

SECTION-1 (AUDITING)

INTRODUCTION TO AUDITING

STRUCTURE:

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1.1 OBJECTIVES

After studying this unit you will be able to understand

- a. the evolution of auditing
- b. the objects of auditing
- c. the advantages and disadvantages of auditing
- d. detection and prevention of frauds and errors
- e. limitations of auditing

1.2 INTRODUCTION -AN OVERVIEW OF AUDITING:

Economic decisions in every society must be based upon the information available at the time the decision is made. For example, the decision of a bank to make a loan to a business is based upon previous financial relationships with that business, the financial condition of the company as reflected by its financial statements and other factors.

If decisions are to be consistent with the intention of the decision makers, the information used in the decision process must be reliable. Unreliable information can cause inefficient use of resources to the detriment of the society and to the decision makers themselves. In the lending decision example, assume that the bank makes the loan on the basis of misleading financial statements and the borrower Company is ultimately unable to repay. As a result the bank has lost both the principal and the interest. In addition, another company that could have used the funds effectively was deprived of the money.

As society become more complex, there is an increased likelihood that unreliable information will be provided to decision makers. There are several reasons for this: remoteness of information, voluminous data and the existence of complex exchange transactions

As a means of overcoming the problem of unreliable information, the decision-maker must develop a method of assuring him that the information is sufficiently reliable for these decisions. In doing this he must weigh the cost of obtaining more reliable information against the expected benefits.

A common way to obtain such reliable information is to have some type of verification (audit) performed by independent persons. The audited information is then used in the decision making process on the assumption that it is reasonably complete, accurate and unbiased.

1.3 ORIGIN AND EVOLUTION

The term audit is derived from the Latin term 'audire,' which means to hear. In early days an auditor used to listen to the accounts read over by an accountant in order to check them

Auditing is as old as accounting. It was in use in all ancient countries such as Mesopotamia, Greece, Egypt, Rome, U.K. and India. The Vedas contain reference to accounts and auditing. Arthasashthra by Kautilya detailed rules for accounting and auditing of public finances.

The original objective of auditing was to detect and prevent errors and frauds

Auditing evolved and grew rapidly after the industrial revolution in the 18th century. With the growth of the joint stock companies the ownership and management became separate. The shareholders who were the owners needed a report from an independent expert on the accounts of the company managed by the board of directors who were the employees.

The objective of audit shifted and audit was expected to ascertain whether the accounts were true and fair rather than detection of errors and frauds.

In India the companies Act 1913 made audit of company accounts compulsory

With the increase in the size of the companies and the volume of transactions the main objective of audit shifted to ascertaining whether the accounts were true and fair rather than true and correct. Hence the emphasis was not on arithmetical accuracy but on a fair representation of the financial efforts

The companies Act.1913 also prescribed for the first time the qualification of auditors

The International Accounting Standards Committee and the Accounting Standard board of the Institute of Chartered Accountants of India have developed standard accounting and auditing practices to guide the. accountants and auditors in the day to day work

The later developments in auditing pertain to the use of computers in accounting and auditing.

In conclusion it can be said that auditing has come a long way from hearing of accounts to taking the help of computers to examine computerised accounts

1.4 DEFINITION

The term auditing has been defined by different authorities.

1. 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 and that the profit and loss account gives true and fair view of the profit/loss for the financial period, according to the best of information and explanation given to him and as shown by the books; and if not, in what respect he is not satisfied."

2. Prof. L.R.Dicksee. "auditing is an examination of accounting records undertaken with a view to establish whether they correctly and completely reflect the transactions to which they relate.
- 3 The book "an introduction to Indian Government accounts and audit" "issued by the Comptroller and Auditor General of India, defines audit "an instrument of financial control. It acts as a safeguard on behalf of the proprietor (whether an individual or group of persons) against extravagance, carelessness or fraud on the part of the proprietor's agents or servants in the realization and utilisation of the money or other assets and it ensures on the proprietor's behalf that the accounts maintained truly represent facts and that the expenditure has been incurred with due regularity and propriety. The agency employed for this purpose is called an auditor."

1.5 FEATURES OF AUDITING

- a. Audit is a systematic and scientific examination of the books of accounts of a business;
- b. Audit is undertaken by an independent person or body of persons who are duly qualified for the job.
- c. Audit is a verification of the results shown by the profit and loss account and the state of affairs as shown by the balance sheet.
- d. Audit is a critical review of the system of accounting and internal control.
- e. Audit is done with the help of vouchers, documents, information and explanations received from the authorities.

- f. The auditor has to satisfy himself with the authenticity of the financial statements and report that they exhibit a true and fair view of the state of affairs of the concern.

- g The auditor has to inspect, compare, check, review, scrutinize the vouchers supporting the transactions and examine correspondence, minute books of share holders, directors, Memorandum of Association and Articles of association etc., in order to establish correctness of the books of accounts.

1.6 OBJECTIVES OF AUDITING

There are two main objectives of auditing. The primary objective and the secondary or incidental objective.

- a. **Primary objective** – as per Section 227 of the Companies Act 1956, the primary duty (objective) of the auditor is to report to the owners whether the balance sheet gives a true and fair view of the Company's state of affairs and the profit and loss A/c gives a correct figure of profit or loss for the financial year.

- b. **Secondary objective** – it is also called the incidental objective as it is incidental to the satisfaction of the main objective. The incidental objective of auditing are:
 - i. Detection and prevention of Frauds, and
 - ii. Detection and prevention of Errors.

Detection of material frauds and errors as an incidental objective of independent financial auditing flows from the main objective of determining whether or not the financial statements give a true and fair view. As the Statement on auditing Practices issued by the Institute of Chartered Accountants of India states, an auditor should bear in mind the possibility of the existence of frauds or errors in the accounts under audit since they may cause the financial position to be mis-stated.

Fraud refers to intentional misrepresentation of financial information with the intention to deceive. Frauds can take place in the form of manipulation of accounts, misappropriation of cash and misappropriation of goods. It is of great importance for the auditor to detect any frauds, and prevent their recurrence. Errors refer to unintentional mistake in the financial information arising on account of ignorance of accounting principles i.e. principle errors, or error arising out of negligence of accounting staff i.e. Clerical errors.

1.7 EXPRESSION OF OPINION

When we speak of the objective, we rationalize the thinking process to formulate a set of attainable goals, with reference to the circumstances, feasibility and constraints. In money matters, frauds and errors are common place of occurrence. Apart from this, the statements of account have their own purpose and use of portraying the financial state of affairs. The objective of audit, naturally, should be to see that what the statements of account convey is true and not misleading and that such errors and frauds do not exist as to distort what the accounts should really convey.

Till recently, the principal emphasis was on arithmetical accuracy; adequate attention was not paid to appropriate application of accounting principles and disclosure, for ensuring preparation of accounting statement in such a way as to enable the reader of the accounting statement to form a correct view of the state of affairs. Quite a few managements took advantage of the situation and manipulated profit or loss and assets and liabilities to highlight or conceal affairs according to their own design. This state of affairs came up for consideration in the *Royal Mail Steam Packet Company's Case* as a result of which the Companies Acts of England and India were amended in 1948 and 1956 respectively to require the auditor to state inter alia whether the statements of account are true and fair. This is what we can take as the present day audit objective. The implication of the substitution of "true and fair" need to be understood. There has been a shift of emphasis from arithmetical accuracy to the question of reliability to the financial statements. A statement may be reliable even though there are some errors or even frauds, provided they are not so big as to vitiate the picture. The word "correct" was somewhat misplaced as the accounting largely consists of estimates.

However, you should not infer that the detection of errors and frauds is no longer an audit objective; it is indeed an audit objective because statements of account drawn up from books containing serious mistakes and fraudulent entries cannot be considered as a true and fair statement. To establish whether the financial statement show a true and fair state of affairs, the auditors must carry out a process of examination and verification and, if errors and frauds exist they would come to his notice in the ordinary course of checking. But detection of errors or frauds is not the primary aim of audit; the primary aim is the establishment of a degree of reliability of the annual statements of account.

If there remains a deep laid fraud in the accounts, which in the normal course of examination of accounts may not come to light, it will not be construed as failure of audit, provided the auditor was not negligent in the carrying out his normal work. This principle was established as early as in 1896 in the leading case in *Re-Kingston*

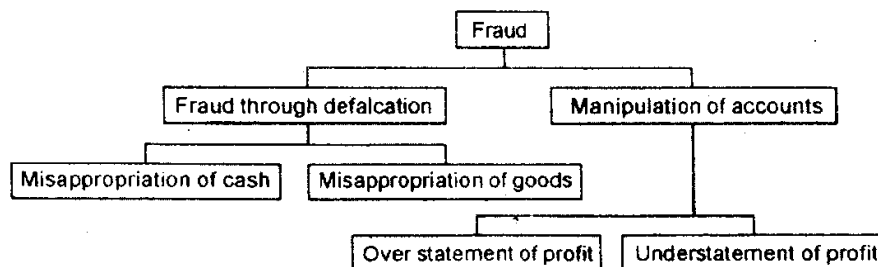
Cotton Mills Co.

1.8 DETECTION OF FRAUD & ERRORS

The term fraud means the willful misrepresentation made with an intention of deceiving others. It is a deliberate mistake committed in the accounts with a view to get personal gain. In accounting, fraud means two things.

- a. Defalcation involving misappropriation of either cash or goods; and
- b. Fraudulent manipulation of accounts not involving defalcation.

1.8.1. FRAUD COVERS THE FOLLOWING



1.8.2 FRAUD THROUGH DEFALCATION.

Following are the methods of defalcation involving misappropriation of cash or goods

- 1 By misappropriating the receipt by not recording the same in the cashbook
- 2 By destroying the carbon copy or counter foil of the receipt and misappropriating the cash received
- 3 By entering lesser amount on the counterfoil and misappropriating the difference between money actually-received and the amount entered on the counterfoil of the receipt book

- 4 By not recording the receipt of sale of a casual nature for example sale of scrap, sale of old newspapers etc.
- 5 By omitting to record cash donations received by non-profit making charitable institutions
- 6 By misappropriating the cash received on discounting the bills receivable and showing them as bills outstanding on hand.
- 7 By misappropriating cash received from debtors and concealing the same by giving artificial credit to the debtors in the form of bad debts, discount or sales return etc.
- 8 By adopting the method of "teeming and lading" or "lapping process". Under this method cash received from one debtor is misappropriated and deficiency in that debtors account is made good when another payment is received from second debtor by crediting the second debtors account less by that amount. This process is carried out round the year.
- 9 By suppressing the cash sales by not recording them or by treating the cash sales as credit sales.
- 10 By misappropriating the sale proceeds of VPP sales or sales of goods on approval basis by treating the transaction as goods received or not approved.
- 11 By under casting receipt side total of the cashbook
- 12 By recording fictitious or bogus payments
- 13 By recording more payments than actual amounts paid by altering the figures on the vouchers.

- 14 By showing the same payment twice.
- 15 By showing credit purchases as cash purchases and misappropriating the amount
- 16 Recording personal expenses as business expenses
- 17 By not recording discounts and allowances given by the creditors and misappropriating the amounts
- 18 By overcasting the payment side total of the cashbook
- 19 Recording fictitious and inflated purchases and misappropriating that amount.
- 20 By suppressing the credit notes for returns and showing the full payment to creditors.
- 21 By including the names of dummy workers or the workers who have? The job in the wage sheets and misappropriating the amount.
- 22 By over casting the total of wages sheets and drawing that amount for misappropriation.
- 23 By misappropriating the undisbursed wages.

1.8.3 FRAUD THROUGH MANIPULATION OF ACCOUNTS

It implies presentation of accounts more favorably than what they actually are. Window dressing means showing a wrong picture. The fraud through manipulation of accounts is also known as window dressing because accounts are manipulated to show a wrong picture of the profit or loss of the business and its financial state of affairs. Generally this type of fraud is committed by the people at the top management level. This does not involve any misappropriation of cash or goods but it is either over statement of profit or understatement of the same. Such fraud is committed with certain objective and is relatively difficult to detect.

