated accurately and follows established cost accounting principles.

- **Nature:** It is **Statutory** (mandatory) for specific industries in many regions (like manufacturing, mining, or utilities) once they cross a certain turnover threshold.

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- **Conducted By:** A practicing **Cost and Management Accountant (CMA)**.
- **Key Focus:** \* To check if materials, labor, and overheads are allocated correctly.
  - To identify "abnormal losses" (wastage that shouldn't have happened).
  - To ensure that the company's pricing strategy is based on real data.

**2. Management Audit-**Management Audit is a forward-looking, "holistic" review of the entire management team's performance. It doesn't just look at numbers; it seems at **decisions**.

- **Nature:** It is **Voluntary**. There is no law that requires a company to conduct a management audit; companies do so to enhance competitiveness.
- **Conducted By:** Internal auditors, management consultants, or specialized independent experts.
- **Key Focus:**
  - **Efficiency:** Is the management using resources (men, money, machines) wisely?
  - **Effectiveness:** Are the company's long-term goals (like market share) being met?
  - **Structure:** Is the organizational chart clear, or is there confusion about who reports to whom?

### 3. Comparison: Cost Audit vs. Management Audit

Feature	Cost Audit	Management Audit
<b>Primary Goal</b>	To verify accuracy of cost records.	To appraise the efficiency of management.
<b>Legal Status</b>	Often Mandatory (Statutory).	Entirely Voluntary.
<b>Basis</b>	Focuses on <b>Cost Statements</b> .	Focuses on <b>Managerial Activities</b> .
<b>Approach</b>	Backward-looking (checks past records).	Forward-looking (suggests future improvements).
<b>Scope</b>	Narrow (Limited to cost of production).	Very Broad (Covers HR, Marketing, Strategy, etc.).
<b>Reporting</b>	To the Board of Directors & Government.	To the Board of Directors or Owners only.

#### 4. Significance (Why do they matter?)-Significance of Cost Audit:

1. **Consumer Protection:** Helps the government ensure that companies aren't overcharging consumers by inflating their costs.
2. **Price Fixation:** Provides a solid foundation for the management to set competitive prices for their products.
3. **Wastage Control:** It acts as a "leak detector," showing where raw materials or labor hours are being wasted.

#### Significance of Management Audit:

1. **Strategic Alignment:** Ensures the company's daily operations are actually helping achieve its 5-year or 10-year plans.
2. **Early Warning System:** Identifies "managerial rot" or poor decision-making before it leads to a financial crisis.
3. **Investor Confidence:** Shows potential investors or buyers (in a merger) that the company is professionally and efficiently run.

#### Internal Control: meaning and objectives

Internal control is the "nervous system" of an organization. It is not just a single event or a set of rules, but a continuous process designed to help a business run smoothly and safely.

#### 1. Meaning of Internal Control

Internal control refers to the entire system of checks and balances—both financial and non-financial—established by the management to ensure that the business operates in an orderly and efficient manner. It is a broad term that includes:

- **Internal Check:** The day-to-day routine where the work of one employee is automatically checked by another.
- **Internal Audit:** An independent review of the company's operations and controls by a specialized staff.

**Key Concept:** Internal control provides "**reasonable assurance**," not absolute certainty. It cannot eliminate all risks (like human error or collusion), but it significantly reduces them.

3. **Objectives of Internal Control-**The goals of a strong internal control system can be grouped into four main categories:
- 4.

## A. Operational Objectives

- **Efficiency and Effectiveness:** To ensure resources (money, time, and materials) are used optimally without wastage.
- **Orderly Conduct:** To ensure business activities follow a systematic "step-by-step" process rather than being chaotic.

## B. Financial Reporting Objectives

- **Accuracy of Records:** To ensure that every transaction is recorded correctly in the books of accounts.
- **Reliability:** To provide management and shareholders with financial statements they can trust for decision-making.
- **Timeliness:** To ensure accounts are updated and reported on time.

## C. Safeguarding Objectives

- **Protection of Assets:** To prevent assets (like cash, inventory, or machinery) from being stolen, misused, or accidentally damaged.
- **Prevention of Fraud and Errors:** To create barriers that make it difficult for employees or outsiders to commit fraud or make significant mistakes.

## D. Compliance Objectives

- **Adherence to Laws:** To ensure the company follows government regulations (Tax laws, Companies Act, Environmental laws).
- **Management Policies:** To ensure that employees are actually following the internal rules set by the board of directors.

## 3. The 5 Components of Internal Control (C.R.I.M.E.)

Modern auditing uses the **COSO Framework** to evaluate internal controls. You can remember it using the acronym **C.R.I.M.E.**:

1. **Control Environment:** The "tone at the top." Does management actually care about ethics and discipline?
2. **Risk Assessment:** Identifying what could go wrong (e.g., "What if our server crashes?" or "What if a manager steals cash?").
3. **Information & Communication:** Ensuring the right people get the correct information at the right time.

4. **Monitoring:** Regularly checking if the controls are still working or if they need to be updated.
5. **Existing Control Activities:** The actual tools used, such as **passwords, physical locks, and segregation of duties** (not letting the same person who buys the goods also pay for them).

### **Internal Check: meaning, objectives**

While **Internal Control** is the broad umbrella of policies and rules, **Internal Check** is the practical, day-to-day operation where those rules come to life.

Think of Internal Control as the "Security Policy" of a bank, and Internal Check as the specific rule that says "Two different people must hold the two different keys needed to open the vault."

**1. Meaning of Internal Check-**Internal Check is a system where the work of one employee is automatically and independently checked by another employee in the ordinary course of business. No single person is allowed to carry out a transaction from start to finish.

**The Golden Rule of Internal Check:** "No one person should have absolute control over every aspect of a single transaction."

### **A Simple Example (Cash Sales)**

If one person sold the item, collected the cash, and recorded the sale in the computer, it would be very easy for them to steal the money. Under an Internal Check system:

1. **Person A** (Salesperson) makes the sale and gives a receipt.
2. **Person B** (Cashier) collects the money and stamps the receipt.
3. **Person C** (Accountant) enters the data into the system at the end of the day. To commit fraud, all three would have to agree to cheat together (**Collusion**), which is much harder to do.

### **2. Objectives of Internal Check**

The primary goal of internal check is to make the business "self-correcting" and "self-policing."

- **Prevention of Fraud:** By dividing duties, it becomes nearly impossible for one person to steal without being caught by the next person in line.
- **Early Detection of Errors:** If the first clerk makes a mistake in an invoice, the second clerk will likely spot it while processing the payment, preventing the error from reaching the final accounts.
- **Fixation of Responsibility:** Since every task is assigned to a specific person, if a mistake is found, the management knows exactly who was responsible.

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- **Reliability of Records:** Because work is checked continuously, the management can trust that the financial statements are accurate even before the audit begins.
- **Increased Efficiency:** Dividing work into smaller, specialized tasks allows employees to become faster and more accurate at their specific jobs (Division of Labor).
- **Moral Pressure:** Employees are less likely to be dishonest if they know that their work will be immediately reviewed by a colleague.

### 3. Difference Between Internal Check and Internal Audit

It is common to confuse these two, but they happen at different times.

Feature	Internal Check	Internal Audit
<b>Timing</b>	Happens <b>during</b> the transaction.	Happens <b>after</b> the transaction.
<b>Performed By</b>	Regular staff (Clerks/Accountants).	Specialized Internal Audit team.
<b>Nature</b>	It is a "simultaneous" check.	It is a "post-mortem" check.
<b>Cost</b>	No extra cost (part of routine work).	Expensive (requires separate staff).

#### Summary Table: Internal Check at a Glance

Objective	Mechanism
<b>Fraud Prevention</b>	Division of duties so no one person has total control.
<b>Error Detection</b>	Automatic cross-verification by the next clerk.
<b>Accountability</b>	Clear assignment of tasks to specific names/IDs.
<b>Speed</b>	Specialization of roles increases transaction speed.

## **Internal Check as regards: Wage Payments, Cash Sales, Cash Purchases**

Implementing an internal audit system for specific high-risk areas, such as wages and cash, involves dividing duties so that one employee's work is automatically verified by another.

### **1. Internal Check: Wage Payments**

The objective is to prevent the inclusion of "dummy workers" and ensure that employees are only paid for the hours they actually worked at the correct rates.

- **Personnel vs. Payroll:** The department that hires staff (HR) should be separate from the department that calculates the pay (Payroll).
- **Time Recording:** Use time-clocks or biometric scanners to record entry and exit. These records should be verified by a supervisor who does not handle the money.
- **Piece-work Records:** If workers are paid per unit, a separate "quality inspector" should certify the number of units produced before the payment is calculated.
- **Calculation:** One clerk should prepare the wage sheets, and a second senior clerk should re-calculate the totals and deductions (taxes, insurance) to check for errors.
- **The Payout:** Wages should ideally be paid via bank transfer. If paid in cash, the person who prepared the wage sheets should **not** be the one handing out the envelopes. An independent official should witness the payout.

### **2. Internal Check: Cash Sales**

Cash sales are highly vulnerable to theft. A robust system ensures that every item leaving the store is paid for and that the cash reaches the bank.

- **Triplicate Memos:** For every sale, a salesman prepares a cash memo in three copies:
  1. **Customer Copy:** Given to the buyer.
  2. **Cashier Copy:** Sent to the cashier with the money.
  3. **Book Copy:** Remains in the salesman's book for record-keeping.
- **The Cashier:** The cashier should be in a separate booth. They receive the cash, stamp the memo "PAID," and enter the amount in a cash register.
- **The Gatekeeper:** In large stores, a gatekeeper checks the customer's "PAID" memo against the actual goods being carried out.
- **Daily Reconciliation:** At the end of the day, the total from the **Salesman's summary** must match the **Cashier's total cash**, which must match the **Gatekeeper's tally**.

### 3. Internal Check: Cash Purchases

Cash purchases are often used to hide "fake" expenses. The goal is to ensure that only authorized goods are bought and that the money isn't misappropriated.

- **Requisition:** A department head must sign a "Requisition Slip" stating the need for the item. One person cannot simply decide to buy something and take cash for it.
- **Purchase Order (PO):** The Purchase Department issues a formal PO to an approved supplier.
- **Receipt of Goods:** When goods arrive, the "Receiving Clerk" checks the quality and quantity. They prepare a **Goods Received Note (GRN)**.
- **The "Three-Way Match":** Before payment is made, the Accounts Department must match three documents:
  1. The **Purchase Order** (What we asked for).
  2. The **GRN** (What we actually got).
  3. The **Supplier's Invoice** (What we are being charged).
- **Payment:** Payments should be made by crossed cheque or bank transfer, signed by two authorized officials.

### Summary of Duty Segregation

Function	Person A	Person B	Person C
<b>Wages</b>	Records Attendance	Prepares Payroll	Distributes/Approves Pay
<b>Cash Sales</b>	Sells Goods	Collects Cash	Reconciles Daily Totals
<b>Purchases</b>	Authorizes/Orders	Receives Goods	Processes Payment

### **Internal Audit: Meaning Advantages and Disadvantages of Internal Audit**

Internal Audit is often described as the "Third Line of Defense" in an organization. While the first two lines (management and risk/compliance teams) manage daily operations, Internal Audit provides an independent, bird's-eye view of whether those defenses are actually working.

## 1. Meaning of Internal Audit

Internal Audit is an **independent, objective assurance and consulting activity** designed to add value and improve an organization's operations. It is conducted by an internal department or an outsourced firm to evaluate the effectiveness of a company's risk management, internal controls, and governance. Unlike an external audit (which focuses on whether the financial statements are "true and fair"), an internal audit focuses on whether the company's **processes and policies** are being followed and if they are efficient.

**Key Distinction:** Internal auditors are "employees" (or consultants) reporting to the **Audit Committee** or the **Board of Directors**, not to the CEO. This reporting line ensures they can criticize management without fear of being fired.

## 2. Advantages of Internal Audit

- **Early Detection & Prevention:** It identifies "red flags" and weaknesses in systems *before* they lead to a major loss or a bad external audit report.
- **Operational Efficiency:** By reviewing workflows, internal auditors can identify bottlenecks, duplicate tasks, or outdated procedures that are wasting the company's money.
- **Risk Mitigation:** It helps management identify emerging risks (like a new cybersecurity threat or a change in tax law) and suggests ways to handle them.
- **Ensures Compliance:** It verifies that every department is following both external laws (like GST/Income Tax) and internal policies (like the company's travel or expense policy).
- **Better Decision-Making:** It provides the Board of Directors with accurate, verified data that hasn't been "filtered" or sugar-coated by department managers.
- **Moral Check:** Just as with internal check, the presence of an internal audit team keeps employees honest and diligent.

## 3. Disadvantages (Limitations) of Internal Audit

- **High Cost:** Maintaining a permanent internal audit department is expensive. It requires hiring specialized staff, providing software, and constant training.
- **Conflict of Interest (Independence Issues):** Even with a reporting line to the Board, internal auditors are technically employees. They may find it difficult to be 100% objective when auditing their own colleagues or superiors.
- **"Police" Perception:** If not managed well, employees may view internal auditors as "spies" or "policemen," leading to a culture of fear and a lack of cooperation.
- **Time Lag:** Internal auditing is a continuous process. Sometimes, by the time an audit is completed and the report is issued, the business situation has already changed.

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- **Subject to Errors:** Like any human process, if the internal auditor is not skilled enough or uses a poor sampling method, they may miss significant frauds or errors.

### Comparison: Internal Check vs. Internal Audit

Feature	Internal Check	Internal Audit
<b>Objective</b>	To prevent errors/frauds during the work.	To review and improve the system.
<b>Timing</b>	Continuous (while work is happening).	Periodic or Post-mortem (after work).
<b>Scope</b>	Restricted to routine clerical work.	Broad; includes operations and strategy.
<b>Personnel</b>	Regular clerical staff.	Specialized internal auditors.

### Differences between Internal Check and Internal Audit.

While both **Internal Check** and **Internal Audit** are parts of a company's overall internal control system, they serve different purposes and operate at various stages of the business process.

The simplest way to distinguish them is that **Internal Check** is "Doing the work correctly," whereas **Internal Audit** is "**Checking if the work was done correctly.**"

### Key Differences at a Glance

Basis	Internal Check	Internal Audit
<b>Meaning</b>	A system where work is divided so that one person's work is automatically checked by another.	An independent and objective review of all business operations and controls.
<b>Nature</b>	It is a <b>continuous</b> process that happens alongside the transaction.	It is a <b>periodic</b> or specific review that happens after the work is completed.
<b>Objective</b>	To prevent errors and frauds from happening in the first place.	To detect errors and frauds that have already occurred and suggest improvements.

Basis	Internal Check	Internal Audit
<b>Who performs it?</b>	Regular clerical staff (accountants, cashiers, sales clerks).	Specialized internal auditors (separate department or external firm).
<b>When it starts?</b>	Starts as soon as a transaction begins.	Starts after the transactions have been recorded.
<b>Cost</b>	Negligible, as it is part of the daily routine.	High, as it requires a separate staff or department.
<b>Scope</b>	Limited to routine accounting and clerical tasks.	Very broad; includes financial, operational, and management performance.
<b>Reports to</b>	No separate report; any error is corrected immediately on the spot.	A formal Audit Report is submitted to the <b>Management or Board of Directors</b> .

## Key Nuances

### 1. The Relationship

Internal check is the **foundation**. If the internal check system is strong (e.g., three different people handle a sale), the internal auditor's job becomes easier because the data is likely more reliable. If internal check is weak, the internal auditor must work much harder.

### 2. The "Automated" vs. "Deliberate" Factor

- **Internal Check** is like a safety lock on a door that engages automatically.
- **Internal Audit** is like a security guard who walks by later to see if the door was actually locked and if the lock is still strong enough.

### 3. Purpose of Detection

- **Internal Check** aims at **Prevention**: "Let's make sure no one can steal the cash today."
- **Internal Audit** aims at **Appraisal**: "Did anyone steal cash last month, and how can we stop it next month?"

## Summary Scenario: A Bank Withdrawal

- **Internal Check:** The clerk verifies your signature, and then a supervisor authorizes the payment before the cashier gives you the money. (The work of the clerk is checked by the supervisor *before* you leave).
- **Internal Audit:** A week later, a specialized auditor reviews the withdrawal slips and video footage to ensure all procedures were followed correctly that day.

## Unit II: Vouching, Verification, and Valuation Of Assets And Liabilities

Meaning -Definition –Importance –Routine Checking and Vouching –Voucher -Types of Vouchers –Vouching of Receipts: Cash Sales, Receipts from debtors, Proceeds of the sale of Investments. Vouching of Payments: Cash Purchases, Payment to Creditors, Deferred Revenue Expenditure

Meaning and Objectives of verification and valuation –Position of an Auditor as regards the Valuation of Assets –Verification and Valuation of different Items: Assets: Land & Building, Plant & Machinery, Goodwill –Investments -Stock in Trade—liabilities: Bills Payable -Sundry Creditors –Contingent Liabilities.

### Vouching, Verification, and Valuation Of Assets And Liabilities

In auditing, these three terms represent the "detective work" an auditor performs to ensure that the financial statements are not merely numbers on a page but a reflection of reality.

**1. Vouching (The Backbone of Auditing)**-Vouching is the examination of documentary evidence (vouchers) to support the transactions recorded in the books of accounts. It is often called the "essence" of auditing.

- **Meaning:** It involves checking the source documents (invoices, receipts, bank statements, contracts) against the entries in the ledger.
- **Objective:** To ensure that transactions are:
  1. **Authentic:** They actually happened.
  2. **Authorized:** Approved by the right person.
  3. **Properly Classified:** e.g., a "repair" isn't recorded as a "new asset."
- **Example:** To vouch for a "Purchase," the auditor will look at the Purchase Invoice, the Goods Received Note (GRN), and the bank payment entry.

**2. Verification-**While vouching deals with **transactions** (income and expenses), verification deals with **items in the Balance Sheet** (assets and liabilities).

- **Meaning:** It is the process by which the auditor satisfies themselves as to the **existence, ownership, possession, and freedom from encumbrance** (liens or debts) of an asset.
- **Objectives:**
  - **Existence:** Does the building/machinery actually exist?
  - **Ownership:** Does the company legally own it? (Checking Title Deeds).
  - **Possession:** Is the asset actually with the company or a third party?
  - **Charge:** Is the asset pledged as collateral for a loan?

**3. Valuation-**Valuation is the process of ensuring that the assets and liabilities are shown in the Balance Sheet at their **correct financial value** according to Generally Accepted Accounting Principles (GAAP).

- **Meaning:** While the auditor is not a "valuer" (they aren't an engineer or an appraiser), they must ensure that the valuation method is consistent and accurate.
- **Difference from Verification:** Verification asks, "Is it there?" whereas Valuation asks, "How much is it worth today?"
- **Methods:**
  - **Fixed Assets:** Usually valued at Cost minus Depreciation.
  - **Stock (Inventory):** Valued at Cost or Market Value, whichever is **lower**.
  - **Debtors:** Valued at the amount expected to be realized (Total minus Provision for Doubtful Debts).

**Comparison: Vouching vs. Verification vs. Valuation**

Basis	Vouching	Verification	Valuation
<b>Focus</b>	Transactions (P&L Items).	Assets & Liabilities (Balance Sheet).	Value of Assets & Liabilities.
<b>Evidence</b>	Vouchers, Invoices, Receipts.	Title Deeds, Physical Inspection.	Certificates, Market Reports.

Basis	Vouching	Verification	Valuation
<b>Timing</b>	Done throughout the audit.	Done at the end of the year.	Done at the end of the year.
<b>Audit Goal</b>	Check for accuracy and authority.	Check for existence and legal ownership.	Check for correct monetary value.

#### 4. Verification & Valuation of Liabilities

Auditors often focus on assets, but verifying liabilities is equally important to ensure the company hasn't "hidden" any debts.

1. **Loans:** Check the loan agreement, interest rates, and confirm the balance directly with the bank.
2. **Creditors:** Perform "circularization" (sending letters to suppliers to confirm how much the company owes them).
3. **Contingent Liabilities:** Check legal files to see if any pending lawsuits might cost the company money in the future.

#### Summary Checklist for an Auditor

- **Vouching:** "Show me the receipt for this expense."
- **Verification:** "Take me to the warehouse so I can see this machinery."
- **Valuation:** "Show me your math on why this 5-year-old car is still worth \$50,000."

#### Meaning Definition Importance Routine Checking and Vouching

In auditing, **Routine Checking and vouching** are two foundational techniques used to verify the reliability of financial records. While Routine Checking focuses on the mechanical accuracy of the books, Vouching goes deeper to establish the authenticity of the transactions.

**1. Routine Checking-Routine Checking** is the detailed and regular examination of daily accounting records to ensure their mathematical accuracy. It is the most basic part of an audit, often performed by junior audit staff.

#### Meaning & Definition

- **Meaning:** It involves verifying the "routine" tasks of bookkeeping, such as checking totals, sub-totals, carry-forwards, and ledger postings.
- **Definition:** "Routine checking is the regular monitoring of business accounts, books, and ledgers to determine how the business is functioning and to detect simple clerical errors or frauds."

### Importance of Routine Checking

1. **Arithmetical Accuracy:** It ensures that all totals (additions) and balances in the subsidiary books and ledgers are correct.
2. **Prevents Alteration:** By using specific colored "ticks" and marks, it prevents the client's staff from changing figures after they have been audited.
3. **Detects Clerical Errors:** It is highly effective in finding simple mistakes like "errors of commission" (wrong amounts) or "errors of posting."
4. **Foundation for Final Audit:** Since it confirms the accuracy of the Trial Balance, it makes the preparation of final accounts (Profit & Loss and Balance Sheet) much easier.

2. **Vouching-Vouching** is often called the "**Backbone of Auditing.**" It moves beyond numbers to check the "evidence" behind every entry.

### Meaning & Definition

- **Meaning:** Vouching is the act of examining documentary evidence (vouchers like invoices, receipts, and contracts) to verify that a transaction is genuine, authorized, and properly recorded.
- **Definition (Dicksee):** "Vouching consists of comparing entries in books of account with documentary evidence in support thereof."

### Importance of Vouching

1. **Ensures Authenticity:** It proves that a transaction actually took place and is not a fictitious entry made to inflate profits.
2. **Verification of Authority:** It confirms that the transaction was approved by a person with the proper authority (e.g., a manager signing an expensive purchase order).
3. **Proper Classification:** It ensures that "Capital" expenses (like buying a machine) are not wrongly recorded as "Revenue" expenses (like repairs).

4. **Legal Protection:** A thorough vouching process protects the auditor from charges of negligence, as it demonstrates that they exercised "reasonable care" in checking the books.

### 3. Comparison: Routine Checking vs. Vouching

Basis	Routine Checking	Vouching
<b>Nature</b>	Mechanical and simple checking.	Analytical and intelligent examination.
<b>Objective</b>	To check mathematical accuracy.	To check validity and authenticity.
<b>Scope</b>	Limited to totals and postings.	Wide; covers every aspect of a transaction.
<b>Staff</b>	Usually done by junior clerks.	Requires senior or experienced audit staff.
<b>Detection</b>	Finds simple clerical errors.	Finds complex frauds and principle errors.

### Summary Checklist for Vouching

When an auditor "vouches" an entry, they check:

- Is the voucher addressed to the client's business?
- Does the date fall within the audit period?
- Is the amount in words and figures consistent?
- Is the voucher signed by an authorized official?
- Is the entry posted to the correct ledger account?

### Voucher & Types of Vouchers

In auditing, a **Voucher** is any documentary evidence that supports an entry in the books of accounts. It is the primary "proof" an auditor uses during the vouching process to verify that a transaction is legitimate.

**Meaning of a Voucher-**A voucher is a written document that confirms a financial transaction has occurred. It contains details such as the date, amount, description of the transaction, and the signatures of the persons authorizing and receiving the payment.

**2. Types of Vouchers-**Vouchers are generally classified into two main categories: **Primary Vouchers** and **Secondary Vouchers**, as well as by their functional use in accounting (Internal vs. External).

**A. Classification by Nature of Evidence**

- 1. Primary Voucher:** The original written evidence produced at the time of the transaction.
  - *Examples:* A purchase invoice, a cash memo for a sale, or a rent receipt.
- 2. Secondary (Collateral) Voucher:** When the original (primary) voucher is missing or not available, the auditor relies on copies or related evidence.
  - *Examples:* A carbon copy of a lost receipt, a bank passbook showing a payment, or a letter confirming a transaction.

**B. Classification by Source (Internal vs. External)**

- 1. Internal Vouchers:** Created within the organization.
  - *Examples:* Sales invoices, payroll sheets, material requisition slips, and petty cash vouchers.
- 2. External Vouchers:** Created by outside parties and sent to the business. These are generally considered more "reliable" by auditors because they are harder to fake.
  - *Examples:* Purchase invoices from suppliers, bank statements, and utility bills (electricity/water).