1.8.4 THE AUDITOR CAN SUSPECT FRAUD UNDER THE FOLLOWING CIRCUMSTANCES.

1. When vouchers, invoices, cheques, contracts are missing etc.
2. When control account does not agree with subsidiary books.
3. When the difference in trial balance is difficult to locate.
4. When there are greater fluctuation in G.P. and N.P. ratios.
5. When there is difference between the balance and the confirmation of the balance by the parties.
6. When there is difference between the stock as per records and the stock physically counted.
7. When the explanation given by the client is not satisfactory.
8. When there is a overwriting of some figures.

9. When there is a contradiction in the explanation given by different parties.

1.8.5 PROCEDURE TO BE FOLLOWED TO DETECT ERRORS.

Following procedures may be adopted by the auditor to detect the errors.

1. Check the opening balances from the balance sheet of the last year.
2. Check the posting into respective ledger accounts
3. Check the total of the subsidiary books.
4. Verify all the castings and the carry forwards.
5. Ensure that the list of debtors and creditors tally with the ledger accounts.
6. Make sure that all accounts from the ledger are taken into accounts.
7. Verify the total of the trial balance.
8. Compare the various items from the trial balance with that of the previous year.
9. Find out the amount of difference and see whether an item of half or such amount is entered wrongly.
10. Check differences involving round figures as Rs. 1,000; Rs. 100 etc .

11. See where there is misplacement or transposition of figures that is 45 for 54; or 81 for 18 etc.
12. Ultimately careful scrutiny is the only remedy for detection of errors.
13. See that no entry of the original book has remained unposted.

1.8.6. THE AUDITOR SHOULD PERFORM THE FOLLOWING DUTIES IN RESPECT OF FRAUD.

1. Examine all aspects of the finance.
2. Vouch all the receipts from the counterfoils or carbon copies or cash memos, sales mart reports etc.
3. Check thoroughly the salary and wages register.
4. Verify the methods of valuation of stocks.
5. Check up stock register, goods inwards notes, goods out wards books and delivery challans etc
6. Calculate various ratios in order to detect fraudulent manipulation of accounts
7. Go through the details of unusual items.
8. Probe into the details of the problems when there is a suspicion.
9. Exercise reasonable skill and care while performing the duty.
10. Make surprise visit to check the accounts.

1.9 ADVANTAGES AND INHERENT LIMITATIONS OF AUDIT

1.9.1 ADVANTAGES OF AUDIT

Advantages of audit

A. Businessman's point of view	B. Investor's point of view	C. Other Advantages.
1. Detection of errors and frauds	1. Protects interest	1. Evaluate financial status
2. Loan from banks	2. Moral check	2. Usting of shares
3. Builds reputation	3. Proper valuation of investments	3. Settlements of claims
4. Proper valuation of assets	4. Good security	4. Evidence in court
5. Government acceptance		5. Settlement of accounts
6. Update accounts		5. Facilitates calculation of Purchase. Consideration.
7. Suggestions for improvement		7. Facilitates taxation
8. Useful for agency		

1.9.2 LIMITATIONS OF AUDITING

At this stage, it must be clear that the objective of an audit of financial statements is to enable an auditor to express an opinion on such financial statements. In fact, it is the auditor's opinion which helps determination of the true and fair view of the financial position and operating results of an enterprise. It is very significant to note that the AAS-2 makes it a subtle point that such an opinion expressed by the auditor is neither an assurance as to the future viability of the enterprise nor the efficiency or effectiveness with which management has conducted affairs of the enterprise. Further, the process of auditing is such that it suffers from certain inherent limitations, i.e., the limitation which cannot be overcome irrespective of the nature and extent of an audit procedure. It is very important to understand these inherent limitations of an audit since understanding of the same would only provide clarity as to the

overall objectives of an audit. The inherent limitations are:

- I. First of all, auditor's work involve exercise of judgment, for example, in deciding the extent of audit procedures and in assessing the reasonableness of the judgment and estimates made by the management in preparing the financial statements. Further much of the evidence available to the auditor can enable him to draw only reasonable conclusions there from. The audit evidence obtained by an auditor is generally persuasive in nature rather than conclusive in nature. Because of these factors, the auditor can only express an opinion. Therefore, absolute certainty in auditing is rarely attainable. There is also likelihood that some material misstatements of the financial information resulting from fraud or error, if either exists, may not be detected.
- II. The entire audit process is generally dependent upon the existence of an effective system of internal control. Further, it is clearly evident that there always be some risk of an internal control system failing to operate as designed. No doubt, internal control system also suffers from certain inherent limitations. Any system of internal control may be ineffective against fraud involving collusion among employees or fraud committed by management. Certain levels of management may be in a position to override controls; for example, by directing subordinates to records transactions incorrectly or to conceal them, or by suppressing information relating to transactions. Such inherent limitations of internal controls system also contribute to inherent limitations of an audit.

Generally following are the Limitations of auditing

1. **Non-detection of errors/frauds:-** Auditor may not be able to detect certain frauds which are committed with malafide intentions.
2. **Dependence on explanation by others:-** Auditor has to depend on the explanation and information given by the responsible officers of the company. Audit report is affected adversely if the explanation and information prove to be false.
3. **Dependence on opinions of others:-** Auditor has to rely on the views or opinions given by different experts viz Lawyers, Solicitors, Engineers, Architects etc. he can not be an expert in all the fields

4. **Conflict with others:** - Auditor may have differences of opinion with the accountants, management, engineers etc. In such a case personal judgement plays an important role. It differs from person to person.
5. **Effect of inflation :** - Financial statements may not disclose true picture even after audit due to inflationary trends.
6. **Corrupt practices to influence the auditors :-** The management may use corrupt practices to influence the auditors and get a favourable report about the state of affairs of the organisation.
7. **No assurance :-** Auditor cannot give any assurance about future profitability and prospects of the company.
8. **Inherent limitations of the financial statements :-** Financial statements do not reflect current values of the assets and liabilities. Many items are based on personal judgement of the owners. Certain non-monetary facts can not be measured. Audited statements due to these limitations can not exhibit true position.
9. **Detailed checking not possible :-** Auditor cannot check each and every transaction. He may be required to do test checking.

1.10 MISCELLANEOUS

1.10.1 AUDITING Vs INVESTIGATION

Points of difference	Auditing	Investigation
1. objects	The object is to find out whether balance sheet and profit and loss account exhibit a true and fair view of business.	It is undertaken to know the essential facts about a matter under inquiry. It is done with some special purpose of view.
2 period	It usually covers one accounting year.	It may cover more than one accounting year.
3 conducted	It is conducted for proprietors only.	It is carried out on behalf of any party interested in the matter.
4 scope	It is restricted to balance sheet and profit and loss account.	It is wider in scope. It may be carried out beyond balance sheet.
5. compulsion	Audit is legally compulsory for companies.	It is voluntary. It is required under certain circumstances.
	It may be conducted at the end of the year.	It may be conducted at any time in case of suspicion about any transaction.
		Form of report is not

6 time	Form of report is prescribed. It is presented to the shareholders.	prescribed. It is presented to the client.
7. report	Owners appoint the auditors. The statutory auditors must possess proper qualifications.	Even third party can appoint an investigator. Even an employee preferably a chartered accountant may be appointed as investigator.
8. appointment		Re - investigation may be undertaken.
9. qualifications	Re - audit is not generally undertaken.	
10. rework		

1.10.2 DISTINCTION BETWEEN ACCOUNTING AND AUDITING

Points of difference	Accounting	Auditing
1. meaning	It is recording of all the day to day transactions in the books of accounts leading to preparation of financial statements.	It is the critical examination of the transactions recorded in the books of accounts.
2. nature	It is concerned with finalisation of accounts. The object is to ascertain the trading results.	It is concerned with establishment of reliability of financial statements. The object is to certify the correctness of financial statements.
3. objects	Accounting commences when book keeping ends.	Auditing begins when accounting ends.
4. commencement	It involves various financial statements. It involves maintenance of books of accounts. It does not go beyond books of accounts.	It depends upon the agreement or upon the provisions of law. It goes beyond books of accounts.
5. scope		

1.10.3 TRUE AND FAIR VIEW.

An audit of accounts by an independent expert assures the outside users that the accounts are proper and reliable. The outsiders can rely on the accounts if the auditor reports that the accounts are true and fair. The accounts are said to be true and fair:

1. **When the profit and loss shown in the profit and loss account is true and fair, and**
2. **Also when the value of assets and liabilities shown in the balance sheet is true and fair.** What constitutes true and fair is not defined under any law. However the following general guidelines may be laid down in connection with true and fair.
 - a) **Conform to accounting principles:** The books of accounts must be kept according to the normally accepted accounting principles such as the concept of entity, continuity, periodical matching of costs and revenue, accrual and double entry system etc.
 - b) **No window dressing or secret reserves:** The accounts must show the financial position and the profit or loss as they are. I.e. there is neither an overstatement nor an understatement. There should be in other words neither window dressing nor secret reserves. In window dressing the accounts are made in such a way as to show a much better condition than the actual condition. The profit and the net worth are overstated

The accounts are said to show true and fair view when the accounts show only the actual conditions as it is. i.e. the profit and the net worth are shown as they are.

In order to show a true and fair view the auditor should ensure that:

1. The final accounts agree with the books of accounts.
2. The provision for depreciation is proper.

3. The closing stock is physically verified and valued properly.
4. Intangible assets like goodwill, patents, preliminary expenses or other deferred revenue expenses are written off properly.
5. Proper provision is made for bad and doubtful debts.
6. Capital expenses is not treated as revenue expenses and vice versa.
7. Capital receipts are not treated as revenue receipts.
8. Effect of changes in rate of foreign exchange on value of assets and liabilities is recorded in the books properly.
9. Contingent liabilities are not treated as actual liabilities and vice versa.
10. Provision is made for all known losses and liabilities
11. A reserve is not shown as a provision and vice versa
12. Cut off transactions are recorded properly, so that all sales invoices are matched with goods delivered and all purchase invoices are matched with goods received.
13. Transactions are recorded on accrual basis, i.e. outstanding expenses, prepaid expenses, income accrued and advance income are recorded properly.
14. Expected or anticipated gains are not credited to the profit and loss account.
15. Effect of events after the balance sheet date on the value of an asset and liability is disclosed in the accounts properly
16. The exceptional or non-recurring transactions are disclosed separately in the accounts.

3. Disclose all material facts: The books of accounts must disclose all material facts regarding revenue, expenses, assets and liabilities. Material means important and essential. The disclosure of important matters in the accounts helps the users in taking business decisions. There should be neither suppression of vital facts nor mis-statements.

4. Legal requirements: In case of limited company the account must disclose the matters required to be disclosed under the Companies Act. The final accounts must be in the format prescribed under Schedule VI of the Companies Act, 1956. Special companies such as banks, insurance, electricity supply companies prepare accounts as prescribed under special laws. A co-operative society, a trust etc. must also prepare the accounts as required under relevant laws.

5. Requirements of Institute of Chartered Accountants of India: The accounts must also be in accordance with the various guidelines prescribed by the ICAI. These guidelines are contained in the statements, standard and guidance notes issued by the institute from time to time.

1.10.4 ADVANTAGES OF AN INDEPENDENT AUDIT

The fact that audit is compulsory by law, in certain cases by itself should show that there must be some positive utility in it. The chief utility of audit lies in reliable financial statement on the basis of which the state of affairs may be easy to understand. Apart from this obvious utility, there are other advantage of audit. Some or all of these are of considerable value even to those enterprises and organization where audit is not compulsory, these advantages are given below:

- (a) It safeguards the financial interest of persons who are not associated with the management of the entity, whether they are partners or shareholders.
- (b) It acts as a moral check on the employees from committing defalcations or embezzlement.
- (c) Audited statements of account are helpful in setting liability for taxes, negotiating loans and for determining the purchase consideration for a business.
- (d) This are also use for settling trade disputes or higher wages or bonus as well as claims in respect of damage suffered by property, by fire or some other calamity.