**3. Specific Functional Vouchers-**In modern accounting systems, vouchers are often categorized by the type of transaction they record:

Type	Used For
<b>Cash Voucher</b>	Recording all cash receipts and payments.
<b>Bank Voucher</b>	Recording transactions made via cheque, NEFT, or bank transfer.

Type	Used For
<b>Purchase Voucher</b>	Recording the credit purchase of goods or assets.
<b>Sales Voucher</b>	Recording the credit sale of goods.
<b>Journal Voucher</b>	Non-cash transactions like depreciation, credit purchase of fixed assets, or adjusting entries.

#### 4. Essentials of a Valid Voucher

When an auditor examines a voucher, they look for specific "hallmarks" of validity:

- **Name of the Party:** It must be addressed to the client's company.
- **Date:** The date must fall within the financial year being audited.
- **Amount:** The amount in words and figures must match.
- **Description:** It must clearly state the nature of the transaction (e.g., "Purchase of Office Stationery").
- **Authority:** It must bear the signature of the manager or official who authorized the expense.
- **Revenue Stamp:** If the payment exceeds a specific legal limit (e.g., ₹5,000 in India), it must have a revenue stamp.
- **Account Coding:** It should indicate which ledger account (e.g., "Repairs Account") the transaction belongs to.

#### Summary Table: Which Voucher for Which Transaction?

Transaction	Primary Voucher
<b>Cash Sales</b>	Carbon copy of Cash Memo.
<b>Purchase of Machinery</b>	Supplier's Invoice and Installation Bill.
<b>Payment of Wages</b>	Wages Sheet signed by workers.
<b>Bank Charges</b>	Bank Statement or Debit Advice.
<b>Insurance Premium</b>	Insurance Policy and Renewal Receipt.

## **Vouching of Receipts: Cash Sales, Receipts from debtors, Proceeds of the sale of Investments.**

Vouching is the "soul of auditing." It involves examining documentary evidence to support the genuineness of transactions recorded in the books of account. When vouching receipts, an auditor ensures that all cash received has been recorded and that no unauthorized entries exist. Here is a breakdown of how to vouch for these specific types of receipts:

### **1. Cash Sales**

The primary risk with cash sales is the omission of transactions (revenue leakage).

- **Internal Control Review:** Evaluate the system for issuing cash memos. Are they pre-numbered? Is there a separation of duties between the person selling the goods and the person receiving the cash?
- **Vouching Cash Memos:** Compare the carbon copies of cash memos with the **Cash Sales Register**.
- **Daily Summaries:** Verify the daily totals of cash memos against the entries in the **Cash Book**.
- **Inventory Reconciliation:** Cross-check the quantities sold according to cash memos with the **Stock Register** (outward movements).
- **Bank Deposits:** Ensure that the total cash collected was deposited into the bank intact, usually on the next working day, by checking the **Bank Pay-in Slips**.

### **2. Receipts from Debtors**

The main objective here is to ensure that payments received aren't misappropriated (e.g., "teeming and lading," where a later receipt is used to cover an earlier theft).

- **Official Receipts:** Examine the counterfoils of receipts issued to customers. Ensure they are dated and sequentially numbered.
- **Remittance Advice:** Check correspondence or "remittance advice" sent by debtors to confirm the amount and any discounts taken.
- **Ledger Reconciliation:** Trace the entries from the Cash Book to the **Debtors' Personal Ledgers**.
- **Discounts and Bad Debts:** Pay special attention to "Cash Discounts" allowed. Ensure they follow company policy and aren't being used to hide a shortfall in cash.
- **Direct Confirmation:** If necessary, the auditor may send balance confirmation letters directly to the debtors to verify the outstanding amounts.

### 3. Proceeds from the Sale of Investments

Investments are high-value items, so the auditor must verify both the authorization and the accuracy of the transaction.

- **Authorization:** Check the **Board Minutes Book** or relevant committee resolutions to ensure the sale was authorized by the proper management.
- **Broker's Sold Note:** Examine the **Broker's Sold Note** or "Contract Note." This document shows the gross sale price, the rate of brokerage/commission, and the net proceeds received.
- **Ex-dividend vs. Cum-dividend:** Verify whether the sale was "Cum-dividend" (including the right to the next dividend) or "Ex-dividend" to ensure the interest/dividend portion is accounted for correctly.
- **Investment Register:** Ensure the sale is recorded in the **Investment Register** and that the cost of the investment sold is removed from the books.
- **Profit or Loss Calculation:** Verify the calculation of the profit or loss on the sale by comparing the net proceeds with the carrying value of the investment.
- **Bank Statement:** Trace the final amount received into the **Bank Statement** or Passbook.

#### Summary Table for Quick Reference

Receipt Type	Key Document to Vouch	Critical Check Point
<b>Cash Sales</b>	Cash Memo Counterfoils	Reconciliation with Stock Register
<b>Debtors</b>	Receipt Counterfoils	Proper recording of Cash Discounts
<b>Investments</b>	Broker's Sold Note	Board Authorization & Brokerage fees

#### Vouching of Payments: Cash Purchases, Payment to Creditors, Deferred Revenue Expenditure

Vouching payments is a critical part of an audit because the "Credit" side of the Cash Book records resource outflows. The auditor's primary goal is to ensure that payments are **genuine, authorized,** and related to the **business period** under audit.

## 1. Cash Purchases

Since cash purchases bypass the "Accounts Payable" ledger, they are a high-risk area for fraud (e.g., fictitious purchases).

- **Cash Memos:** The primary document is the **supplier's cash memo**. Verify the date, name of the seller, description of goods, and the amount.
- **Goods Inward Book:** Cross-check the purchase with the **Goods Inward Register** or Gate Entry records to ensure the goods actually entered the premises.
- **Net Amount:** Ensure only the net amount (after trade discount) is recorded.
- **Authorization:** Verify that the purchase was authorized by a responsible official (e.g., Purchase Manager).
- **Requisition Slips:** Check the internal **Purchase Requisition** to see if there was a genuine need for the goods.

## 2. Payment to Creditors

This involves payments for goods or services previously bought on credit. The auditor must prevent "Double Payment" or payment to "Ghost Creditors."

- **Creditor's Receipt:** Examine the official receipt issued by the creditor. It should be signed and, in many jurisdictions, bear a revenue stamp if the amount exceeds a certain limit.
- **Statement of Account:** Compare the payment with the **Monthly Statement of Account** sent by the creditor to ensure the balance matches.
- **Invoices and GRNs:** Match the payment to specific **Purchase Invoices** and **Goods Received Notes (GRN)** to ensure payment is only for goods actually received.
- **Discount Received:** If a "Cash Discount" was taken for early payment, verify that the gross amount was debited to the creditor and the discount was credited to the **Discount Received Account**.
- **Full & Final Settlement:** If the payment is a "Full and Final Settlement," check if any remaining small balances in the creditor's ledger were properly written off as discount or income.

## 3. Deferred Revenue Expenditure

This is a heavy expenditure of a revenue nature (like a massive advertising campaign for a new product) whose benefits will be felt over several years.

- **Total Expenditure:** Vouch the total initial cost using bills, contracts, and receipts. For example, if it's a massive advertisement, check the **contract with the ad agency**.

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- **Nature of Expense:** Ensure the expense is truly revenue in nature but provides long-term benefits. If it creates a tangible asset, it should be capitalized, not deferred.
- **Authorization:** Check the **Board Resolution** or minutes of the meeting where the decision to defer the expenditure was made.
- **Allocation/Amortization:** Verify the logic for spreading the cost. If the benefit is expected to last 5 years, then should be charged to the P&L account this year, and should be shown as an asset in the Balance Sheet.
- **Reasonableness:** The auditor must judge if the "benefit period" is realistic and not just a way to artificially inflate current profits by hiding expenses.

### Summary Table for Payments

Payment Type	Key Document	Verification Focus
<b>Cash Purchases</b>	Cash Memos	Physical receipt of goods (Goods Inward)
<b>Creditors</b>	Creditor's Receipt	Statement of Account reconciliation
<b>Deferred Exp.</b>	Contracts & Board Minutes	Proper period of write-off (Amortization)

### Meaning and Objectives of verification and valuation

While vouching confirms that a transaction occurred, **Verification** and **Valuation** focus on whether the items listed in the Balance Sheet actually exist and are reported at the correct amount.

**1. Verification-**Verification is the process by which an auditor satisfies themselves about the accuracy of the assets and liabilities appearing in the Balance Sheet. It goes beyond checking paper entries to confirm the item's physical and legal reality.

As defined by **Spicer and Pegler**: "Verification of assets implies an inquiry into the value, ownership and title, existence and possession, and the presence of any charge on the assets."

### Objectives of Verification

- **Existence:** To confirm that the asset actually exists on the date of the Balance Sheet (e.g., physically counting cash or inspecting machinery).
- **Ownership and Title:** To ensure the asset is legally owned by the business (e.g., checking title deeds for land).

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- **Possession:** To verify that the asset is in the possession of the business or held by an authorized third party on its behalf.
- **Freedom from Charges:** To check if the asset is "free" or if it has been pledged as collateral for a loan (mortgage/lien).
- **Proper Recording:** To ensure that no assets or liabilities have been omitted from the books.

**2. Valuation-Meaning:** Valuation is the process of determining the proper monetary value at which an asset or liability should be recorded in the financial statements. While management is responsible for the initial valuation, the auditor must verify its accuracy based on **Generally Accepted Accounting Principles (GAAP)**.

### Objectives of Valuation

- **True and Fair View:** To ensure the Balance Sheet reflects the actual financial health of the company.
- **Accuracy of Profit/Loss:** Since items like depreciation and closing stock directly affect the Profit & Loss account, correct valuation is essential to calculate the year's actual profit.
- **Adherence to Principles:** To ensure that different assets are valued according to standard methods (e.g., Fixed assets at Cost less Depreciation; Stock at Cost or Net Realizable Value, whichever is lower).
- **Consistency:** To verify that the same valuation methods are used year after year to allow for comparison.

### Key Differences: Verification vs. Valuation

Feature	Verification	Valuation
<b>Nature</b>	A broad process including existence, title, and value.	Specifically focuses on the monetary value of an item.
<b>Evidence</b>	Physical inspection and legal documents.	Invoices, market price, and depreciation schedules.
<b>Personnel</b>	Performed by the <b>Auditor</b> .	Initially performed by <b>Management</b> ; audited by the Auditor.

Feature	Verification	Valuation
<b>Timing</b>	Done at the end of the financial year.	An ongoing process throughout the year (e.g., recording depreciation).

### Why are they interdependent?

An auditor cannot truly "verify" an asset without "valuing" it. For example, if an auditor verifies that a car exists but it is recorded at \$100,000 when its market value is only \$10,000, the verification is incomplete. Conversely, a value is meaningless if the asset doesn't physically exist.

**Position of an Auditor as regards the Valuation of Assets, Verification and Valuation of different Items: Assets: Land & Building, Plant & Machinery, Goodwill, Investments, Stock in Trade. Liabilities: Bills Payable, Sundry Creditors, Contingent Liabilities.**

In auditing, the legal position of an auditor regarding valuation is often summarized by the famous phrase from the **Kingston Cotton Mills Co. case (1896)**: "*An auditor is a watchdog, but not a bloodhound.*" This means the auditor is not a technical expert in valuation (like an engineer or an appraiser) but must exercise "reasonable care and skill" to ensure that the values provided by management are consistent with accounting principles and appear logically sound.

**1. Position of the Auditor**-The legal duties of an auditor regarding valuation were established through several landmark cases:

- **London and General Bank Case (1895)**: It was held that an auditor is not an insurer. He does not guarantee that the Balance Sheet is accurate; he only certifies that it gives a "true and fair view" based on the information given to him.
- **Kingston Cotton Mills Case (1896)**: This case established that an auditor is entitled to rely on certificates from trusted responsible officers of the company (like a manager's certificate for stock) unless there is cause for suspicion.
- **Current Standard**: Today, while auditors still rely on experts, they must perform "test checks" and verify the **process** of valuation. They cannot blindly accept management's figures.

### 2. Verification and Valuation of Assets

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## Land and Building

- **Verification:** Examine the **Title Deeds** to ensure the property is in the client's name. For mortgaged property, obtain a certificate from the mortgagee (the bank).
- **Valuation:** \* **Freehold Land:** Valued at cost (purchase price + legal charges + registration). Land is generally not depreciated.
  - **Building:** Valued at cost less depreciation.

## Plant and Machinery

- **Verification:** Inspect the **Plant Register** and physically verify a sample of machines. Check the purchase invoices and "Goods Inward Book."
- **Valuation:** Recorded at cost (including installation and freight) less cumulative depreciation. The auditor must ensure the depreciation rate is adequate.

## Goodwill

- **Verification:** Examine the **Purchase Agreement**. Goodwill should only appear in the books if it was purchased (acquired through a business merger/buyout). Internally generated goodwill is not recorded.
- **Valuation:** Recorded at cost. It is a common practice to write it off over its useful life, but it is not legally mandatory unless it has lost its value.

## Investments

- **Verification:** Physically inspect the **Share Certificates** or "Demat Statements." If held by a bank, obtain a confirmation letter.
- **Valuation:** \* **Current Investments:** Lower of cost or fair market value.
  - **Long-term Investments:** At cost (unless there is a permanent decline in value).

## Stock-in-Trade (Inventory)

- **Verification:** Since the auditor isn't a "stock-taker," they attend the physical count as an observer. They check **Stock Sheets** and "Inventory Logs."
- **Valuation:** Valued at **Cost or Net Realizable Value (NRV), whichever is lower**. This is a fundamental application of the Principle of Prudence.

## 3. Verification and Valuation of Liabilities

## Bills Payable

- **Verification:** Compare the list of unpaid bills with the **Bills Payable Book**. Check the "Bills Paid" after the balance sheet date in the Cash Book to see if they were outstanding on the closing date.
- **Valuation:** Shown at the face value of the bills expected to be honored.

## Sundry Creditors

- **Verification:** Obtain a **Schedule of Creditors** and compare it with the Purchase Ledger. The auditor may send "Confirmation of Balance" requests directly to major creditors.
- **Valuation:** Valued at the actual amount owed after adjusting for any "Discounts Receivable" or returns.

## Contingent Liabilities

These are "potential" liabilities that depend on a future event (e.g., a pending lawsuit).

- **Verification:** Review minutes of board meetings, legal correspondence with the company's lawyers, and "Bank Guarantees."
- **Valuation:** They are not usually given a "value" in the main Balance Sheet columns. Instead, they must be clearly disclosed in the **Notes to Accounts**.

## Comparison of Audit Focus

Item	Primary Evidence	Valuation Basis
<b>Fixed Assets</b>	Title Deeds / Invoices	Cost - Depreciation
<b>Current Assets</b>	Physical Count / Bank Stmt	Cost or Market (Lower)
<b>Liabilities</b>	Confirmation Letters	Actual Amount Due

### Unit III: Audit of Limited Companies and Audit Report

Company Auditor –Appointment –Qualification -Powers -Duties and Liabilities –Professional Ethics of an Auditor, Audit of Educational Institutions –Audit of Insurance Companies-Audit of Co-operative societies.

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**Audit Report and Special Audit** Contents and types of audit report, Qualified and Unqualified report; National Financial Reporting Authority. Special Audit: Banking and Insurance company; Forensic Audit.

### Audit of Limited Companies and Audit Report

The audit of a limited company is a statutory requirement designed to protect the interests of shareholders and stakeholders. Since the owners (shareholders) are usually separate from the managers (directors), the auditor acts as an independent intermediary to verify the company's financial health.

**1. Audit of Limited Companies**-In most jurisdictions (such as under the **Companies Act, 2013** in India), every company—whether private or public—must have its accounts audited annually, regardless of its turnover or profit.

#### Key Aspects of Company Audit:

- **Appointment of Auditor:**
  - **First Auditor:** Usually appointed by the Board of Directors within 30 days of registration.
  - **Subsequent Auditors:** Appointed by shareholders at the Annual General Meeting (AGM) for a term of 5 years (subject to certain conditions).
- **Qualifications (Section 141):** Only a practicing **Chartered Accountant (CA)** or a firm of CAs can be appointed.
- **Disqualifications:** An officer/employee of the company, a person indebted to the company, or someone holding securities in the company is disqualified to ensure independence.

#### The Audit Process:

1. **Examination of Minute Books:** Reviewing decisions made in Board and Shareholder meetings.
2. **Verification of Share Capital:** Ensuring shares were issued according to legal provisions and recorded correctly.
3. **Review of Internal Controls:** Testing the company's "Internal Financial Controls" (IFC) to see if they prevent fraud or errors.
4. **Statutory Compliance:** Ensuring the company follows specific schedules (like Schedule III for Balance Sheets) and tax laws.

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**2. The Audit Report-**The **Audit Report** is the final product of the audit. It is a formal document where the auditor expresses their opinion on whether the financial statements present a "**True and Fair View**" of the company's affairs.

**Contents of an Audit Report:**

- **Title:** "Independent Auditor's Report."
- **Addressee:** Usually addressed to the **Members** (Shareholders) of the company.
- **Opinion Paragraph:** The most critical part, stating the auditor's conclusion.
- **Basis for Opinion:** Explaining that the audit was conducted according to Auditing Standards.
- **Management's Responsibility:** Clarifying that the Directors are responsible for preparing the accounts.
- **Auditor's Responsibility:** Clarifying that the auditor's job is to provide reasonable assurance, not a guarantee.

**3. Types of Audit Opinions-**Based on their findings, an auditor will issue one of the following four types of opinions:

Type of Report	Meaning	When it is issued
<b>Unqualified (Clean)</b>	Everything is fine.	The financials are accurate, follow GAAP, and show a true and fair view.
<b>Qualified</b>	"Except for..."	The financials are mostly okay, but there is a specific, non-pervasive disagreement or lack of evidence.
<b>Adverse</b>	"Does not give a true view."	There are material and pervasive misstatements; the accounts are misleading.
<b>Disclaimer</b>	"No opinion expressed."	The auditor cannot form an opinion because the company didn't provide enough evidence or restricted their work.

**4. Special Reports (CARO)**-In many regions, auditors must also provide a **CARO (Companies Auditor's Report Order)** report. This is a specific checklist where the auditor comments on matters like:

- Proper maintenance of fixed asset records.
- Physical verification of inventory.
- Regularity in depositing statutory dues (like PF or GST).
- Details of any fraud noticed during the year.

### **Company Auditor Meaning and Appointment and Qualification of auditor-**

A company auditor is a professional appointed to conduct an independent examination of a company's financial records. Their primary role is to provide an objective opinion on whether the financial statements—such as the Balance Sheet and Profit & Loss Account—present a "**true and fair view**" of the company's financial position.

**1. Meaning of a Company Auditor**-An auditor acts as a "watchdog" for the shareholders. Since shareholders provide the capital but do not manage the daily operations (which is done by Directors), the auditor ensures that the managers are reporting the financial truth.

#### **Key Roles:**

- Verifying the accuracy of books of accounts.
- Checking compliance with accounting standards and legal regulations.
- Reporting any fraud or financial irregularities.
- Expressing an independent opinion in the **Audit Report**.

**2. Appointment of an Auditor**-The procedure for appointment depends on whether the auditor is being appointed for the first time or as a subsequent auditor, and whether the company is a government or non-government entity.

#### **A. Non-Government Companies**

Type of Auditor	Appointed By	Time Limit	Tenure
<b>First Auditor</b>	Board of Directors	Within <b>30 days</b> of registration	Until the conclusion of the 1st AGM

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Type of Auditor	Appointed By	Time Limit	Tenure
<b>First Auditor (if Board fails)</b>	Shareholders (EGM)	Within <b>90 days</b>	Until the conclusion of the 1st AGM
<b>Subsequent Auditor</b>	Shareholders (AGM)	At the 1st AGM	5 years (until the 6th AGM)

## B. Government Companies

Type of Auditor	Appointed By	Time Limit
<b>First Auditor</b>	C&AG (Comptroller & Auditor General)	Within <b>60 days</b> of registration
<b>Subsequent Auditor</b>	C&AG	Within <b>180 days</b> from the start of the FY

## 3. Qualifications of an Auditor (Section 141)

To be eligible for appointment, a person must meet specific professional and legal criteria:

- **Individual:** Must be a **Chartered Accountant (CA)** holding a valid Certificate of Practice (COP).
- **Firm/LLP:** A firm can be appointed if the majority of partners practicing in India are Chartered Accountants. In the case of an LLP, only partners who are CAs are authorized to sign on behalf of the firm.

## 4. Disqualifications (Who CANNOT be an Auditor)

The law lists several disqualifications to ensure the auditor remains **independent**:

1. **Body Corporate:** Any company (except an LLP) is disqualified.
2. **Internal Ties:** An officer or employee of the company cannot be its auditor.

3. **Related Parties:** A person who is a partner or employee of an officer/employee of the company.
4. **Indebtedness:** A person (or their relative/partner) who owes more than **₹5 Lakhs** to the company or its subsidiary.
5. **Shareholding:** A person (or partner) holding any security in the company. *Note: A relative can hold shares with a face value of up to ₹1 Lakh.*
6. **Business Relationship:** Anyone having a commercial/business relationship with the company (except professional services).
7. **Conviction:** Anyone convicted by a court for an offense involving **fraud**, if 10 years have not yet passed.

### Summary Checklist for Auditor Appointment

- [ ] Verify the candidate is a practicing CA.
- [ ] Obtain a **Written Consent** and **Eligibility Certificate** from the auditor.
- [ ] Pass a Board or Shareholder Resolution.
- [ ] File **Form ADT-1** with the Registrar of Companies (ROC) within 15 days of appointment.

### Powers Duties and Liabilities of an auditor

In a company audit, the auditor is granted specific legal rights (powers) to perform their job effectively, but these rights come with heavy responsibilities (duties) and potential legal consequences (liabilities) if they fail to act with due care.

Under the **Companies Act, 2013**, these are categorized as follows:

#### 1. Powers (Rights) of an Auditor

To ensure the auditor is not obstructed by management, the law provides them with several statutory rights:

- **Right of Access (Sec 143):** Right to access the books of account, vouchers, and documents of the company at all times, whether kept at the registered office or elsewhere.
- **Right to Information:** Right to require from the officers of the company any information or explanations necessary for the performance of their duties.
- **Right to Attend General Meetings (Sec 146):** Right to receive all notices of any general meeting (AGM/EGM) and to be heard on any part of the business that concerns them as an auditor.

- **Right to Visit Branches:** Right to visit branch offices and access their records, unless the branch is audited by another qualified auditor.
- **Right to Sign the Audit Report (Sec 145):** Only the person appointed as the auditor (or a partner in the firm) has the right to sign the audit report or any other company document.
- **Right to Lien (Common Law):** In some jurisdictions, auditors may have a right to retain the client's books and documents if their audit fees have not been paid (though this is restricted in many modern legal frameworks).

**2. Duties of an Auditor-**The auditor's duties are primarily toward the shareholders (members) of the company.

- **Duty to Report (Sec 143):** To make a report to the members on the accounts and financial statements examined. The report must state whether the accounts give a "true and fair view."
- **Duty of Inquiry:** The auditor must specifically inquire into matters like:
  - Whether loans and advances are properly secured.
  - Whether personal expenses have been charged to the revenue account.
  - Whether loans shown as deposits are genuine.
- **Duty to Comply with Auditing Standards (Sec 143(9)):** Every auditor must follow the Standards on Auditing (SAs) issued by the regulatory body (like ICAI).
- **Duty to Report Fraud (Sec 143(12)):** If the auditor has reason to believe an offense involving fraud (above a certain threshold) is being committed, they must report it to the **Central Government** within a specified time.
- **Duty to Assist in Investigations:** If the company is under investigation by the government, the auditor must provide all assistance and information required by the investigating officers.

**3. Liabilities of an Auditor-**If an auditor is negligent or fraudulent, they can be held legally accountable under civil and criminal law.

### Civil Liability

- **Liability for Negligence:** If the auditor fails to exercise "reasonable care and skill" and the company suffers a financial loss as a result, the company can sue the auditor for damages.
- **Liability for Misfeasance:** This occurs if the auditor breaches their duty or trust, resulting in a loss of company assets (usually applicable during company liquidation).

## Criminal Liability

- **Falsification of Reports:** Under Section 147, if an auditor willfully makes a false statement in the audit report with the intent to deceive, they can face **imprisonment** and heavy fines.
- **Abetment of Fraud:** If an auditor actively colludes with the management to hide fraud, they are liable under the criminal sections of the Companies Act and the Penal Code.

## Professional Liability

- **Disciplinary Action:** The professional body (e.g., ICAI) can cancel the auditor's **Certificate of Practice** or remove their name from the Register of Members for "Professional Misconduct."

## Quick Comparison: Power vs. Duty

Power (Right)	Corresponding Duty
Access to Books	Duty to examine books with professional skepticism.
Ask for information	Duty to report if information was not provided.
Attend AGM	Duty to answer relevant shareholder queries.
Report to Members	Duty to be honest and independent in that report.