(e) An audit can also help in the detection of wastage and losses to show the different ways by which these might be checked, especially those that occur due to the absence of inadequacy of internal checks or internal control measures.

(f) Audit ascertains whether the necessary books of accounts and allied records have been properly kept and helps the client in making good deficiencies or inadequacies in this respects.

(g) As an appraisal function, audit reviews the existence and operations of various controls in the organizations and reports weakness, inadequacy, etc., in them.

(h) Audited accounts are of great help in the settlement of accounts at the time of admission or death of partner.

(i) Government may require audited and certificated statement before it gives assistance or issues a licence for a particular trade.

1.10.5 QUALITIES OF AN AUDITOR

So far we have discussed the question of formal qualifications of an auditor. But it is not enough to realise what an auditor should be. He is concerned with the reporting on financial matters of business and other institutions. Financial matters inherently are to be set with the problems of human fallibility; errors and frauds are frequent. The qualities required, according to Dicksee, are tact, caution, firmness, good temper, integrity, discretion, industry, judgment, patience, clear headedness and reliability. In short, all those personal qualities that goes to make a good businessman contribute to the making of a good auditor. In addition, he must have the shine of culture for attaining a great height. He must have the highest degree of integrity backed by adequate independence. In fact, AAS-1 mentions integrity, objectivity and independence as one of the basic principles.

He must have a thorough knowledge of the general principles of law which govern matters with which he is likely to be in intimate contact. The Companies Act, 1956 and the Partnership Act, 1932 need special mention but mercantile law, specially the law relating to contracts, is no less important.

Needless to say, where undertakings are governed by a special statute, its knowledge will be imperative; in addition, a sound knowledge of the law and practice of taxation is unavoidable.

He must pursue an intensive programme of theoretical education in subjects like financial and management accounting, general management, business and corporate laws, computers and information systems, taxation, economics, etc. Both practical training and theoretical education are equally necessary for the development of professional competence of an auditor for undertaking any kind of audit assignment.

The auditor should be equipped not only with a sufficient knowledge of the way in which business generally is conducted but also with an understanding of the special features peculiar to a particular business whose accounts are under audit. AAS-8 on 'Audit Planning' emphasises that an auditor should have adequate knowledge of the client's business. The auditor, who holds a position of trust, must have the basic human qualities apart from the technical requirement of professional training and education.

He is called upon constantly to critically review financial statements and it is obviously useless for him to attempt that task unless his own knowledge is that of an expert. An exhaustive knowledge of accounting in all its branches is the *sine qua non* of the practice of auditing. He must know thoroughly all accounting principles and techniques.

Auditing is a profession calling for wide variety of knowledge to which no one has yet set a limit; the most useful part of the knowledge is probably that which cannot be learnt from books because its acquisition depends on the alertness of the mind in applying to ever varying circumstances, the fruits of his own observation and reflection; only he who is endowed with common sense in adequate measure can achieve it.

Lord Justice Lindley in the course of the judgment in the famous *London & General Bank case* had succinctly summed up the overall view of what an auditor should be as regards the personal qualities. He said, "an auditor must be honest that is, he must not certify what he does not believe to be true and must take reasonable care and skill before he believes that what he certifies is true".

1.13 LET US SUM UP

Auditing is a systematic and scientific examination of the books of accounts and records of business to enable the auditor to satisfy himself that the profit and loss account and the balance sheet are properly drawn up so as to exhibit a true and fair view of the financial state of affairs of the business and profit or loss for the financial period.

The term auditing has been distinguished from accounting and investigation. The main point of distinction is that accountancy is concerned with the preparation of financial statements whereas auditing is concerned with checking of these financial statements and reporting on the financial position and result of operation of the organisation. Investigation is undertaken for some special purpose i.e. to determine the extent of fraud or to determine the purchase price of the organisation and the like.

Objectives of audit are broadly classified into a) primary objective and b) secondary objective. Primary objective of audit is to substantiate the accuracy of the financial statements prepared by the accountant while the secondary objective is to detect and prevent errors and frauds.

A number of advantages can be derived from getting the accounts audited by a qualified auditor, such as early detection of errors and frauds, reliability of accounts, statements of various types of claims, securing loans from banks and other financial institutions, etc.

Audit is classified into various types, viz., audit under statute, audit of accounts of private firm, audit of accounts of private individuals, audit of trust accounts. An auditor can adopt any one of the modes to conduct his audit of an organisation, viz. continuous audit or periodical audit or interim audit.

Besides being a Chartered Accountant an auditor should possess certain other qualities, such as knowledge of relevant laws, intelligence, tactfulness, vigilance, honesty and integrity, courage, impartiality, broadmindedness, patience, perseverance, maintaining secrecy of his client, commonsense etc.

1.14 KEYWORDS

Auditing: Auditing is a systematic and scientific examination of the books of accounts and records of business to enable the auditor to satisfy himself that the profit and loss account and the balance sheet are properly drawn up so as to exhibit a true and fair view of the financial state of affairs of the business and profit or loss for the financial period.

Continuous audit: An audit which involves a detailed and exhaustive examination of the books of accounts at regular intervals throughout the year along with the accounting work.

Errors: Mistakes committed innocently and unknowingly while making entries in the books of accounts.

Frauds: Fictitious entries made in the books of accounts with certain motives.

Interim audit: An audit which is conducted for a part of the accounting period for some specific purpose.

Investigation: Examination of accounts for special purpose.

Qualified auditor: A person who is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949.

Statutory audit: An audit undertaken under any specific statute or Act.

True and fair view: A phrase which means that the financial statements must not contain anything which is untrue, unfair, unlawful, immoral and unethical i.e. the financial statements must not contain **errors** and fraud.

1.15 BIBLIOGRAPHY

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1.16 QUESTIONS

1. Check your progress

- i) Define auditing.
- ii) Distinguish between accountancy and auditing.
- iii) State whether the following statements are true or false.
 - a) Auditing of accounts is compulsory in a partnership firm.
 - b) Auditing of accounts is undertaken to detect fraud in the books of accounts.
 - c) A professional auditor cannot take up the work of preparing the accounts of a company.
 - d) Investigation is taken up only on behalf of the owner of the entity.
 - e) Investigation of accounts is not compulsory but audited by the qualified professional accountant.
 - f) In ancient period the audit was confined to cash audit and not to locate fraud.
 - g) Audit of company accounts is compulsory under the Chartered Accountants Act, 1949.

2. Check your progress

1. List the types of clerical errors.
2. Distinguish between errors and fraud.
3. What do you mean by window dressing.
4. Fill in the blanks with the appropriate word given in the bracket:
 - a) when two or more errors are committed in such a way that the result of these errors on the debits and credits is nil, they are known as _____(error of omission/compensating error)
 - b) _____are always committed deliberately and intentionally to defraud the proprietors of the organisation (error/fraud)
 - c) the main objective of _____is to avoid or reduce the tax liability.(window dressing/secret reserves)
 - d) to determine and judge the reliability of the financial statements and the supporting accounting records for a particular financial period is_____of an audit .(primary objective/secondary objective)

5 State whether the following statements are true or false.

- a) The main object of auditing is to detect frauds from the books of accounts.
- b) The allocation of amount between capital and revenue expenditure is a compensating error.

- c) Audited accounts are free from errors and fraud.
- d) The main purpose of auditing is to report on the effectiveness of the internal check system of organisation.
- e) Compensating errors do not affect the balance sheet of the company as the trial balance does not disagree.
- f) The auditor is appointed to report on the financial position of the company carrying out an analytical examination of the books of accounts related documents and internal and external evidences.
- g) An auditor who compromises on important matters of accounting with the Board of Directors is known as dependent auditor.



INTRODUCTION TO AUDITING II

STRUCTURE:

- 2.0 Objectives
- 2.1 Meaning And Definition Of Errors And Frauds
- 2.2 Reasons And Circumstances
- 2.3 Types Of Errors
- 2.4 Types Of Frauds
- 2.5 Risk Of Fraud And Error In Audit
- 2.6 Auditor's Duties And Responsibilities In Respect Of Fraud
- 2.7 Basic Principles Of Audit
- 2.8 Audit Types
- 2.9 Accounting Concept Relevant To Auditing

2.0 OBJECTIVES

After studying the unit the students will be able to

- Understand the meaning of Errors and Frauds
- Classify the reasons and circumstances of errors and frauds.
- Explain the types of Errors and fraud
- Elaborate the Authors duty in case of Errors and frauds.
- Explain the types of Audit
- Understand the principles of Audit

2.1 MEANING AND DEFINITION OF ERRORS AND FRAUDS

DEFINITIONS :

Error refers to unintentional mis-statements or mis-descriptions in the records or books of accounts by the books keepers. In other words, they are unintentional mistakes arising on account of negligence or ignorance. Errors may be basically of two types :

(a) Principal Errors and (b) Clerical Errors

(a) principal Errors and : these errors arise generally when the principals of accountancy are not observed while recording a transaction. For instance a capital expenditure is recorded as a revenue expenditure or vice versa. Such errors are difficult to detect as the Trial Balance tallies inspite of such errors. Basically it arises on account of ignorance of accounting principles. Following are the examples of principles errors :

(1) Wages paid for installation of plant and machinery is recorded as wages paid to workers

- (2) Revenue receipt is recorded as a capital receipt
- (3) Incorrect provisions for doubtful debts
- (4) Incorrect provisions for discount on debtors
- (5) Rent paid to landlord debited to the landlord account instead of rent ac account
- (6) Overvaluation or undervaluation of stock on account of ignorance

(b) Clerical Errors – these errors arise on account of negligence of the accounting staff. They are called technical errors clerical errors may be further divided as errors of omission, Errors of Commission, Duplicating Errors and Compensating Errors.

2.2 REASONS AND CIRCUMSTANCES

R.K. Mautz, has classified the reasons and circumstances of errors and he has include fraud in the broad category of errors. The classifications are the following.

1. ignorance on the part of employees of accounting development, generally accepted accounting principles, appropriate account classification of the necessary reconciling subsidiary ledgers with controlling accounts and of good accounting practices in general.
2. carelessness on the part of those doing the accounting work.
3. A desire to conceal the effect of defalcations of shortage of one kind or another.
4. A tendency of the management to permit prejudice or bias to influence the interpretation of transactions or events or their presentation in the financial statements.
5. An ever presents desires to hold taxes on income to minimum.

A sixth cause may be added to those Mr.Mautz has listed and that is more serious in nature. It is the intentional effort committed by persons in positions of authority to :

- I. Show up the picture depicted by the statements;
- II. Depress the picture depicted by the statements; and
- III. Convert the error to a personal benefit.

2.3 TYPES OF ERRORS

2.3.1 Commission

It includes posting errors, casting errors and totalling errors. For example sale to A has been recorded in B's A/c, it is a posting error or it is recorded in A's A/c but the amount is wrongly recorded. Similarly the balance of Rs.510 is carried forward as Rs.501, and then it is a casting error. Certain errors will not affect the trial balance for example posting in a wrong account will not affect the trial balance but if there is a totalling error or a casting error then the trial balance does not agree.

2.3.2 Omission

In the process of recording the accounting clerk may omit a transaction from recording either fully or partially. If a transaction is fully omitted, then it will be difficult to trace out, as both the debit and the credit are missing and the trial balance will tally inspite of these errors. However if a transaction is partly omitted, then only one aspect of the transaction is recorded. In this case it is easier to locate such an error.