**Professional Ethics of an Auditor**-Professional ethics are the moral principles and standards of conduct that guide auditors in performing their duties. Since the public and shareholders rely on the auditor's report to make financial decisions, the profession must maintain the highest level of **trust, credibility, and independence**. The **International Ethics Standards Board for Accountants (IESBA)** and national bodies like the **ICAI** prescribe five fundamental principles of ethics.

### 1. Fundamental Principles of Ethics

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**Integrity**-An auditor must be straightforward and honest in all professional and business relationships. Integrity implies fair dealing and truthfulness. An auditor should not be associated with reports or information that they believe contains materially false or misleading statements.

**Objectivity**-Auditors must not allow bias, conflict of interest, or undue influence of others to override their professional judgment. They must remain impartial when evaluating evidence and forming an opinion.

### **Professional Competence and Due Care**

An auditor has a duty to maintain professional knowledge and skill at the level required to ensure that a client receives competent service.

- **Competence:** Attaining and maintaining necessary skills.
- **Due Care:** Acting diligently and in accordance with applicable technical and professional standards.

**Confidentiality**-Auditors are privy to sensitive business secrets. They must respect the confidentiality of information acquired during the audit and should not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose.

**Professional Behavior**-An auditor must comply with relevant laws and regulations and avoid any conduct that might discredit the profession. This includes being honest in marketing and not making exaggerated claims about the services they can offer.

## **2. Independence: The Cornerstone of Auditing**

Independence is the most critical ethical requirement. It means the auditor must be independent of the entity being audited so that their opinion is not influenced by any relationship.

- **Independence of Mind:** The state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment.
- **Independence in Appearance:** The avoidance of facts and circumstances that are so significant that a reasonable third party would conclude an auditor's integrity or objectivity has been compromised.

**3. Threats to Professional Ethics**-Auditors often face "threats" that could compromise these principles. Ethical frameworks categorize them as follows:

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Threat Type	Meaning	Example
<b>Self-Interest</b>	A financial or other interest will inappropriately influence judgment.	Owning shares in the client's company.
<b>Self-Review</b>	The auditor is forced to evaluate their own previous work.	Auditing financial statements that the auditor's firm prepared.
<b>Advocacy</b>	Promoting a client's position to the point that objectivity is compromised.	Promoting the sale of a client's shares or representing them in a legal dispute.
<b>Familiarity</b>	Being too sympathetic to the client's interests due to a close relationship.	Having a close relative as a Director in the client's company.
<b>Intimidation</b>	Being deterred from acting objectively by threats (actual or perceived).	Threat of replacement over a disagreement on accounting treatment.

#### 4. Safeguards

To counter these threats, the profession implements safeguards:

- **Educational requirements** and professional standards.
- **External reviews** (Peer Review) of the audit work.
- **Rotation of audit partners** to prevent familiarity.
- **Internal firm policies** that prohibit financial interests in clients.

**Audit of Educational Institutions: The audit of educational institutions (schools, colleges, universities) focuses on ensuring that funds—primarily collected from students and donors or granted by the government—are used** for their intended educational purposes. Since many institutions are run by trusts or societies, the auditor must verify that the institution is not only financially sound but also in compliance with its governing statutes (such as a Trust Deed or the State Education Code).

**1. Preliminary Steps-**Before beginning the actual audit, the auditor must:

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- **Examine the Constitution:** Study the **Trust Deed, Charter, or University Act** to understand the governing rules and financial powers.
- **Review Internal Controls:** Evaluate the system for collecting fees, managing grants, and authorizing expenses.
- **Check the Previous Year's Report:** Look for any "qualifications" (issues) raised by the previous auditor.

## 2. Audit of Income (Receipts)-The primary risk in educational institutions is the **under-reporting of fees** or misappropriation of cash.

- **Tuition Fees:** Compare the **Fee Register** with the student headcount from the attendance registers. Cross-check counterfoils of fee receipts with the Cash Book.
- **Fee Concessions:** Verify that any "free-ships" or discounts were authorized by a competent person (e.g., the Principal or Trustee).
- **Grants-in-Aid:** Check the **Grant Sanction Letter** from the Government or UGC. Ensure that "Recurring" grants (for salaries) and "Non-recurring" grants (for buildings/equipment) are credited to the correct accounts.
- **Donations:** Check the receipts for donations and ensure that "Specific Donations" (e.g., for a new library) are kept in a separate fund and not spent on general expenses.
- **Caution Money:** Ensure that deposits received from students are shown as a liability and that refunds are properly documented.

## 3. Audit of Expenditure (Payments)

- **Salaries:** Verify the **Salary Register** against employee contracts. Ensure proper deductions for Provident Fund (PF), Income Tax (TDS), and Professional Tax are made and deposited.
- **Scholarships:** Vouch the payments for scholarships against the list of eligible students and obtain their acknowledgments.
- **Establishment Expenses:** Vouch regular bills for electricity, water, stationery, and laboratory supplies. Ensure that major purchases were made after calling for competitive **quotations**.
- **Maintenance:** Check repairs and maintenance costs for buildings and equipment to ensure they are "revenue" expenses and not capital improvements.

## 4. Audit of Assets and Liabilities

- **Fixed Assets:** Physically verify furniture, lab equipment, and library books. Ensure the **Stock Register** is up-to-date and that depreciation is correctly calculated.

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- **Investments:** Verify the certificates for "Endowment Funds" or "Prize Funds." Ensure the interest earned is being added back to the specific fund if required by the donor.
- **Library Books:** This is a specialized area. The auditor should check the system for "stock-taking" of books and ensure that lost books are properly written off with authorization.

### 5. Summary Table: Key Focus Areas

Area	Key Document	Audit Objective
<b>Fees</b>	Student Fee Register	To ensure no "Ghost Students" or unrecorded fees.
<b>Grants</b>	Government Sanction Letter	To ensure compliance with grant conditions.
<b>Salaries</b>	Attendance & Salary Register	To verify genuine employees and statutory deductions.
<b>Endowments</b>	Specific Fund Investment Docs	To ensure funds aren't diverted to general use.

**6. Academic Audit vs. Financial Audit-**In modern practice, institutions also undergo an **Academic Audit**.

- **Financial Audit:** Focuses on the "True and Fair View" of the Balance Sheet.
- **Academic Audit:** Evaluates the quality of teaching, syllabus coverage, and student performance. While these audits are usually done by peers/professors, the financial auditor may review their results to assess the institution's overall health.

**Audit of Insurance Companies-**The audit of an insurance company is a specialized task because of the complex nature of its operations—collecting small premiums to cover large future risks. Auditors must follow specific statutes, such as the **Insurance Act** and regulations set by authorities like **IRDAI** (Insurance Regulatory and Development Authority). Unlike a trading

company, the main focus here is on the **Revenue Account** (which shows the profit or loss of a specific class of business) rather than a single Profit & Loss account.

**1. Audit of Premiums (Income)**-Premium income is the "lifeblood" of an insurance company. The risk is that premiums might be collected but not recorded, or recognized in the wrong period.

- **Verification of Premium Register:** Ensure that premiums are recorded as soon as they are received.
- **Section 64VB Compliance:** In many jurisdictions, insurance risk cannot be assumed unless the premium is received in advance. The auditor must check that policies were issued only after the premium was paid.
- **Unexpired Risk Reserve:** Since a policy might start in the middle of the year, the auditor ensures that a portion of the premium (for the period falling in the next financial year) is carried forward as a reserve.
- **Reinsurance Premium:** Verify the premium paid to "Re-insurers" (companies that insure the insurance company) and ensure it is deducted from the gross premium.

**2. Audit of Claims (Expenditure)**-Claims are the largest expense. The auditor must ensure that claims are genuine and that "provisions" are made for claims that have happened but haven't been paid yet.

- **Claim Register:** Vouch claims paid with the claim forms, discharge vouchers, and doctor/surveyor reports.
- **IBNR (Incurred But Not Reported):** This is a critical area. The auditor verifies the actuarial estimate for claims that have occurred by the balance sheet date but haven't been reported to the company yet.
- **Legal Disputes:** Review the list of "Claims Repudiated" (rejected) or under litigation to ensure adequate provisions for potential losses.

**3. Audit of Commission and Operating Expenses**

- **Agents' Commission:** Insurance companies pay commissions to agents. The auditor must verify that commissions do not exceed the statutory limits set by the regulator.
- **Vouching Commission:** Cross-check the commission paid with the **Premium Register** and the **Agency Agreement**.
- **Direct Expenses:** Ensure that expenses like medical fees for check-ups or surveyor fees are properly categorized.

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**4. Verification of Investments and Assets-**Insurance companies hold massive amounts of "Policyholders' Funds" in investments to pay future claims.

- **Statutory Deposits:** Verify that the company has maintained the mandatory deposit with the Central Bank or Regulator.
- **Investment Valuation:** Ensure investments are valued as per the regulator's norms (usually a mix of "Held to Maturity" at cost and "Available for Sale" at fair value).
- **Physical Verification:** Check the share certificates or Demat statements for all investments held.

**5. Summary Table: Life vs. General Insurance Audit**

Feature	Life Insurance Audit	General (Non-Life) Insurance Audit
<b>Primary Account</b>	Policyholders' Account (Technical Account)	Revenue Account (per class: Fire, Marine, etc.)
<b>Actuarial Valuation</b>	Central to the audit (valuation of liability).	Focus on "Unexpired Risk Reserve" (e.g., 50% or 100%).
<b>Key Risk</b>	Long-term solvency and bonus declarations.	Frequent claims and accurate estimation of "Outstanding Claims."

**6. The Auditor's Report-**In addition to the standard audit report, an insurance auditor must often certify:

- The correctness of the **Solvency Margin** (the "safety net" capital the company must keep).
- Compliance with **Anti-Money Laundering (AML)** guidelines.
- That no part of any specific fund (like the Life Fund) has been used for other purposes.

**Audit of Co-operative Societies-**The audit of a Co-operative Society is a **statutory audit** conducted under the Co-operative Societies Act of the respective state or the Multi-State Co-operative Societies Act. The primary objective is to protect the interests of the members (who are often individuals with limited means) and to ensure that the society is functioning according to the principles of "Self-help and Mutual Aid." Unlike a company audit, a Co-operative audit is

more comprehensive, often including aspects of a "Performance Audit" to ensure the welfare of its members.

### Co-operative Audit

- **Appointment:** The auditor is usually appointed by the **Registrar of Co-operative Societies** or from a panel of auditors approved by the Registrar.
- **Audit Classification:** One unique feature is that the auditor must award an "**Audit Class**" (**A, B, C, or D**) to the society based on its financial performance, management efficiency, and adherence to co-operative principles.
- **Scope:** It covers not just financial verification but also an inquiry into the "overdue" debts and the "valuation of assets and liabilities."

### 2. Specific Audit Procedures-Examination of Overdue Debts

In a co-operative society (especially credit societies), the recovery of loans is critical.

- The auditor must categorize debts into: **Good, Doubtful, and Bad.**
- Loans that have been outstanding for more than 6 months to 5 years are scrutinized.
- The auditor must check if adequate "Bad Debt Reserves" have been created.

### Adherence to Co-operative Principles

- **Democratic Control:** Check if the Managing Committee meetings and the Annual General Meeting (AGM) were held regularly.
- **Limited Interest on Capital:** Ensure that the interest paid on shares does not exceed the limit specified in the Act (usually 10%–12%).
- **Distribution of Surplus:** Verify that the "Patronage Dividend" (bonus) is distributed based on the volume of business a member did with the society, not just their shareholding.

### Verification of Cash and Investments

- **Physical Cash:** Since co-operative societies deal heavily in cash, the auditor must perform a **surprise physical verification** of the cash in hand.
- **Statutory Reserve Fund:** Societies are required to transfer a certain percentage (usually **25%**) of their net profit to a "Reserve Fund" before declaring any dividend. The auditor must verify this transfer.

### 3. Rights and Duties of the Auditor

- **Access to Books:** Similar to a company audit, the auditor has the right to access all books, accounts, and securities.
- **Power to Summon:** In many jurisdictions, a co-operative auditor has the power to summon any officer of the society to provide information under oath.
- **Reporting to the Registrar:** The auditor must submit the report to both the Society and the Registrar of Co-operative Societies.

### 4. Summary Table: Focus Areas

Area	Audit Checkpoint
<b>Membership</b>	Verify if all members have paid their entrance fees and share capital.
<b>Loans to Members</b>	Ensure loans are within the limits prescribed by the Bye-laws.
<b>Reserve Fund</b>	Verify the mandatory 25% transfer from net profit.
<b>Education Fund</b>	Check if contributions have been made to the Co-operative Education Fund.

**5. The Audit Report (Special Points)**-In addition to the financial opinion, the co-operative auditor must comment on:

1. Any transactions which appear to be **contrary to the Bye-laws**.
2. Any **sums which ought to have been**, but have not been, brought into account.
3. Any **material impropriety** or irregularity in the expenditure.
4. The **total amount of loans** outstanding against members of the Managing Committee.

**Audit Report and Special Audit Contents**-An **Audit Report** is the final stage of the audit process, representing the auditor's formal opinion on the financial statements. While a standard audit report follows a set format, a **Special Audit** (often conducted under government direction or in specific circumstances) is much more detailed and investigative.

**1. Contents of a Standard Audit Report-**According to modern auditing standards (like SA 700), a standard company audit report must include the following sections:

- **Title:** Clearly stating it is an "Independent Auditor's Report."
- **Addressee:** Usually the Shareholders/Members of the company.
- **Opinion Paragraph:** States whether the financial statements give a "**True and Fair View**" in accordance with the financial reporting framework.
- **Basis for Opinion:** Confirms the audit was conducted according to Standards on Auditing (SAs) and that the auditor is independent.
- **Key Audit Matters (KAM):** (For listed companies) Highlights the areas that required significant auditor attention during the audit.
- **Management's Responsibility:** Outlines the board's duty to prepare accounts and maintain internal controls.
- **Auditor's Responsibility:** Defines the scope and limitations of an audit.
- **Report on Other Legal Requirements:** In many countries, this includes comments on CARO (Companies Auditor's Report Order), internal financial controls, and statutory dues.
- **Signature & Date:** Signed by the auditor in their personal name and on behalf of the firm, including their membership number and UDIN.

**2. Special Audit: Meaning and Context-**A **Special Audit** is not a routine annual audit. It is usually ordered by a regulatory body (like the Central Government or a Court) when there are reasons to believe that:

1. The affairs of the company are not being managed according to sound business principles.
2. The company is being managed in a way likely to cause serious injury or damage to the interests of the trade, industry, or consumers.
3. The financial position of the company is such as to endanger its solvency.

**3. Contents of a Special Audit Report-**Unlike a standard report that focuses on a "True and Fair View," a Special Audit Report is **fact-finding** and **investigative**. Its contents typically include:

- **Scope of Investigation:** A clear definition of the specific areas the auditor was asked to investigate (e.g., a specific fraud or a period of heavy losses).
- **Detailed Findings on Mismanagement:** Observations regarding any "ultra-vires" acts (actions beyond legal power) or violations of the Articles of Association.

- **Analysis of Losses:** If the audit was triggered by financial distress, the report details exactly where and why the losses occurred.
- **Detection of Frauds/Irregularities:** Specific instances of embezzlement, window dressing of accounts, or misappropriation of assets.
- **Commentary on Internal Controls:** An evaluation of the failures in the system that allowed the irregularities to happen.
- **Recommendations:** Suggestions for remedial action to restore the company's health or to take legal action against guilty parties.
- **Attribution of Responsibility:** Identifying specific officers or directors responsible for the mismanagement.

#### 4. Summary: Audit Report vs. Special Audit

Feature	Standard Audit Report	Special Audit Report
<b>Objective</b>	Expression of Opinion (True & Fair).	Investigation of specific issues/mismanagement.
<b>Authority</b>	Appointed by Shareholders/Board.	Usually appointed by Government/Regulators.
<b>Period</b>	Usually covers one financial year.	May cover any period as directed.
<b>Recipient</b>	Shareholders of the company.	The Appointing Authority (e.g., Central Government).

**Types Of Audit Report-**In auditing, the final "opinion" expressed by an auditor is categorized based on two main factors: **Materiality** (how significant the error is) and **Pervasiveness** (how much of the financial statements are affected). There are four primary types of audit reports:

1. **Unqualified Opinion (Clean Report)-**This is the most common and desirable report. It indicates that the auditor is satisfied that the company's financial records are fair, accurate, and comply with accounting standards (GAAP/IFRS).

- **Meaning:** "Everything is correct in all material respects."
- **Impact:** Investors and lenders see this as a "green flag" for financial health.

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2. Qualified Opinion (Modified Report)-The auditor issues this when the financial statements are mostly accurate, **except for** a specific matter.

- **Meaning:** "The statements are fair, **except for** this one specific issue."
- **Reasons:** A minor deviation from accounting principles or a "scope limitation" where the auditor couldn't verify one specific area (e.g., inventory in a remote warehouse).
- **Impact:** It signals a minor "red flag" but doesn't necessarily mean the whole report is unreliable.

3. Adverse Opinion-This is the most serious negative report. It is issued when the auditor finds that the financial statements are **grossly misstated** and do not reflect the true financial position of the company.

- **Meaning:** "The financial statements are misleading and should not be relied upon."
- **Reasons:** Significant fraud, severe non-compliance with accounting laws, or massive errors that affect almost every part of the balance sheet.
- **Impact:** This can lead to legal action, a total loss of investor trust, and potential bankruptcy.

4. Disclaimer of Opinion-A disclaimer is not an "opinion" but a statement that the auditor **cannot form an opinion**.

- **Meaning:** "We cannot say if these records are right or wrong because we weren't allowed to do our job."
- **Reasons:** The company restricted access to records, destroyed evidence, or the auditor's independence was compromised.
- **Impact:** It creates an image of extreme secrecy or lack of transparency, which is highly alarming to regulators.

Summary Table: Materiality vs. Pervasiveness

Nature of Issue	Material but NOT Pervasive	Material AND Pervasive
<b>Financials are Misstated</b>	<b>Qualified Opinion</b>	<b>Adverse Opinion</b>

Nature of Issue	Material but NOT Pervasive	Material AND Pervasive
<b>Inability to get Evidence</b>	<b>Qualified Opinion</b>	<b>Disclaimer of Opinion</b>

### Other Specialized Reports

While the four above are the "big ones," you might also encounter:

- **Interim Audit Report:** Issued for a period shorter than a year (e.g., quarterly).
- **Partial Audit Report:** Focuses only on one specific part of the business (e.g., a "Cost Audit").
- **Tax Audit Report:** Specifically for tax compliance purposes.

**Qualified and Unqualified audit report-**In auditing, the distinction between a **Qualified** and an **Unqualified** report is a matter of the "cleanliness" of the financial statements.

#### 1. Unqualified Audit Report (Clean Report)

An unqualified report is the best possible outcome for a company. It indicates that the auditor is fully satisfied that the financial statements present a "**true and fair view**" of the company's financial position and results.

- **Meaning:** The auditor found no significant problems, and the company followed all accounting principles (GAAP/IFRS).
- **Wording:** The opinion paragraph will state: *"In our opinion, the financial statements present fairly, in all material respects, the financial position of..."*
- **Impact:** High investor confidence, easier access to loans, and a positive market reputation.

**Note on "Emphasis of Matter":** An auditor can still issue an Unqualified opinion while adding an "Emphasis of Matter" paragraph. This is used to draw attention to something already correctly disclosed, like a major pending lawsuit or a catastrophe, without making the report "negative."

2. Qualified Audit Report (Modified Report)-A qualified report is issued when the auditor finds something wrong that is **material but not pervasive**. This means the error or limitation is significant enough to notice, but it doesn't make the entire set of financial statements misleading.

- **Meaning:** "The accounts are true and fair, **EXCEPT FOR** [this specific issue]."
- **Key Reasons for Qualification:**
  - **Departure from GAAP:** The company used an incorrect accounting method for one specific item (e.g., wrong depreciation rate).
  - **Scope Limitation:** The auditor couldn't verify a specific part of the accounts (e.g., they couldn't attend the physical stock count at a remote branch).
  - **Inadequate Disclosure:** A specific footnote required by law was missing.
- **Wording:** Uses phrases like "*Subject to...*" or "*Except for the effects of the matter described in the Basis for Qualified Opinion section...*"

### 3. Key Differences at a Glance

Feature	Unqualified Report	Qualified Report
<b>Status</b>	Clean Bill of Health	Clean with Reservations
<b>Standard Language</b>	"True and Fair View"	"Except for..."
<b>Materiality</b>	No material misstatements found	One or more material misstatements
<b>Pervasiveness</b>	Not applicable	Not pervasive (issue is isolated)
<b>Management Duty</b>	General cooperation	Must explain qualifications to shareholders
<b>Investor View</b>	Trustworthy and reliable	Caution required regarding specific items

## Specimen of Opinion Paragraphs

**Unqualified Specimen:** *"In our opinion, the accompanying financial statements give a true and fair view of the financial position of ABC Ltd as at March 31, 2026..."*

**Qualified Specimen:** *"In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion section of our report, the accompanying financial statements give a true and fair view..."*

### Summary Checklist

- **Unqualified** = No material errors + Complete evidence.
- **Qualified** = A material error exists OR evidence is missing, but the rest of the report is fine.

## National Financial Reporting Authority

The **National Financial Reporting Authority (NFRA)** is India's independent regulator for the auditing profession and accounting standards. Established in October 2018 under **Section 132** of the Companies Act, 2013, it was created in response to major corporate scams to move away from the profession's "self-regulation" and toward independent oversight.

### 1. Why was NFRA established?

Before NFRA, the **ICAI (Institute of Chartered Accountants of India)** was the primary body for disciplining auditors. However, the need for an independent regulator was felt following high-profile frauds (like the Satyam and PNB scams), where the auditor's role came under heavy scrutiny. NFRA is modeled after similar global bodies, such as the **PCAOB** in the USA.

### 2. Composition of NFRA-The NFRA consists of:

- **A Chairperson:** Appointed by the Central Government (a person of high eminence and experience).
- **Members:** A maximum of **15 members** (including full-time and part-time members).

### 3. Powers and Functions-NFRA has broad and significant powers that supersede the disciplinary powers of the ICAI for large companies.

- **Accounting Standards:** It recommends accounting and auditing policies and standards to the Central Government for adoption.
- **Monitoring & Enforcement:** It monitors compliance with these standards and oversees the quality of service of the professionals.

- **Investigative Powers:** It has the power to investigate "Professional Misconduct" by Chartered Accountants.
- **Civil Court Powers:** NFRA has the same powers as a Civil Court while trying a suit. It can:
  - Summon and enforce the attendance of persons.
  - Inspect any books, registers, or documents.
  - Issue commissions for the examination of witnesses.

4. Jurisdiction (Who does it regulate?)-NFRA does not regulate every small company. Its focus is on **Public Interest Entities (PIEs)**, which include:

1. **Listed Companies** (on any stock exchange).
2. **Unlisted Public Companies** with:
  - Paid-up capital **₹500 crores**, OR
  - Annual turnover **₹1,000 crores**, OR
  - Outstanding loans/debentures **₹500 crores**.
3. **Insurance, Banking, and Power companies**.
4. **Subsidiaries or Associates** of the above companies if their income/net worth exceeds 20% of the consolidated total.

5. Penalties and Sanctions-If professional or other misconduct is proved, NFRA can impose severe penalties:

Type of Penalty	Limit for Individuals	Limit for Firms
<b>Monetary Fine</b>	Not less than <b>₹1 Lakh</b> (up to 5x fees received)	Not less than <b>₹5 Lakhs</b> (up to 10x fees received)
<b>Debarment</b>	Debarred from practice for <b>6 months to 10 years</b>	Debarred from practice for <b>6 months to 10 years</b>

6. NFRA vs. ICAI-While NFRA has taken over the oversight of large/listed companies, the **ICAI** remains the regulator for:

- The audit of private limited companies.
- Unlisted public companies below the NFRA thresholds.
- Conducting CA examinations and granting Certificates of Practice.

Summary Table: Key Facts

Feature	Detail
<b>Act</b>	Section 132 of Companies Act, 2013
<b>Status</b>	Statutory Independent Regulator
<b>Headquarters</b>	New Delhi
<b>Primary Goal</b>	Protect public interest and enhance audit quality

### **Special Audit: Banking and Insurance company**

In the world of auditing, a **Special Audit** (or Statutory Audit with specific regulatory requirements) for Banks and Insurance companies is highly specialized because these entities handle public money. These audits are governed by sector-specific regulators: the **RBI** (Reserve Bank of India) for banks and the **IRDAI** for insurance companies.

1. Special Audit of a Banking Company-The audit of a bank is often called a **Statutory Branch Audit** or **Central Statutory Audit**. The primary focus is on the "Quality of Assets" and "Liquidity."

A. Verification of Advances (Loans)-This is the most critical part of a bank audit. The auditor must check:

- **NPA Classification:** Ensure that loans are correctly classified as Standard, Sub-standard, Doubtful, or Loss assets based on the **90-day overdue rule**.
- **Provisioning:** Verify that the bank has set aside enough money (provisions) to cover potential losses from bad loans.