2.3.3 Principle and compensating

PARTICULARS	PRINCIPLE	COMPENSATING
MEANING	A Transaction Is Basically Recorded In The Books In An Incorrect Manner.	An error which is counter balanced by another error, so that it is not disclosed by the trial balance.
Types.	(a) errors which do not affect profit: e.g. manufacturing wages posted to trade expenses A/C or wrong classification of assets or Liabilities. (b) Error which affect profit : e.g. treating rent paid as a debtor instead of as expenses, when capital expenditure is treated as revenue and debited to P&L account.	It may or may not affect profit. If both original and compensating errors arise in revenue accounts, profit will not be affected, but if one arises in a revenue account and other in an asset or liability account, trial balance will agree, but profit will be incorrectly stated. It arises in various ways, most frequently in casting, e.g., cast of expenditure account may be Rs.96,000 too much, profit and asset being thereby shown improperly.
3 Effect on trial balance.	These errors will not affect the trial balance.	These errors will not affect the trial balance.
Effect on profit	Error that involves income and expenditure a/c e.g. wrong distinction between capital and revenue	Compensating errors, involving income and affect profit. But if error is in asset and liability accounts only, profits may not be

	expenditure will affect profit.	affected.
Detection	These errors are detected by audit procedures like analytical reviews, ledger scrutiny, analysis of comparative financial statements, etc.	Such errors are generally deliberately concealed and hence difficult to detect. Audit procedures like analytical review, posting checking, ledger scrutiny, etc. can partly help to locate these errors.

2.4 TYPES OF FRAUDS

According to the standard Auditing practices issued by the Institute of Chartered Accountants of India, the term fraud refers to intentional misrepresentation of finance information by one or more individuals among management or third parties. In other words, it is intentional or wilful misrepresentation or deliberate concealment of a material fact with a view to deceive, cheat or mislead another person.

Frauds may be of different types:

- i) Manipulation of accounts,
- ii) Misappropriation of cash,
- iii) Misappropriation of Goods.

2.4.1 Manipulation of Accounts

Manipulation of accounts is said to be committed when a person makes a false entry in the books of accounts knowing it to be wrong, alters or destroys a true entry in the business records or prevents the making of a true entry in the business records. Normally it is done by people at the top management level. It is done to overstate or understate the profits and the financial conditions of the business so as to serve their purpose. Manipulation may be done in any of the following ways :

- 1) Non provisions of depreciation on fixed assets
- 2) Overvaluation or undervaluation of assets
- 3) Recording revenue expenditure as capital expenditure
- 4) Showing expenses of the next year in the current year's profit and loss account
- 5) Not recording current year's accrued expenses etc.

A common form of manipulation of accounts is known as "window Dressing."

2.4.2 Misappropriation of Cash

Misappropriation of cash is also called embezzlement of cash. It means fraudulent appropriation of cash belonging to another person by one who has been entrusted to it. Misappropriation may take place in the following ways:

- 1) Not recording full cash sales and pocketing a part of the proceeds
- 2) Teeming and Lading
- 3) Misappropriation the money received from sale of goods sent on sale or return basis
- 4) Making fictitious entries in customer's accounts for bad debts, discount etc.
- 5) Misappropriation the amount received from sale of defective goods by not recording such sale
- 6) Recording fictitious cash purchase
- 7) Recording payments to fictitious creditors
- 8) Not recording discounts received from creditors
- 9) Recording payments to dummy or ghost workers and pocketing the money, etc.

2.4.3 Misappropriation of Goods

It refers to fraudulent application of goods by those who handle them. It can be done by recording sales of larger quantities and misappropriating the balance or by recording purchase of large quantities receiving less quantity and then receiving the balance amount privately.

2.5 RISK OF FRAUD AND ERROR IN AUDIT

The following events may increase the risk of fraud or error -

1. **Internal Control Faults:** Weaknesses in the design of internal control system and non-compliance with laid down control procedures, e.g. a single person being responsible for receipt of all posts/ mails and marking it to the relevant sections or two persons responsible for receipt of all posts/ mails but the same is not followed in the practice.
2. **Doubts about the integrity or competence of the management,** e.g. domination by one person, high rate of employee turnover, frequent change of legal counsel or Auditors, significant and prolonged understaffing of the accounts department, etc.
3. **Unusual pressures within the entity,** e.g. industry is doing well but the Company's performance is poor, heavy dependence on a single line of product, inadequate working capital, need to show more profit to support the share market price, etc.
4. **Unusual transactions** e.g. transactions with related parties, excessive payment for certain services to lawyers, etc.

5. Problems in obtaining sufficient and appropriate audit evidence,

E.g. inadequate documentation significant differences between the figures as per accounting records and confirmation received from third parties. Etc.

2.6 AUDITOR'S DUTIES AND RESPONSIBILITIES IN RESPECT OF FRAUD

The primary objective of an auditor is to express an opinion on the financial statements. However, the auditor while conducting the audit is required to consider the risk of material misstatements in the financial statements resulting from fraud or error.

An audit conducted in accordance with the auditing standards generally accepted in India is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. The fact that an audit is carried out may act as a deterrent, but the auditor is not and cannot be held responsible for the prevention of fraud and error.

The auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance; hence, in an audit, the auditor does not guarantee that material misstatements, whether from fraud or error, will be detected. Therefore, the subsequent discovery of a material misstatement of the financial statement resulting from fraud or error does not, in and of itself, indicate:

- a) Failure to obtain reasonable assurance,
- b) Inadequate planning, performance or judgment,
- c) Absence of professional competence and due care, or,
- d) Failure to comply with auditing standards generally accepted in India.

This is particularly the case for certain kinds of intentional misstatements, since auditing procedures may be ineffective for detecting an intentional misstatement that is concealed through collusion between or among one or more individuals among management. Those charged with governance, employees, or third parties, or involves falsified documentation. Whether the auditor has performed an audit in accordance with auditing standards generally accepted in India is determined by the adequacy of the audit procedures performed in the circumstances and the suitability of the auditor's reports based on the result of these procedures.

In planning and performing his examination the auditor should take into consideration the risk of material misstatements of the financial information caused by fraud or error. He should inquire with the management as to any fraud or significant error. Which has occurred in the reporting period, and modify his audit procedures, if

necessary. If circumstances indicate the possible existence of fraud and error, the auditor should consider the potential effect of the suspected fraud and error on the financial information. If he is unable to obtain evidence to confirm, he should consider the relevant laws and regulations before expressing his opinion.

The auditor also has the responsibility to communicate the misstatement to the appropriate level of management on a timely basis and consider the need to report to it then changed with governance. He may also obtain legal advice before reporting on the financial information or before withdrawing from the engagement. The auditor should satisfy himself that the effect of fraud is properly reflected in the financial information or the error is corrected in case the modified procedures performed by the auditor confirm the existence of the fraud.

The auditor should also consider the implications of the frauds and errors, and frame his report appropriately. In case of a significant fraud, the same should be disclosed in the financial statement. If adequate is not made, there should be a suitable disclosure in his audit report.

2.7 BASIC PRINCIPLES OF AUDIT

AAS-1 describes the basic principles, which govern the auditor's professional responsibilities and which should be complied with whenever an audit is carried out. These are:-

1. Integrity, objectivity and independence:

The auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and appear to be free of any interest which might be regarded. Whatever its actual effect, as being incompatible with integrity and objectivity.

2. Confidentiality:

The auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is legal or professional duty to disclose. It is remarked that an auditor should keep his ears and eyes open but his mouth shut.

3. Skill and competence:

The audit should be performed and the report prepared with due professional care by persons who have adequate training, experience and competence. This can be acquired through a combination of general education, technical knowledge obtained through study and formal courses concluded by a qualifying

examination recognized for this purpose and practical experience under proper supervision.

4. Work performed by others:

When the auditor delegates work to assistant* or uses work performed by other auditors or experts, he will continue to be responsible for forming and expressing his opinion on the financial information. At the same time he is entitled to rely on work performed by others provided he exercises adequate skills and care and is not aware of any reason to believe that he should not have relied. The auditor should carefully direct, supervise & review work delegated by assistants. He should obtain reasonable assurance that work performed by other auditors or experts is adequate for this purpose.

5. Documentation:

The auditor should document matters, which are important in providing evidence that the audit was carried out in accordance with the basic principles.

6. Planning:

The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of client's business. They should be further developed and revised, if required, during the course of audit.

7. Audit evidence:

The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive test procedure. It will enable him to draw reasonable conclusions there from on which he has to base his opinion on the financial information.

8. Accounting system & internal control:

The auditor should gain an understanding of the accounting system and related internal controls. He should study and evaluate the operation of those internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures.

9. Audit conclusions and reporting:

The auditor should review and assess the conclusions drawn from the audit evidence obtained and from his knowledge of business of the entity as the basis for the expression of his opinion on the financial information.

The audit report should contain a written expression of opinion of the financial information. It should comply with the legal requirements. In case of a qualified opinion, adverse opinion or disclaimer of opinion is given or reservation on any matter is to be made reasons thereof.

2.8 AUDIT TYPES

MEANING:

Audit is not legally obligatory for all types of business organizations or institutions. On this basis audits may be of two broad categories i.e., audit required under law and voluntary audits.

(i) Audit required under law : The organizations which require audit under law are the following:

- (a) companies governed by the Companies Act, 1956;
- (b) banking companies governed by the Banking Regulation Act, 1949;
- (c) electricity supply companies governed by the Electricity supply Act, 1948;
- (d) co-operative societies registered under the co-operative Societies Act, 1912;
- (e) public and charitable trusts registered under various Religious and Endowment Acts;
- (f) corporations set up under an Act of parliament or State Legislature such as the Life Insurance Corporation of India.
- (g) Specified entities under various sections of the Income-tax Act, 1961.

(ii) In the voluntary category are the audits of the accounts of proprietary entities, partnership firms, Hindu undivided families, etc. in respect of such accounts, there is no basic legal requirement of audit. Many of such enterprises as a matter of internal rules require audit. Some may be required to get their accounts audited on the directives of Government for various purpose like sanction of grants, loans, etc. But the important motive for getting accounts audited lies in the advantages that follow from an independent professional audit. This is perhaps the reason why large numbers of proprietary and partnership business get their accounts audited.

Government companies have some special feature which will be seen later.

INTERIM AUDIT:

An audit that is taken up between two annual audits is called an Interim Audit. A specific date, as per the client's requirement is taken into account, e.g. 30th September, 31st December, etc. a trial balance is drawn and verified with a view to prepare financial statement. Financial statement are prepared and authenticated for the interim audit period. Assets and liabilities are verified for interim

balance sheet purposes. Independence is considered less independent than the statutory Auditor; generally an employee of the enterprise will be the internal auditor. In the interim audit no format is prescribed. It depends on the nature of work, coverage and audit observations.

CONTINUOUS AUDIT:

A continuous audit is one in which the auditor's staff is engaged continuously in checking the accounts of the client, during the whole year round or when for the purpose, the staff attends at quite frequent intervals say weekly basis during the financial period.

A continuous audit is preferred for the following reasons:

- i. It makes it possible for the management to exercise a stricter control over the accounts in as much as one is able to check sooner the causes of any errors or frauds uncovered by such an audit.
- ii. The frequent attendance by the staff deters persons so inclined, from committing a fraud.
- iii. The accounting staff of the client is motivated to keep the books of account up-to-day.

2.9 ACCOUNTING CONCEPT RELEVANT TO AUDITING

INTRODUCTION

1. The purpose of this standard is to establish standards on the concept of materiality and its relationship with audit risk.
2. The auditor should consider materiality and its relationship with audit risk when conducting an audit.

2.9.1 MATERIALITY:

1. Information is material if its misstatement (i.e., omission or erroneous Statement) could influence the economic decisions of users taken on the Basis of the financial information. Materiality depends on the size and Nature of the item, judged in the particular circumstances of its misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful.
2. The objective of an audit of financial information prepared within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, is to enable the auditor to express an opinion on such financial information. The assessment of what is materiality of professional judgment.
3. The concept of materiality recognizes that some matters, either individually or in the aggregate, are relatively important for true and fair presentation of financial information in conformity at

both the overall financial information level and in relation to individual account balances and classes of transactions. Materiality may also be influenced by other considerations, such as the legal and regulatory requirements, non-compliance with which may have a significant bearing on the financial information, and consideration relating to individual account balances and relationships. This process may result in different levels of materiality depending on the matter being audited.

4. Although the auditor ordinary establishes an acceptable materiality level to detect quantitatively material misstatements, both the amount (quantity) and nature (quality) of misstatements need to be considered. An example of a qualitative misstatement would be the inadequate or improper description of an accounting policy when it is likely that a user of the financial statements would be misled by the description.
5. The auditor needs to consider the possibility of misstatements of relatively small amounts that, cumulatively, could have a material effect on the financial information. For example, an error in a month-end (or other periodic) procedures could be an indication of a potential material misstatement if that error is repeated each month or each period, as the case may be.
6. Materiality should be considered by the auditor when-
 - (a) Determining the nature, timing and extent of audit procedures;
 - (b) Evaluating the effect of misstatements.

2.9.2 GOING CONCERN:

1. The purpose of this Auditing and Assurance standard (AAS) is to establish standards on the auditor's responsibilities in the audit of financial statements regarding the appropriateness of the going concern assumption as a basis for the financial statements.
2. When planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of the going concern assumption underlying the preparation of the financial statements.
3. The auditor's report helps establish the credibility of the financial statements. However, the auditor's report is not a guarantee as to the future viability of the entity.
4. An entity's continuous as a going concern for the foreseeable future, generally a period not to exceed one year after the balance sheet date, is assumed in the preparation of financial statements in the absence of information to the contrary. Accordingly, asset and liabilities are recorded on the normal course of business. If this assumption is unjustified, the entity

may not be able to realize its assets at the recorded amounts and there may be changes in the amounts and maturity dates of liabilities. As a consequence, the amounts and classification of assets and liabilities in the financial statement may need to be adjusted.

APPROPRIATENESS OF THE GOING CONCERN ASSUMPTION

- I. The auditor should consider the risk that the going concern assumption may no longer be appropriate.
- II. Indications of risk that continuance as a going concern may be questionable could come from the financial statements or from other sources. Examples of such indications that would be considered by the auditor are listed below. This listing is not all-inclusive nor does the existence of one or more always signify that the going concern assumption needs to be questioned.



AUDIT PLANNING

STRUCTURE:

- 3.0 Objectives
- 3.1 Meaning:
- 3.2 Objectives Of Planning
- 3.3 Factors To Be Considered
- 3.4 Sources Of Obtaining Information
- 3.5 Development Of An Overall Plan
- 3.6 Meaning Of Audit Programme
- 3.7 Factors Advantages And Disadvantages Of Audit Programme
- 3.8 Audit Working papers

3.0 OBJECTIVES

After studying the unit the students will be able to

- Define Audit Planning
- Understand the Objectives of Audit Planning
- Understand the Meaning of Audit Programme
- Explain the factors, advantages and disadvantages of Audit Programme
- Know the meaning of Audit Papers.

3.1 MEANING

As per Auditing and Assurance Standard 1, “Basic Principles Governing an Audit”, Audit Planning is one of the basic principles. Accordingly, it states

“The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client’s business. Plans should be made to cover, among other things:

- (a) Acquiring knowledge of the client’s accounting systems, policies and internal control procedures;
- (b) Establishing the expected degree of reliance to be placed on internal control;
- (c) Determining and programming the nature, timing, and extent of the audit procedures to be performed; and

(d) Coordinating the work to be performed.

Plans should be further developed and revised as necessary during the course of the audit.”

AAS-8 further expounds this principle. According to it, planning should be continuous throughout the engagement and involves

- Developing an overall plan for the expected scope and conduct of the audit; and
- Developing an audit programme showing the nature, timing and extent of audit procedures.

Changes in conditions or unexpected results of audit procedures may cause revisions of the overall plan of and the audit programme. The reasons for significant changes may be documented.

3.2 OBJECTIVES OF PLANNING

Adequate audit planning helps to:

- Ensure that appropriate attention is devoted to important areas of the audit.
- Ensure that potential problems are promptly identified;
- Ensure that the work is completed expeditiously;
- Utilize the assistants properly; and
- Co-ordinate the work done by other auditors and experts.

In planning his audit, the auditor will consider factors such as complexity of the audit, the environment in which the entity operates his previous experience with the client and knowledge of the client's business.

The auditor may wish to discuss elements of his overall plan and certain audit procedures with the client to improve the efficiency of the audit and to coordinate audit procedures with work of the client's personnel. The overall audit plan and the audit programme, however, remain the auditor's responsibility.

3.3 FACTORS TO BE CONSIDERED

Planning his audit, the Auditor will consider the following factors -

Complexity of the Audit: The scope of work and reporting responsibilities is analysed in order to determine the complexity of audit.

Environment in which the entity operates: This enables the Auditor to understand various operational aspects of audit, e.g. extent of computerization, nature of internal controls, general attitude of personnel, etc.

Previous experience with the client: By analysing the previous year's audit working papers and other relevant files, the Auditor should pay

particular attention to matters that required special consideration and decide whether they might affect the work to be done in the current year.

Knowledge of the client's business: This is required to establish the overall audit plan. The Auditor will be able to - (a) identify areas of special audit consideration, (b) evaluate the reasonableness both of accounting estimates and management representations, and (c), make judgments regarding the appropriateness of accounting policies and disclosures.

Discussion with Client: The Auditor can discuss his overall plan and certain audit procedures with the client to improve the efficiency of the audit and to coordinate audit procedures with work of the client's personnel. The overall audit plan and the audit Programme, however, remain the Auditor's responsibility.

3.4 SOURCES OF OBTAINING INFORMATION

Sources of information listed under AAS - 8: The Auditor should obtain a level of knowledge of the client's business that will enable him to identify the events, transactions and practices that, in his judgment, may have significant effect on the financial information. The Auditor can gain knowledge of client's business from –

The client's Annual Reports to Shareholders.

Minutes of Meetings of Shareholders, Board of Directors and important Committees.

Internal Financial Management Reports for current and previous periods, including Budgets, if any.

Previous year's Audit Working Papers, and other relevant files.

Key Personnel responsible for non-audit services to the client who may be able to provide information on

matters that may affect the audit.

Discussions with Client.

Client's Policy and Procedures Manual.

Relevant publications of the ICAI and other professional bodies, Industry Publications, Trade Journals,

Magazines, Newspapers or Textbooks.

Consideration of the state of the economy and its effect on the client's business.

Visits to the client's premises and plant facilities.

Discussion with client:

ording to AAS - 8, during the course of planning the audit, discussions with the client might include the wing subjects -

Changes in Management, Organisational Structure, and activities of the client.

Current Government Legislation, Rules, Regulations and Directives affecting the client.

Current Business Developments affecting the client.

Current or impending Financial Difficulties or Accounting Problems.

Existence of Interested Parties and transactions with them.

3.5 DEVELOPMENT OF AN OVERALL PLAN

The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit:

- The terms of his engagement and any statutory responsibilities.
- The nature and timing of reports or other communication.
- The applicable legal or statutory requirements.
- The accounting policies adopted by the client and changes in those policies.
- The effect of new accounting or auditing pronouncements on the audit.
- The identification of significant audit areas.
- The setting of materiality levels for audit purposes.
- Conditions requiring special attention, such as the possibility of material error or fraud or the involvement of parties in whom directors or persons who are substantial owners of the entity are the act of examining vouchers is referred to as vouching. It is the practice followed in an audit, with the objective of establishing the authenticity of the transactions recorded in the primary books of account. It essentially consists of verifying a transaction recorded in the books of account with the relevant documentary evidence and the authority on the basis of which the entry has been made; also confirming that the amount mentioned in the voucher has been posted to an appropriate account which would disclose the nature of the transaction on its inclusion in the final statements of account. On these considerations, the essential points to be borne in mind while examining a voucher are:

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

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

3.6 MEANING OF AUDIT PROGRAMME

MEANING:

It is desirable that in respect of each audit and more particularly for bigger audits an audit programme should be drawn up. Audit programme is nothing but a list of examination and verification steps to be applied set out in such a way that the inter-relationship of one step to another is clearly shown and designed, keeping in view the assertions discernible in the statement of account produced for audit or on the basis of an appraisal of the accounting records of the client. In other words, an audit programme is a detailed of the accounting records of applying the audit procedures in the given circumstances with instructions for the appropriate techniques to be adopted for accomplishing the audit objectives. Businesses vary in nature, size and composition; work which is suitable to one business may not be suitable to be rendered by the auditor are the other factors that vary from assignment to assignment. Because of such variations, evolving one audit programme applicable to all business under all circumstances is not practicable. However it becomes a necessity to specify in details in the audit programme the nature of work to be done so that no time will be wasted on matters not pertinent to the engagement and any special matter or any specific situation can be taken care of.

An audit programme consists of a series of verification procedures to be applied to the financial statements and accounts of a given company for the purpose of obtaining sufficient evidence to enable the auditor to

express an informed opinion on such statements. For the purpose of programme construction, the following points should be kept in view:

1. stay within the scope and limitation of the assignment.
2. determining the evidence reasonable available and identify the best evidence for deriving the necessary satisfaction.
3. Apply only these steps and procedures which are useful in accomplishing the verification purpose In the specific situation.
4. consider all possibilities of error.
5. co-ordinate the procedures to be applied to related items.

Amplification is not necessary of the above points except the one under evidence: that is the very basis for formulation of opinion and an audit programme is designed to provide for that by prescribing procedures and techniques. What is best evidence for testing the accuracy of any assertion is a matter of experts knowledge and evidence. This is the primary task before the auditor when he draws up the audit programme. Transactions are varied in nature and impact; procedures to be prescribed depend on prior knowledge of what evidence is reasonable available in respect of each transaction

3.7 FACTORS ADVANTAGES AND DISADVANTAGES OF AUDIT PROGRAMME

3.7.1 FACTORS

While construction an audit programme, the Auditor should keep the following points in his mind-

1. to operate within the scope and limitations of the assignment.
2. to determine the evidence reasonably available and identify the best evidence for deriving the necessary satisfaction.
3. to apply only those steps and procedures, which are useful in accomplishing the verification purpose in the specific situation.
4. to consider all possibilities of error.
5. to co-ordinate the procedures to be applied to related items.

3.7.2 ADVANTAGES OF AUDIT PROGRAMME

- a. It provides the assistant carrying out the audit with total and clear set of instructions of the work generally to be done.
- b. It is essential, particularly for major audits, to provide a total perspective of the work to be performed.
- c. Selection of assistants for the jobs on the basis of compatibility becomes easier when the work is rationally planned, defined and segregated.
- d. Without a written and pre-determined programme, work is necessarily to be carried out on the basis of some 'mental' plan. In such a situation there is always a danger of ignoring or overlooking certain books and records. Under a properly framed programme, the danger is significantly less and the audit can proceed systematically.
- e. The assistance, by putting their signature on programme, accepts the responsibility for the work carried out by them individually and, if necessary, the work done may be traced back to the assistant.
- f. The principal can control the progress of the various audits in hand by examination of audit programmes initiated by the assistants deputed to the jobs for completed work.
- g. It serves as a guide for audits to be carried out in the succeeding year.
- h. A properly drawn up audit programme serves as evidence in the event of any charge of negligence being brought against the auditor. It may be of considerable value in establishing that he exercised reasonable skill and care that was expected of professional auditor.

3.7.3 DISADVANTAGES OF AUDIT PROGRAMME

- a. The work may become mechanical and particular parts of the programme may be carried out without any understanding of the object of such parts in the whole audit scheme.
- b. The programme often tends to become rigid and inflexible following set grooves; the business may change in its operation or conduct, but the old programme may still be carried on. Changes in staff or internal control may render precaution necessary at points different from those originally decided upon.
- c. Inefficient assistants may take shelter behind the programme i.e., defend deficiencies in their work on the ground that no instructions in the matter are contained therein.

- d. A hard and fast audit programme may kill the initiative of efficient and enterprising assistants.

All these disadvantages may be eliminated by imaginative supervision of the work carried on by the assistants; the auditor must have a receptive attitude as regards the assistants; the assistants should be encouraged to observed matters objectively and bring significant matters to the notice of supervisor/principal.