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- **Security:** Ensure that the loans are backed by adequate collateral (Land, Stock, Gold, etc.) and that the value of the security is not inflated.

#### B. Verification of Cash and Liquidity

- **Physical Cash:** Surprise physical verification of cash in the vault and ATM balances.
- **CRR and SLR:** Ensure the bank is maintaining the mandatory **Cash Reserve Ratio (CRR)** and **Statutory Liquidity Ratio (SLR)** as per RBI norms.

#### C. Revenue Recognition

- **Income Recognition:** Banks cannot record interest income on NPAs unless the cash is actually received (Cash Basis). The auditor must ensure interest is not being "accrued" on bad loans to inflate profits.

2. Special Audit of an Insurance Company-Insurance audits are unique because the liability (claims) is often uncertain and estimated by actuaries.

#### A. Audit of Premiums

- **Advance Premium:** Verify compliance with **Section 64VB** of the Insurance Act, which states that risk can only be covered after the premium is received.
- **Unearned Premium Reserve (UPR):** Ensure a portion of the premium is carried forward to the next year to cover the remaining risk period.

#### B. Audit of Claims

- **Outstanding Claims:** The auditor must verify the "Provision for Outstanding Claims." This includes **IBNR (Incurred But Not Reported)** claims—events that happened but haven't been filed yet.
- **Settlement:** Check the "Discharge Vouchers" and ensure claims are paid only to the rightful nominees or policyholders.

#### C. Verification of Investments

- **Statutory Deposits:** Verify the mandatory deposits held with the Central Bank.
- **Valuation:** Investments must be valued strictly according to IRDAI Investment Regulations (Cost vs. Market Value rules).

### 3. Comparison: Bank Audit vs. Insurance Audit

Feature	Banking Audit Focus	Insurance Audit Focus
<b>Primary Asset</b>	Loans and Advances	Investments and Re-insurance Assets
<b>Primary Liability</b>	Deposits from Public	Policyholders' Claims and Reserves
<b>Regulatory Body</b>	RBI (Reserve Bank of India)	IRDAI
<b>Key Risk</b>	Credit Risk (Bad Loans)	Underwriting Risk (Excessive Claims)
<b>Revenue Source</b>	Interest and Commission	Premium Income

### 4. The Long Form Audit Report (LFAR)

In addition to the standard audit report, auditors of banks and insurance companies must submit a **Long Form Audit Report (LFAR)**.

- It contains a questionnaire designed by the regulator (RBI/IRDAI).
- It requires the auditor to give detailed comments on internal controls, fraud, large-value advances, and any breach of regulatory limits.

**Forensic Audit-**A **Forensic Audit** is a specialized, deep-dive examination of a firm's financial records to derive evidence that can be used in a **court of law** or legal proceeding.

While a standard statutory audit looks for "material misstatements," a forensic audit looks for "**who, how, and how much**" regarding specific illegal activities like fraud, embezzlement, or money laundering. It combines accounting, auditing, and investigative skills.

#### 1. Objectives of a Forensic Audit

Unlike a regular audit which aims to provide a "true and fair view," a forensic audit is "investigative" and "adversarial" in nature. Its goals are:

- **Identification of Fraud:** To determine if a fraud has occurred.
- **Identification of Perpetrators:** To name the individuals involved in the scheme.

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- **Quantification of Loss:** To calculate the exact financial damage.
- **Evidence Gathering:** To collect admissible evidence for criminal or civil trials.
- **Asset Recovery:** To trace and recover misappropriated funds or property.

## 2. When is a Forensic Audit Conducted?

It is usually triggered by specific suspicions or events, such as:

- **Corruption:** Conflicts of interest, bribery, or extortion.
- **Asset Misappropriation:** Theft of cash, inventory fraud, or fake invoicing.
- **Financial Statement Fraud:** Intentionally manipulating records to show better performance ("Window Dressing").
- **Money Laundering:** Tracing the origin of "dirty money" through complex layers of transactions.

## 3. The Forensic Audit Process

The process is more rigorous than a standard audit and follows these steps:

1. **Planning the Investigation:** Defining the scope and the "theories" of how the fraud might have been committed.
2. **Evidence Collection:** Gathering documents, digital trails, and physical evidence. This must follow a "Chain of Custody" to prevent tampering.
3. **Interviews:** Questioning suspects and witnesses to gain insights or confessions.
4. **Data Analysis:** Using specialized software to find patterns (e.g., duplicate payments to the same address).
5. **Reporting:** Presenting findings in a format suitable for a judge or jury.
6. **Court Proceedings:** The forensic auditor may appear as an **Expert Witness** to explain the findings in court.

## 4. Statutory Audit vs. Forensic Audit

Feature	Statutory Audit	Forensic Audit
<b>Objective</b>	To express an opinion on financial statements.	To determine legal facts regarding a specific suspicion.

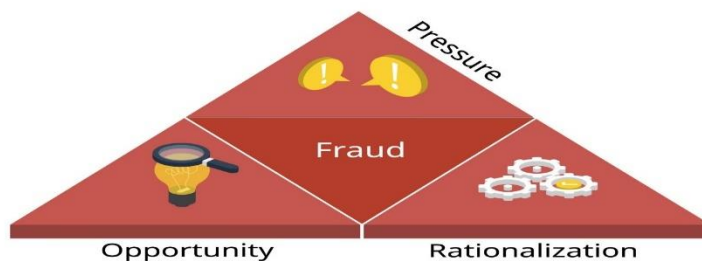
Feature	Statutory Audit	Forensic Audit
<b>Approach</b>	Professional Skepticism (Trust but verify).	Investigative Mindset (Assume fraud exists).
<b>Technique</b>	Sampling and Test Checking.	Substantive 100% examination of specific areas.
<b>Outcome</b>	Audit Report (Opinion).	Investigation Report (Evidence).
<b>Reliance</b>	Shareholders and Public.	Lawyers, Courts, and Law Enforcement.

## 5. The Fraud Triangle

Forensic auditors often use the "Fraud Triangle" to understand the motivation behind a crime. It suggests that three elements must be present for fraud to occur:

1. **Pressure (Motive):** Financial problems, addiction, or greed.
2. **Opportunity:** Weak internal controls or lack of oversight.
3. **Rationalization:** The perpetrator justifies the act (e.g., "I'm just borrowing the money" or "I am underpaid").

### The Fraud Triangle Theory



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## 6. Techniques Used in Forensic Auditing

- **Benford's Law:** A mathematical tool used to detect if a set of numbers (like expense reports) is natural or fabricated.
- **Digital Forensics:** Recovering deleted emails or tracking IP addresses of unauthorized transfers.
- **Net Worth Method:** Analyzing a suspect's lifestyle vs. their known income to find "unexplained wealth."

## Unit IV: Corporate Governance

Conceptual Framework of Corporate Governance, Corporate Governance Reforms. Major Corporate Scandals in India and Abroad: Common Governance Problems Noticed in Various Corporate Failures. Codes & Standards on Corporate Governance.

### Conceptual Framework of Corporate Governance

The conceptual framework of corporate governance serves as the "blueprint" for how an organization is directed and controlled. It is a multi-dimensional system that balances the interests of a company's many stakeholders while ensuring long-term sustainability and value creation.

The framework can be broken down into four core pillars: **Theories, Pillars of Practice, Key Participants, and Global Models.**

### 1. Theoretical Foundations

The framework is built on several competing and complementary theories that explain why governance is necessary:

- **Agency Theory:** The most dominant theory. It assumes a conflict of interest between **Principals** (shareholders) and **Agents** (managers). Governance mechanisms (such as audits and performance-linked pay) are needed to ensure that managers act in the best interests of owners.
- **Stewardship Theory:** A more optimistic view where managers are seen as "stewards" of the company's assets. It assumes managers are inherently motivated to do a good job and that their interests are naturally aligned with the firm's success.
- **Stakeholder Theory:** Argues that a corporation is responsible not just to shareholders, but to a wider group including employees, customers, suppliers, and the community.
- **Resource Dependence Theory:** Views the Board of Directors as a tool to gain access to resources (capital, information, networks) essential for the firm's survival.



2. The Five Pillars of Good Governance-According to the latest **G20/OECD Principles** (updated for 2025- 2026), a robust framework must uphold these values:

Pillar	Focus Area
<b>Accountability</b>	Ensuring the Board is answerable to shareholders and management is answerable to the Board.
<b>Transparency</b>	Timely and accurate disclosure of all material matters, including financial health and ESG (Environmental, Social, and Governance) performance.
<b>Fairness</b>	Protecting shareholder rights and ensuring equitable treatment for all shareholders, including minority shareholders.

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Pillar	Focus Area
<b>Responsibility</b>	The Board's duty is to oversee strategy, risk management, and legal compliance.
<b>Sustainability</b>	(Recent Addition) Focusing on long-term resilience and the company's impact on the environment and society.

3. Structural Components-The framework functions through a specific hierarchy of roles:

1. **Shareholders:** Provide capital and exercise oversight through voting and the Annual General Meeting (AGM).
2. **Board of Directors:** The central "engine" of governance. They set strategy, hire/fire the CEO, and ensure internal controls are met.
3. **Management (CEO & C-Suite):** Execute the strategy and manage day-to-day operations.
4. **Assurance Mechanisms:** Internal and external auditors who provide independent verification of financial and operational health.

4. Major Governance Models-Globally, the framework is applied differently based on the local legal and economic environment:

- **Anglo-American Model (Shareholder-centric):** Common in the US and UK. Focuses heavily on shareholder interests and independent directors.
- **Continental European/Japanese Model (Stakeholder-centric):** Often features "two-tier boards" (a supervisory board and a management board) and emphasizes bank and labor union involvement.
- **Family-Controlled Model:** Prevalent in Asia and Latin America, where a founding family maintains significant control through majority stakes.

**Note on 2026 Trends:** The conceptual framework has shifted significantly toward **Digital Governance**, emphasizing the role of AI in decision-making and the necessity of cybersecurity as a core fiduciary duty.

**Corporate Governance Reforms:** Corporate governance reforms are the continuous adjustments to the rules, practices, and processes by which companies are operated. While historically triggered by scandals (such as Enron and Wirecard), modern reforms are increasingly driven by technology (AI), climate urgency, and geopolitical volatility.

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As of 2026, the focus has shifted from simple "box-ticking" compliance to **strategic resilience** and **long-term sustainability**.

## 1. The Historical Evolution of Reforms

To understand current reforms, it helps to see the "waves" that shaped today's landscape:

<b>Era</b>	<b>Key Reform Trigger</b>	<b>Primary Resulting Regulation</b>
<b>Early 2000s</b>	Enron, WorldCom scandals	<b>Sarbanes-Oxley Act (US):</b> Mandated CEO/CFO certification of financial reports and strict internal controls.
<b>Post-2008</b>	Global Financial Crisis	<b>Dodd-Frank Act (US):</b> Focused on "Say-on-Pay," clawback provisions, and risk management in the financial sector.
<b>2020–2024</b>	COVID-19 & Climate Crisis	<b>CSRD (EU):</b> Moved ESG from "voluntary" to "mandatory" reporting with the same rigor as financial data.
<b>2025–2026</b>	Generative AI & Fraud	<b>AI Governance Acts:</b> Emerging mandates for boards to oversee algorithmic bias, data privacy, and AI ethics.

## 2. Key 2025–2026 Global Reform Trends

The current reform landscape is dominated by three "megatrends":

### A. AI Governance & Digital Oversight

Regulators no longer view AI as just an IT issue; it is now a **fiduciary duty**.

- **Mandatory AI Literacy:** Reforms in the UK and EU now suggest that boards must have at least one member with digital/tech competency.
- **Anti-"AI Washing":** Similar to "greenwashing," new SEC (US) and ESMA (EU) guidelines penalize companies for exaggerating their AI capabilities to investors.
- **Algorithmic Accountability:** Boards are being held responsible for "black box" decisions that result in discrimination or privacy violations.

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## B. The "Internal Controls" Revolution

Following the **UK Corporate Governance Code 2024** (fully effective for 2026 reporting), there is a massive shift toward **Provision 29**:

- **Board Declaration:** Boards must now provide an annual declaration on the **effectiveness of their material internal controls**, including financial, operational, and compliance controls.
- **Outcome-Based Reporting:** Moving away from boilerplate "comply or explain" language toward demonstrating *how* governance actions led to specific business outcomes.

## C. Sustainability & ESG Harmonization

The era of fragmented "green" reporting is ending as standards converge:

- **ISSB (International Sustainability Standards Board):** These global standards are being adopted across Australia, Canada, and various Asian markets to ensure global comparability.
- **Social & Human Capital:** Reforms are expanding to include mandatory reporting on **Ethnicity and Disability Pay Gaps** and **Modern Slavery** within supply chains.