3.8 AUDIT WORKING PAPERS

3.8.1 MEANING:

The audit working papers constitute the link between the auditor's report and the client's records. Documentation is one of the basic principles listed in AAS 1. according to AAS 3 (reproduced in Appendix I), documentation refers to working papers prepared or obtained by the auditor and retained by him in connections with performance of his audit. The objects of an auditor's working papers are to record and demonstrate the audit work from one year to another. Therefore, working papers should provide for:

- a) Means of controlling current audit work;
- b) Evidence of audit work performed;
- c) Schedules supporting or additional item in the accounts; and
- d) Information about the business being audited, including the recent history.

Working papers are varied in nature but the foundation of all working paper can be traced to:

- 1. the basic constitutional document like memorandum and Articles of association, partnership Deed, trust deed, etc.;
- 2. the contents of the minute books;
- 3. the contents of the balance sheet and the profit and loss account; and
- 4. the letter of engagement.

3.8.2 IMPORTANCE OF AUDIT WORKING PAPERS:

- I. IT provides guidance to the audit staff regard to the manner of checking the schedules.
- II. The auditor is able to fix responsibility on the staff member who signs each schedule checked by him.

- III. It acts as an evidence in the court in the court of law when a charge of negligence is brought against the auditor.
- IV. It acts as the process of planning for the auditor so that he can estimate the time that may be required for checking the schedules.

The auditor should adopt reasonable procedures for custody and confidentiality of his working papers and should retained them for a period of time sufficient to meet the needs of his practice and satisfy any pertinent legal or professional requirements of record retention.

3.8.3 FACTOR DETERMINING FORM AND CONTENTS OF AUDIT WORKING PAPERS:

Working papers should record the audit plan, nature, timing and extent of auditing procedures performed, and the conclusions drawn from the evidence obtained. The form and content of working papers are affected by matters such as:

- Nature of the engagement.
- Form of the auditor's report.
- Nature and complexity of the client's business.
- Nature and condition of the client's records and degree of reliance on internal controls.
- Need in particular circumstances for direction, supervision and review of work performed by assistants.

Working papers should be designed and properly organized to meet the circumstances of each audit and the auditor's needs in respect thereof. The standardization of working papers (for example, checklists, specimen letters, standard organisation of working papers) improves the efficiency with which they are prepared and reviewed. It also facilitates the delegation of work while providing a means to control its quality. Working papers should be sufficiently complete and detailed for an auditor to obtain an overall understanding of the audit. The extent of the documentation is a matter of professional judgement since it is neither necessary nor practical that every observation, consideration, consideration or conclusion is documented by the auditor in his working papers.

3.8.4 A Permanent Audit File

A permanent audit file normally includes

- ◆ Information concerning the legal and organizational structure of the entity. In case of a company, this includes the memorandum and Article of association. In the case of a statutory corporation, this includes the act and regulations under which the corporation functions.
- ◆ Extracts or copies of important legal documents, agreements and minute relevant to the audit.
- ◆ A record of the study and the evaluation of the internal controls related to the accounting system. This might be in the form of narrative descriptions, questionnaires or flow charts, or some combination thereof.
- ◆ Copies of audited financial statements for previous years.
- ◆ Analysis of significant ratios and trends.
- ◆ Copies of management letters issued by the auditor, if any.
- ◆ Record of communication with the retiring auditor, if any, before acceptance of the appointment as auditor.
- ◆ Notes regarding significant accounting policies.
- ◆ Significant audit observations of earlier years.

3.8.5 The Current File

The current file normally includes

- ◆ Correspondence relating to acceptance of annual reappointment.
- ◆ Extracts of important matters in the minutes of board meetings and general meetings as relevant to audit.
- ◆ Evidence of the planning of the audit and audit programme.
- ◆ Analysis of transactions and balances.
- ◆ A record of the nature, timing and extent of auditing procedures performed, and the results of such procedures.
- ◆ Evidence that the work performed by assistants was supervised and reviewed.
- ◆ Copies of communication with other auditors, experts and other third parties.
- ◆ Letters of representation or confirmation received from the client.
- ◆ Conclusions reached by the auditor concerning significant aspects of the audit, including the manner in which exceptions and unusual matters, if any, disclosed by the auditor's procedures were resolved or treated.
- ◆ Copies of the financial information being reported on the related audit reports.

3.8.6 MAIN FUNCTIONS/ IMPORTANCE

- i. It provides guidance to the audit staff with regards to the manner of checking the schedules.
- ii. The auditor is able to fix responsibility on the staff member who sign each schedule checked by him.
- iii. It acts as an evidence in the court of law when a charge of negligence is brought against the auditor.
- iv. It acts as the process of planning for the auditor so that he can estimate the time that may be required for checking the schedules.

The auditor should adopt reasonable procedures for custody and confidentiality of his working papers and should retain them for a period of time sufficient to meet the needs of his practice and satisfy any pertinent legal or professional requirement of record retention.

Clarification On The Auditor's Rights Where Clients And Other Auditors Seek Access To Their Audit Working Papers.

1. Auditing and Assurance standard (AAS) 1, "Basic principles governing an audit", states in para6: "The auditor should respect the confidentiality of information acquired in the course of his work and should not disclosed any such information to a third party without specific authority or unless there is a legal or professional duty to disclosed". Auditing and Assurance standard (AAS) 3, "Documentation" (paragraph 13), states: 'working papers are the property of the auditor. The auditor may at his discretion, make portions of or extracts from his working papers available to his client. "AAS 3 further requires (paragraph 14)",inter alia, that the "auditor should adopt reasonable procedures for custody and confidentiality of his working papers."

2. part I of the second schedule to the chartered Accountants Act, 1949, provides that "A Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he disclosed information acquired in the course of his professional engagement to any person other than his client, without the consent of his client or otherwise than as required by any law for the time being in force."

3. Request are sometime received by the members of the institute, who have/had been performing the duties as the auditor of an enterprises, to provide access to their audit working papers. The request may be made by the clients or other auditors of the enterprise or its related enterprise such as a parent enterprise.

4. It is hereby clarified that except to the extent stated in para 5 below, an auditor is not required to provide the client or the other auditors of the same enterprise or its related enterprise such as a parent or a subsidiary,

access to his audit working papers. The main auditors of an enterprise do not have right of access to the audit working papers of the branch auditors. In the case of a company, the statutory auditor has to consider the report of the branch auditor and has a right to seek clarifications and/or to visit the branch if he deems it necessary to do so for the performance of the duties as auditor. An auditor can rely on the work of another auditor, without having any right of access to the audit working papers of the other auditor. For this purpose, the term 'auditor' includes 'internal auditor'.

5. As stated in para 4, the client does not have a right to access the working papers of the auditor. However, the auditor may, at his discretion, in case considered appropriate by him, make portions of or extracts from his working papers available to the client.

3.8.7 FEATURES

As audit working papers are quite useful they should be prepared properly. They should have the following essentials:

- a) **Standard form** - they should be prepared in a standard form. The subject matter should be arranged under various heading and sub-headings.
- b) **Proper layout** – there should be proper design and layout of the working papers. This will bring uniformity into the maintenance of working papers.
- c) **Space for margins** – there should be enough space for margin after each note for noting down the auditor's remarks and decisions.
- d) **proper organisation and arrangement** – the working papers should be properly organized and arranged. In other words the working papers should be so organized and arranged that the auditor will be able to locate any particular matter easily.
- e) **Completeness** – the audit working papers should be complete in all respects. They should contain detailed information on all essential facts or points.
- f) **Clarity and Accuracy** – the working papers should be quite clear and self explanatory. The information contained in the working papers should be accurate.
- g) **Good quality paper** – paper of good quality should be used for working papers as they are subject to frequent handling further the paper used should be of uniform and convenient size so that they can be easily filed.

3.8.8 OWNERSHIP, AND CUSTODY OF WORKING PAPERS

Working papers are the property of the auditor. The auditor may, at his discretion may, at his discretion, make portions of or extracts from his working papers available to his client. Audit working papers are the

property of the auditor and he is entitled to retain them. (chantery martin & co. v. martin).



AUDITING TECHNIQUES AND INTERNAL AUDIT INTRODUCTION I

STRUCTURE

- 4.0 Objectives
- 4.1 Test Checking Meaning
- 4.2 Features Of Test Checking
- 4.3 Factors To Be Considered
- 4.4 Advantages And Disadvantages Of Test Checking
- 4.5 Test Checking Vs Routing Checking
- 4.6 Audit Sampling

4.0 OBJECTIVES

- Know the meaning of Test Checking
- Understand the features of Test Checking
- Know the advantages and disadvantages of Test Checking
- Distinguish between test checking and routing checking
- Understand the meaning of Audit sample

4.1 TEST CHECKING MEANING

4.1.1 Meaning: Examination in Depth means examination of a few selected transactions from the beginning to the end through the entire flow of the transaction. It involves studying the recording of transactions the

various stages through which they have passed **2. Aspects of Verification**

- (a) At each stage, relevant records and authorities are examined; it is also judged whether the person who has exercised the authority in relation to the transactions is fit to do so in terms of the prescribed procedure.
 - (b) While auditing in depth, the Auditor reviews all the accounting and operational aspects of the transaction from the origin to the end. This enables him to have an overall view and evaluate the procedures through selected transactions.
- 3. A Representative Sample** must be open and each item selected must be traced meticulously.
 - 4. A smaller number of transactions** are checked at each successive stage with an in-depth test, on statistical grounds (based on probability theory) that the optimum sample size decreases as the Auditor's "level of confidence" concerning the functioning of the

system increases.

5. **Examination in depth** reconstructs the audit trail and reveals more about the functioning (or malfunctioning) of the client's system in practice than the haphazard and mechanical approach to testing
6. **Example:** Audit in depth of transactions relating to purchase of goods involves verification of the following
 - (a) Purchase Requisition - pie-printed, pre-numbered and authorised;
 - (b) Invitation of quotations and analysis of the same;
 - (c) Official Purchase Order, sequentially pre-numbered, authorised and placed with approved suppliers only;
 - (d) Receipt of goods, together with Delivery Challan / Advice Note;
 - (e) Admission of goods to stores after verification of quality, quantity etc.;
 - (f) Entry in Stores Records;
 - (g) Receipt of Supplier's Invoice and Statement;
 - (h) Approval of Purchase Invoice regarding compliance for specification, quantity and quality;
 - (i) Entries in Purchases day book;
 - (j) Postings to Purchase Ledger and Purchase Ledger Control Account;
 - (k) Payment of Cheque in settlement of invoice after availing discounts; if any;
 - (l) Entry for payment in Cash / Bank Book;
 - (m) Posting from Cash Book to Ledger and Control Accounts.
1. Test Checking means to select and examine a representative sample from a large number of similar items.
2. Test Checking is an accepted auditing procedure wherein instead of checking all transactions, only a part of it is checked in detail to form an opinion on the whole

4.2 FEATURES OF TEST CHECKING

Test checking consists of selecting and checking a proportion of transactions selected by the Auditor. The salient features of Test Checking are -

1. **Scientific:** It is a mathematical truth that a scientifically selected sample would reveal the features and characteristics of the population. The statistical theory of sampling is based on a scientific law. Hence, it

can be relied upon to a greater extent than any arbitrary technique which lacks basis and acceptability.

2. Estimation Process: Test Checking and Sampling can never bring complete reliability; it cannot give accurate results. It is a process of estimation. What error is tolerable for a particular matter under examination is a matter of the individual's judgment in that particular

3. Coverage of material items: Entries involving large amounts or relating to material accounts are seen exhaustively and other entries are picked up for verification from the remainder according to a certain plan. Sometimes entries are checked for a few specified months exhaustively and the rest go unchecked.

4. Full Coverage over a time period: Test Check is normally planned in such a way that the audit programmes for 3 to 5 years cover all types of transactions in case of a medium or large sized Company. Thus, if in one year the months of January, June and December are checked; April, July and September may be checked in the second year and so on.

5. Surprise Element: The staff and management of the Auditee Company should not be able to anticipate the pattern of test checking, otherwise they will predict the areas and periods to be covered in any one year and will be careful regarding the same.

6. Flexibility: If test checking becomes routine, predictable and mechanical, it loses its value. Hence, the Auditor should keep changing the methods of test checking at reasonably frequent intervals.

7. Judgment Based: The extent of test checking would primarily depend on the Auditor's judgment of a particular situation. This judgement in turn depends on the previous experience of the Auditor, current developments and the efficacy of Internal Control System.

4.3 FACTORS TO BE CONSIDERED

The factors to be considered for deciding upon the extent of checking on a sampling plan are -

1. Size of the organization under audit.
2. State and efficacy of the internal control.
3. Adequacy and reliability of books and records.
4. Tolerable error range.
5. Degree of the desired confidence.

WHEN TEST CHECK CAN BE USED?

Test checks can be adopted in the following cases -

- 1. Volume of Transactions:** In case of big concerns where number of transactions is quite large.
- 2. Time factor:** Where the Auditor has very little time at his disposal to check all the transactions of a medium or large sized concern.

Identical Transactions: When there are a number of transactions of identical and homogeneous nature. **Internal Control:** When there exists a satisfactory internal control system, manual and / or computerized.

4.4 ADVANTAGES AND DISADVANTAGES OF TEST CHECKING

4.4.1 ADVANTAGES OF TEST CHECKING

The advantages of Test Checking include -

Audit Objective: The Auditor is required to form an opinion on the Financial Statements. Even after 100% checking, he may not derive absolute satisfaction. Hence, proper and careful test checking serves the audit objective in obtaining reasonable audit assurance.

Expertise: Application of test check principles involves the application of mind and intelligent judgment. It enables the Auditor to use his expertise effectively.

Exception Principle: Test Checking adopts the principle of exception in control. If certain aspects of internal control do not create suspicion, there is no need to verify all those transactions exhaustively.

Scientific Assessment of Risk: The Auditor assesses the risk of material misstatements in the Financial Statements in a scientific manner by drawing suitable samples and studying the same in detail.

Saving in time: As fewer transactions are verified, time is saved to a great extent. This, in turn, enables completion of all the audits / verification procedures in time.

Reduction in Work: Volume of work is reduced by test checking methods. Audit processes are not carried out mechanically on all transactions.

4..4.2 DISADVANTAGES PRECAUTIONS

The disadvantages of Test Checking are –

Naive and Biased: The extent to which test checking can be resorted to is a matter of Auditor's personal assessment. It does not ensure selection of representative samples of adequate size and offers opportunities for bias to enter into selection process.

Unauthentic : Test Checking lacks authenticity, precision and an acceptable basis. It does not give the Auditor an idea about the degree of reliability that can be placed on the findings for application to the whole set of entries.

Higher Risk: runs the risk that some of the material error may not be discovered and some of the important areas may go unaudited. Sometimes, it may increase the level of inherent Audit Risk.

Unscientific: It involves lot of arbitrariness on the part of the Auditor in determining and selecting the number of transactions. Therefore, the approach cannot be considered as a scientific one.

Difference in activity levels: Where activity levels vary in a year, e.g. a few months of peak production and sales seasons, the Auditor cannot draw reasonable conclusions about the transactions of the whole year merely by checking transactions of a few specified months.

Lack of Surprise Element: If the surprise element is absent, the client may predict the pattern of checking.

4.5 TEST CHECKING VS ROUTING CHECKING

Particulars	Test checking	Routine checking
Meaning	Test checking is an accepted auditing procedure wherein only a part of its transactions is checked to form an opinion instead of checking the transactions.	Routine checking is the detailed checking of all transactional aspects such as casts, sub – casts, carry-forwards, extensions and calculations etc. in subsidiary books, checking of posting into the ledgers, casting of ledger accounts and extraction of their balances etc.
Objectives	To obtain a reasonable level of satisfaction about all transactions but verifying a few representative transactions called “sample”.	(a) to verify the arithmetical accuracy of the entries, (b) to verify the accuracy of posting to ledgers. © to check that the ledger accounts have been correctly balanced, and (d) to ensure that no figures are altered after checking.
Advantages	(a) Saving in time. (b) Proper and careful test checking is helpful & serves the audit objective. © Volume of work is reduced. (d) Time available for other audits.	(a) Checking of posting and ledgers. (b) Arithmetical accuracy can be checked. © Trial balance tallying is facilitated. (d) Easy detection of errors and frauds. (e) Delegation of audit work to junior staff.
Disadvantages	(a) Client staff may become careless. (b) Some errors and frauds may go undetected. © All items and transactions are not checked. (d) An elements of doubt and risk is present in the Auditor's opinion.	(a) Is a highly mechanical process. (b) Monotonous activity may lead to boredom. © Major items of frauds and high level intricacies and complexities may not be revealed. (d) Compensating Errors and Errors of Principle will not come to light.

4.6 AUDIT SAMPLING

4.6.1 MEANING:

1. The purpose of this Auditing and Assurance Standard (AAS) is to establish standards on the design and selection of an audit sample and the evaluation of the sample results. This AAS applies equally to both statistical sampling methods. Either method, when properly applied, can provide sufficient appropriate audit evidence

2. **When using either statistical or non-statistical sampling methods, the auditor should design and select an audit sample, perform audit procedures thereon, and evaluate sample results so as to provide sufficient appropriate audit evidence.**

3. “Audit sampling” means the application of audit procedures to less than 100% of the items within an account balance about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population.

4. It is important to recognise that certain testing procedures do not come within the definition of sampling. Tests performed on 100% of the items within a population do not involve sampling. Likewise, applying audit procedures to all items within a population which have a particular characteristic (for example, all items over a certain amount) does not qualify as audit sampling with respect to the population examined, nor with regard to the population as a whole, since the items were not selected from the total population on a basis that was expected to be representative. Such items might imply some characteristic of the remaining portion of the population but would not necessarily be the basis for a valid conclusion about the remaining portion of the population.

4.6.2 FACTORS IN DETERMINING SAMPLE SIZE- SAMPLING RISK

(1) When determining the sample size, the auditor should consider sampling risk, the tolerable error, and the expected error. Examples of some factors affecting sample size are contained in Appendix 1 and Appendix 2.

SAMPLING RISK

(2) Sampling risk²⁰ arises from the possibility that the auditor conclusion, based on a sample, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure.

(3) The auditor is faced with sampling risk in both tests of control and substantive procedure as follow:

(a) Tests of control:

- (I) Risk of under reliance: The risk that, although the sample result dose not support the auditor's assessment of control risk, the actual compliance rate would support such an assessment.
- (II) Risk of over reliance: The risk that, although the sample result supports the auditor's assessment of control risk, the actual compliance rate would not support such as an assessment.

(b) Substantive procedures:

- (I) Risk of incorrect rejection: The risk that, although the sample results the supports the conclusion that a recorded account balance or class of transactions is materially misstated, in fact it is not materially misstated.
 - (II) Risk of incorrect acceptance: The risk that, although the sample result supports the conclusion that a recorded account balance or class or transactions is not materially misstated.
- (4) The risk of under reliance and the risk of incorrect rejection affect audit efficiency as they would ordinarily lead to additional work being performed by the auditor, or the entity, which would establish that the initial conclusions were incorrect. The risk of over reliance and the risk of incorrect acceptance affect audit effectiveness and are more likely to lead to an erroneous opinion on the financial statements than either the risk of under reliance or the risk of incorrect rejection.
- (5) Sample size is affected by the level of sampling risk the auditor is willing to accept from the results of the sample. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

Tolerable Error

1. Tolerable error is the maximum error in the population that the auditor would be willing to accept and still conclude that the result from the sample has achieved the audit objective. Tolerable error is considered during the planning stage and, for substantive procedures, is related to the auditor's judgement about materiality. The smaller the tolerable error, the greater the sample size will need to be.

16. In tests of control, the tolerable error is the maximum rate of

deviation from a prescribed control procedure that the auditor would be willing to accept, based on the preliminary assessment of control risk. In substantive procedures, the tolerable error is the maximum monetary error in an account balance or class of transactions that the auditor would be willing to accept so that when the results of all audit procedures are considered, the auditor is able to conclude, with reasonable assurance, that the financial statements are not materially misstated.

Expected Error

2. If the auditor expects error to be present in the population, a larger sample than when no error is expected ordinarily needs to be examined to conclude that the actual error in the population is not greater than the planned tolerable error. Smaller sample sizes are justified when the population is expected to be error free. In determining the expected error in a population, the auditor would consider such matters as error levels identified in previous audits, changes in the entity's procedures, and evidence available from other procedures

4.6.3 SELECTION OF THE SAMPLE

18. The auditor should select sample items in such a way that the sample can be expected to be representative of the population. This requires that all items in the population have an opportunity of being selected.

19. While there are a number of selection methods, three methods commonly used are:

Random selection, which ensures that all items in the population have an equal chance of selection, for example, by use of random number tables.

Systematic selection, which involves selecting items using a constant interval between selections, the first interval having a random start. The interval might be based on a certain number of items (for example, every 20th voucher number) or on monetary totals (for example, every Rs 1,000 increase in the cumulative value of the population). When using systematic selection, the auditor would need to determine that the population is not structured in such a manner that the sampling interval corresponds with a particular pattern in the population. For example, if in a population of branch sales, a particular branch's sales occur only as every 100th item and the sampling interval selected is 50, the result would be that the auditor would have selected all, or none, of the sales of that particular branch.

- * *Haphazard selection*, which may be an acceptable alternative to random selection, provided the auditor attempts to draw a representative sample from the entire population with no intention to either include or exclude specific units. When the auditor uses this method, care needs to be taken to guard against making a selection that is biased, for example, towards items which are easily

located, as they may not be representative.

4.6.4 EVALUATION OF SAMPLE RESULTS

20. Having carried out, on each sample item, those audit procedures that are appropriate to the particular audit objective, the auditor should:

- (a) analyse any errors detected in the sample;**
- (b) project the errors found in the sample to the population;**
and
- (c) Reassess the**
sampling risk.
Analysis of
Errors in the
Sample

21. In analyzing the errors detected in the sample, the auditor will first need to determine that an item in question is in fact an error. In designing the sample, the auditor will have defined those conditions that constitute an error by reference to the audit objectives. For example, in a substantive procedure relating to the recording of accounts receivable, a mis-posting between customer accounts does not affect the total accounts receivable. Therefore, it may be appropriate to consider this an error in evaluating the sample results of this particular procedure, even though it may have an effect on other areas of the audit such as the assessment of doubtful accounts.

12. When the expected audit evidence regarding a specific sample item cannot be obtained, the auditor may be able to obtain sufficient appropriate audit evidence through performing Alternative procedures. For example, if a positive account receivable confirmation has been equated and no reply was received, the auditor may be able to obtain sufficient appropriate audit evidence that the receivable is valid by reviewing subsequent payments from the customer. If the auditor does not, or is unable to, perform satisfactory alternative procedures, or if the procedures performed do not enable the auditor to obtain sufficient appropriate audit evidence, the item would be treated as an error.

>3. The auditor would also consider the qualitative aspects of the errors. These include the nature and cause of the error and the possible effect of the error on other phases of the audit.

24. In analysing the errors discovered, the auditor may observe that many have a common feature, for example, type of transaction, location, product line, or period of time. In such circumstances, the auditor may decide to identify all items in the population which possess the common feature, thereby producing a sub-population, and extend audit procedures in this area. The auditor would then perform a separate analysis based on the items examined for each

sub-population.

Projection of Errors

25. The auditor projects the error results of the sample to the population from which the sample was selected. There are several acceptable methods of projecting error results. However, in all the cases, the method of projection will need to be consistent with the method used to select the sampling unit. When projecting error results, the auditor needs to keep in mind the qualitative aspects of the errors found. When the population has been divided into sub-population, the projection of errors is done separately for each sub-population and the results are combined.

Reassessing Sampling Risk

26. The auditor needs to consider whether errors in the population might exceed the tolerable error. To accomplish this, the auditor compares the projected population error to the tolerable error taking into account the results of other audit procedures relevant to the specific control or financial statement assertion. The projected population error used for this comparison in the case of substantive procedures is net of adjustments made by the entity. When the projected error exceeds tolerable error, the auditor reassesses the sampling risk and if that risk is unacceptable, would consider extending the audit procedure or performing alternative audit procedures.