## 3. Structural Reform: The Changing Boardroom

Modern reforms are physically changing who sits in the boardroom and how they work:

1. **Identity Verification:** New laws (like the UK's ECCTA) require all directors to undergo mandatory identity verification to prevent shell-company fraud.
2. **Executive Succession:** There is a renewed focus on "Holistic Succession Planning," where boards are required to show they are developing a diverse pipeline of future leaders, not just a "replacement for the CEO."
3. **Shareholder Activism:** Reforms in proxy voting have empowered "retail" and "younger" investors, making **Virtual/Hybrid AGMs** a permanent, regulated fixture rather than a temporary pandemic measure.

## 4. Why Reforms Fail vs. Why They Succeed

**The Compliance Trap:** Research suggests that when reforms create a "compliance-only" culture, they can actually *increase* risk by making boards focus on checklists rather than the "spirit" of governance. Successful reforms are those that treat governance as a **competitive advantage** rather than a legal burden.

## Major Corporate Scandals in India and Abroad

Corporate scandals are the "pathology reports" of corporate governance; they reveal exactly where the systems of control, ethics, and oversight broke down. While historical scandals like **Enron** (USA) and **Satyam** (India) redefined the 2000s, recent failures in 2024–2026 are increasingly driven by **fintech fraud**, **toxic sales cultures**, and **supply chain ethics**.

### 1. Major Scandals Abroad (Global Context)

#### A. Historical Benchmarks

- **Enron (2001, USA):** The "Gold Standard" of accounting fraud. Enron used "Special Purpose Entities" (SPEs) to hide billions in debt while booking phantom profits.
  - **Impact:** Led to the dissolution of audit giant Arthur Andersen and the creation of the **Sarbanes-Oxley Act**.
- **Volkswagen "Dieselgate" (2015, Germany):** The company installed "defeat devices" in 11 million cars to cheat emissions tests.
  - **Impact:** Shifted the focus of governance toward **Environmental Compliance** and criminal liability for engineers and executives.

#### B. The "New Wave" (2020–2025)

- **Wirecard (2020, Germany):** Known as "The German Enron." The fintech giant admitted that **€1.9 billion** in cash on its balance sheet—supposedly held in Philippine banks—did not exist.
  - **Governance Failure:** Regulators (BaFin) and auditors (EY) were accused of "sleeping at the wheel" and ignoring whistleblower reports for years.
- **FTX (2022, Bahamas/Global):** A massive collapse of the crypto exchange where customer funds were diverted to a sister company, Alameda Research, for high-risk trading.
  - **Governance Failure:** A complete lack of board oversight; the company didn't even have a list of its own employees or bank accounts.
- **TD Bank (2024, Canada/USA):** Fined a record **\$3 billion** for failing to uphold Anti-Money Laundering (AML) controls, allowing drug cartels to move \$670 million through its system.

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## 2. Major Scandals in India

### A. The "Big Three" Legacy Scandals

- **Satyam Computer Services (2009):** Founder Ramalinga Raju confessed to inflating the company's cash and bank balances by **₹7,136 crore** (approx. \$1.5 billion).
  - **The "Tiger" Quote:** Raju famously said, *"It was like riding a tiger, not knowing how to get off without being eaten."*
- **Kingfisher Airlines (2012):** Vijay Mallya's airline collapsed due to reckless debt, unpaid salaries, and diversion of funds.
  - **Impact:** Led to the **Insolvency and Bankruptcy Code (IBC)** and tougher laws for "Wilful Defaulters."
- **ICICI Bank-Videocon (2018):** CEO Chanda Kochhar was accused of a "quid pro quo" loan where bank credit was extended to Videocon in exchange for investments in her husband's firm.

### B. Recent Failures (2023–2026)

- **The "Startup Taint" (BYJU'S & BharatPe):** \* **BYJU'S:** Faced severe governance heat over delayed audits, massive debt, and allegations of aggressive accounting and "misleading" sales tactics.
  - **BharatPe:** Involved a public legal battle between founders and the board over alleged siphoning of funds and lack of internal controls.
- **BlueSmart (2025):** The EV cab service faced accusations of transferring funds to "related parties" (family members) using debt taken from state-backed agencies.

## 3. Comparison: India vs. Abroad

Feature	Global Scandals (e.g., Wirecard/FTX)	Indian Scandals (e.g., Satyam/BYJU'S)
<b>Common Theme</b>	Complexity, use of offshore accounts, and tech-driven fraud.	Promoter-driven control, "Related Party Transactions," and siphoning.

Feature	Global Scandals (e.g., Wirecard/FTX)	Indian Scandals (e.g., Satyam/BYJU'S)
<b>Audit Role</b>	Often a failure of "Independence" (Auditors being too close to the client).	Often a failure of "Verification" (Auditors trusting forged bank statements).
<b>Regulatory Response</b>	Quick legislative change (SOX, FISG).	Structural cleanup (IBC, SEBI LODR Regulations).

### Summary Table: Governance Breakdown Patterns

1. **Concentration of Power:** When a "Super-CEO" or "Strong Promoter" has no one on the Board to say "No."
2. **Information Asymmetry:** Independent directors are often given "curated" information by management, hiding the red flags.
3. **Audit Failure:** External auditors becoming too dependent on the audit fees, leading to "box-ticking" rather than deep forensic checking.

### Common Governance Problems Noticed in Various Corporate Failures

When corporate giants collapse, investigators almost always find a recurring pattern of governance "red flags." These problems are rarely isolated; they usually form a toxic combination that turns off the company's internal steering and braking systems.

Based on major failures from **Enron to FTX (2022)** and **BYJU'S (2024-2025)**, the following are the most common governance problems observed.

#### 1. The "Dominant CEO" & Board Passivity

In many failures, the Board of Directors becomes a "rubber stamp" for a charismatic or powerful founder/CEO.

- **The Problem:** The CEO exerts "undue influence," and the Board fails to provide critical oversight or challenge risky decisions.
- **Example:** At **FTX**, the lack of a functional Board allowed Sam Bankman-Fried to move customer funds without any oversight. Similarly, the **Satyam** scam thrived because the Board didn't verify the CEO's fabricated bank statements.

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## 2. Ineffective Internal Controls & "Information Silos."

A company's internal controls are its first line of defense against fraud and error.

- **The Problem:** Management intentionally bypasses controls (Management Override), or departments operate in silos where the "right hand doesn't know what the left hand is doing."
- **Recent Trend (2025-2026):** Many fintech and tech startups have failed because they prioritized **growth at all costs** over building basic financial and compliance systems.

## 3. Lack of True Board Independence

Regulations mandate "Independent Directors," but in reality, many are independent only on paper.

- **The Problem:** Directors are often personal friends of the founder, former consultants, or have "hidden" business ties to the company.
- **The Result:** They are hesitant to ask "uncomfortable questions" for fear of losing their directorship or damaging personal relationships.

## 4. Misaligned Executive Compensation

The way executives are paid can actually encourage them to cheat.

- **The Problem:** When bonuses are tied strictly to **short-term share prices** or quarterly earnings, executives are incentivized to "cook the books" or take extreme risks to meet those targets.
- **Example:** The **WorldCom** scandal was driven by a need to keep stock prices high to support the CEO's personal stock-backed loans.

## 5. Poor Transparency & "Creative Accounting."

Transparency is the bedrock of trust, but failed companies often use "smoke and mirrors" to hide their true health.

- **The Problem:** Using **Off-Balance Sheet** entities (hiding debt in separate companies), recognizing revenue before it's actually earned, or capitalizing expenses.
- **Common Sign:** Financial statements that are so complex that even expert analysts struggle to understand how the company actually makes money.

## 6. Comparison: Public vs. Family-Owned Failures

Governance problems often look different depending on the ownership structure:

Failure Type	Common Governance Problem
<b>Public Companies</b>	<b>Agency Problem:</b> Managers acting in their own interest at the expense of distant shareholders.
<b>Family-Owned</b>	<b>Nepotism &amp; Siphoning:</b> Using company funds for personal lifestyle or hiring family members who lack the necessary skills.
<b>Tech Startups</b>	<b>Compliance Lag:</b> Innovation is moving much faster than the board can understand or regulate the associated risks.

## 7. The "Audit Failure."

External auditors are supposed to be the "watchdogs," but they often fail to bark.

- **Conflict of Interest:** Audit firms often make more money from **consulting fees** than the audit itself, making them reluctant to issue a "qualified" (negative) report.
- **Example:** The collapse of **Arthur Andersen** alongside Enron proved that the failure of the auditor is often the final nail in the coffin for a corporation.

**Key takeaway for 2026:** Modern governance failures are increasingly characterized by "**Digital Blind Spots**"—where boards fail to oversee risks associated with automated AI decision-making or cybersecurity vulnerabilities.

## **Codes & Standards on Corporate Governance**

Corporate governance codes and standards act as the "rulebooks" for the corporate world. They vary by country but increasingly converge around a set of global principles that prioritize **transparency, sustainability, and technological accountability**.

As of 2026, these codes have evolved from "box-ticking" compliance into dynamic frameworks that require boards to demonstrate the **impact** of their decisions.

### 1. The Global Gold Standard: G20/OECD Principles

Revised recently (2023-2025), the **G20/OECD Principles of Corporate Governance** serve as the foundation for most national codes worldwide.

- **Sustainability & Resilience:** For the first time, a dedicated chapter requires boards to manage climate-related risks and ensure the company's long-term resilience.

- **Digital Technologies:** Guidance on using tech for "e-voting" and the board's responsibility for **data privacy** and **cybersecurity**.
- **Stewardship:** Increased focus on the role of institutional investors (like pension funds) to act as active owners rather than passive shareholders.

## 2. The UK Corporate Governance Code (The 2024-2026 Shift)

The UK remains a global leader in governance via its "Comply or Explain" model. The **2024 Code** (fully active for 2026 reporting) introduces a massive change in accountability.

- **Provision 29 (The "Internal Controls" Declaration):** Starting in 2026, boards must formally declare that they have reviewed the effectiveness of **all material controls** (financial, operational, and compliance) and explain any failures.
- **Outcomes-Based Reporting:** Companies can no longer say "we have a policy." They must show the **results** of that policy (e.g., "Our diversity policy led to a 15% increase in female leadership this year").
- **Malus & Clawback:** Stronger requirements to reclaim executive bonuses in cases of misconduct or financial misstatement.

## 3. India: SEBI (LODR) Regulations

In India, corporate governance is primarily governed by the **SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015**, which saw significant "tightening" in 2025.

Feature	New 2025-2026 Requirement
<b>High-Value Debt Entities</b>	Entities with listed debt of <b>₹1,000 crore or more must now follow the same strict governance standards</b> as equity-listed firms.
<b>Director Tenure</b>	Shareholders must re-approve a director's continuation on the board every <b>5 years</b> .
<b>Related Party Transactions</b>	Stricter "prior approval" is needed for any royalty/brand payments exceeding 5% of consolidated turnover.
<b>Board Vacancies</b>	Any vacancy must be filled within <b>3 months</b> to prevent "leaderless" boards.

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#### 4. USA: SOX and the Shift to "Real-Time."

While the **Sarbanes-Oxley Act (SOX)** of 2002 remains the law of the land, its implementation in 2026 has become high-tech.

- **Continuous Monitoring:** Companies are moving away from "annual audits" to **real-time data verification** using AI.
- **Section 404(b):** Auditors now expect access to digital "control dashboards" rather than just looking at paper samples.
- **Cyber-Financial Link:** Under new SEC rules, a major data breach is now considered a **material financial risk** that must be disclosed within four business days.

#### 5. Other Notable Global Standards

- **Australia (ASX Principles):** Follows an "If not, why not" approach. The 4th Edition (and 2025 updates) focuses heavily on **organizational culture** and "social license to operate."
- **South Africa (King IV Report):** Unique for its "**Apply and Explain**" regime. It treats the company as a "corporate citizen" with duties toward society, not just shareholders.
- **European Union (CSRD):** The **Corporate Sustainability Reporting Directive** is now the strictest in the world, mandating that ESG data be audited with the same level of detail as financial profit/loss.

#### Summary Table of Governance Philosophies

Philosophy	Meaning	Primary Example
<b>Rule-Based</b>	"Follow these exact laws or go to jail."	USA (SOX)
<b>Principle-Based</b>	"Follow these principles or explain why you didn't."	UK, Australia
<b>Outcomes-Based</b>	"Show us the actual results of your governance."	South Africa, UK (2026)