INTERNAL CONTROL

STRUCTURE

- 5.1 Objectives
- 5.2 Introduction
- 5.3 Meaning and definition of internal control
- 5.4 Forms of internal control
- 5.5 Internal audit
- 5.6 Internal check

5.1 OBJECTIVES:

After studying this unit you will be able to

- Explain the meaning and objectives of internal control.
- Enumerate the features of a good internal control system.
- Distinguish between internal audit and statutory audit.
- Describe the meaning and objectives of internal check system.
- Device system of internal check with regard to cash sales.
credit sales, wages and salaries, purchases, stock etc.
- Explain the duty of the auditor with regard to internal check.
- Understand audit in respect of computerised environment.

5.2 INTRODUCTION

Internal control is another important area of auditing. Internal control refers to a number of checks and controls exercised in a business to ensure its efficient and economic working. In this unit you will learn the meaning and objectives of internal control and internal check. You will also learn various system of internal check and generally understand audit in respect of computer environment.

5.3 MEANING AND DEFINITION OF INTERNAL CONTROL

Internal control is an important tool of management. It assists the management in the performance of its various functions. It means the built in cross-checks in the system supplemented with proper supervision and internal audit carried out by the staff appointed by the organisation. These days business has become more complex both in nature and size and the management finds it difficult to get correct information about the various aspects of the business. Internal control assures the management that the information supplied to it is reliable and accurate. The internal controls are exercised to ensure the accuracy and the reliability of accounting data and other records, to identify weaker areas of operation and to improve them to increase operational efficiency of the business, to safeguard its assets and to ensure orderly conduct of business.

The American Institute of Public Accountants has defined internal control as the plan of organisation and all the co-ordinate methods, and measures adopted within a business to safeguard its assets, check the accuracy and the reliability of its accounting data, promote operational efficiency and encourage adherence to prescribed managerial policies. A system of internal control extends beyond those matters which relate directly to the function of the accounting and financial departments.

The Institute of Chartered Accountants of England and Wales defines internal control as "internal control means not only internal check or internal audit, but the whole system of control financial and otherwise, established by management in order to carry on the business of the company in an orderly manner, safeguard its assets and secure as far as possible accuracy and reliability of its records".

If we analyze the above definitions it would be evident that internal control is a broad term with a wide coverage. It consists of a number of checks and controls which are exercised in a business to ensure its efficient and economic working. Thus internal control involves a sort vigilance and directions over important matters like budget and finance, purchase and sales and internal administration by the management.

Every business enterprise is expected to devise a suitable system of internal control in order to carry on the business in an efficient and orderly manner. These controls are accounting control, budgetary control, statistical analysis and internal checks and internal audit. In simple words, it means number of checks and controls over the various activities of a business. Generally, a system of internal control will include all those measures which assist a business enterprises to fulfill the following objectives.

Objective of internal control

- To minimize, if not completely eliminate, wastage and inefficiencies in business operations and to safeguard the assets of the business.
- To ensure high degree of accuracy and reliability of accounting data and promote operational efficiency.
- To measure how far the policies of the management are being implemented, and
- To evaluate the efficiency of performance in all aspects of business activities and to highlight the weaknesses.

5.4 FORMS OF INTERNAL CONTROL

Various forms of internal control help in ensuring correct and reliable records of transactions and operational efficiencies. Let us discuss them in detail.

Accounting control

It ensures correct and reliable records of transactions in conformity with normally accepted accounting principles. Such controls comprise primarily the plan of organisation and the procedures and records that are concerned with and directly related to the safeguarding of assets and liabilities of financial records. Accounting financial controls include budgetary control, standard cost control, self balancing ledger, bank reconciliation and internal checks and internal auditing.

Accounting controls deal with the process of recording of transactions, safeguarding the assets and adherence to prescribed managerial policies

Administrative control

The scope of this control is very wide. They also include accounting controls. Such controls comprise of the plan of organisation that are concerned mainly with operational efficiencies. In short they may include anything from plan of organisation to procedures, record keeping, distribution of authority and the process of decision making. They include controls viz. Time and motion studies, quality control through inspection, statistical analysis and performance evaluation etc. An auditor should make a careful review of accounting controls as they have a direct bearing on the reliability of the financial statements. He is primarily concerned with the accounting controls.

Internal control and auditor

The position of the auditor regarding internal control has been stated in the statement of auditing practices issued by the Institute of Chartered Accountants of India which says "the duty of safeguarding the assets of a company is primarily that of management and the auditor is entitled to rely upon the safeguard and internal controls instituted by the management, although he will take into account the deficiencies, he may note therein while drafting his audit program". It clearly means that an auditor is concerned only with the evaluation of internal control to know its strength and weaknesses. In case he finds that the internal control

system is inadequate, he should then plan to carry out detailed examination of those areas where the system is weak. It is therefore necessary for the auditor to acquaint himself fully with the internal control in force and their actual operation. It will help him in the formulation of his audit program. He may also bring the shortcomings of the internal control system to the notice of the management.

Requisites of a good internal control system

The following are the essential requisites of a good internal control system :-

- i. A well developed plan of organisation with proper delegation of functional responsibilities should be devised. No internal control system can be effective without such plan of organisation.
- ii. A scientific system of authorisation and record procedure should be developed with a view to provide proper control over assets, liabilities, revenue and expenses of the organisation. It should be developed in such a fashion as to ensure that a) assets are under proper custody and they are not improperly applied, b) expenditures are incurred on getting proper authorisation and c) revenues received are duly accounted for.
- iii. A system of healthy practices and traditions should be developed with a view to discharge the duties and functions of the various departments of the organisation smoothly.
- iv. Since internal control system is to be exercised by the personnel employed in the organisation, there should be a team of people with sound character and integrity who are properly trained and capable of discharging their responsibilities.
- v. Constant managerial supervision and periodical review of the system should be introduced with a view to make the system more efficient and effective.

1. Check Your Progress

1. Define internal control
2. Distinguish between accounting control and administrative control.
3. State whether each of the following is true or false:
 - a) Internal control is different from internal check.
 - b) Internal control does not include accounting control
 - c) Internal control is compulsory in all business organisation
 - d) Internal control include quality control and time and motion studies.
 - e) An effective internal control system helps external auditor to design suitable audit.

5.5 INTERNAL AUDIT

Internal audit is described as the verification of the operations within the business by a specially assigned staff. It is an important tool of management to evaluate the correctness of records on a continuous basis in an organisation.

The term internal audit has been defined as "an independent appraisal of activity" within an organisation for review of operations as a basis of service to management. It is a managerial control which functions by measuring and evaluating the effectiveness of other controls.

According to Howard F. Stettler, "internal auditing is an independent appraisal activity within an organisation for the review of operations as a service to management."

The overall objective of internal auditing, therefore, is to assist the management in the effective discharge of their responsibilities by

furnishing them with objective analysis, appraisals, recommendations and pertinent comments concerning the activities reviewed. **In short internal audit assures the management that the system of internal check and other types of controls are effective in design and operation.**

Thus, internal audit is a thorough examination of the accounting transactions to ensure that-

- The transactions are properly recorded.
- The accounts are maintained systematically and
- There is no possibility for manipulation of accounts or misappropriation of property of the business.

In modern times, an internal auditor carries a new task. The traditional function of checking the arithmetical correctness of the accounts with the help of vouchers and documents and verification of few items such as stock, cash and fixed assets is not sufficient. The duty of internal auditor now is to chart the procedure, examine the efficiency and work on programs of improvement of assessing the effectiveness of controls. He is expected to plan and arrange his task for effective functioning, set clear objectives of his own section, phase his objectives, gain the confidence of the management and demonstrate the value of his functions in areas of performance.

The internal audit is carried out generally in the same manner as is followed for a professional audit. However, it varies in form from enterprise to enterprise according to its size and specific needs. It is installed in large organisation and is carried out by the salaried staff who are qualified to conduct professional audit. Being the employee of the organisation he has to ensure that there is no waste in the organisation. Internal auditor has to follow the provisions of law, standard auditing practices and procedure prescribed for professional auditors and by the professional bodies controlling the audit system in the country. At the same time internal auditor must be aware of the policies and programs of the enterprise he should be professionally competent to carry out a detailed examination of the working of the business. Equipped with professional expertise and knowledge of the business, he will be in a better position to make the internal audit system more effective.

5.5.1 Objectives of internal audit

The main objectives of internal audit are as under:-

- To verify the correctness and authenticity of the financial records and statistical records presented to the management.
- To ensure that the standard accounting practices are strictly followed in the organisation.
- To facilitate early detection of errors and frauds.
- To ensure that all the transactions have been carried out under a proper authority and by persons authorised for the same in the business.
- To review the system of internal check from time to time to advise the management on improvement of the system and to undertake special investigation for the management.
- To confirm that the liabilities have been incurred by the organisation for legitimate activities.

Thus, efficiency of internal audit depends on the efficiency of the staff employed for the purpose, internal audit can be effective only if the internal auditor is given wider authority to investigate the transactions not only from financial angles but also from other organizational activities. Internal auditor should report directly to the top management. He must operate independently of the accounting and other staff. He must be given an independent status as an important functionary and a part of the management.

5.5.2 Internal audit v/s statutory audit

Internal audit helps the statutory audit to a large extent. Both the internal auditor and the statutory auditor have a common interest as far as authenticity of the accounts are concerned. However soundness of internal audit relieves the statutory auditor from detailed checking.

The internal auditor reviews the operations and performs such functions as evaluation, compliance, verification and ensures that policies, procedures, rules and other type of controls of the business are carried out efficiently.

He is helpful to statutory auditor in the matter of examination of books of accounts. Generally, the statutory auditor accepts some of the detailed checking made by the internal auditor. However, the area of co-operation between internal auditor and statutory auditor is somewhat limited as the statutory auditor has a responsibility under law to various authorities, while the internal auditor is responsible only to the management. The statutory auditor has to carry out his duties in accordance with standard accounting and auditing practices and provisions of law which govern the organisation. Before accepting the checking of accounts and other documents carried out by internal auditor, the statutory auditor must undertake such test checks necessary to find out the effectiveness of internal audit.

Both internal auditor and statutory auditor carry out examination of records and documents and make physical and other verifications. Despite these similarities there are differences in the status, responsibilities, approach and scope of work of internal auditor and statutory auditor.

Differences between internal audit and statutory audit-

The following are the points of differences between internal audit and statutory audit:

Internal audit	Statutory audit
1. Internal audit is the arrangement within the organisation to verify on continuous basis the correctness and truthfulness of the transactions by the salaried staff.	Statutory audit is the examination of the books of accounts of the business by an external auditor and to report that the profit and loss account and balance sheet are drawn according to provisions of law and the financial statements reveal the true and fair view of the results of operations and financial state of affairs of the business.
2. Internal audit is not compulsory.	Statutory audit is compulsory in case of business houses incorporated under the Companies Act and other acts. Statutory audit can be carried out only by those who are qualified for appointment as per the provision of the Companies Act and other acts.
3. Internal audit is carried out by the staff appointed by the business enterprises. It is not necessary that the internal audit staff should possess the qualification prescribed for professional auditor	The rights, duties, responsibilities and liabilities of auditors are governed by the provisions of law. The auditor is independent of management.
4. Being an employee of the organisation internal auditor is answerable to the management. His duties, responsibilities etc. regarding	

audit work are determined by the management. The management can increase the powers and authority of the internal auditor. Similarly it can also curtail his powers.	
5. The internal auditor points out irregularities in the procedural aspects and suggests ways and means to rectify the same. He assures that the financial operations and other types of control in force are carried out in conformity with the accounting systems.	The statutory auditor is concerned with the legality and validity of the transactions of business. His audit work is based on the financial statement prepared by the business.

5.6 INTERNAL CHECK

Internal check is a system enforced in business under which the recording of business transactions is arranged in such a manner that the work of one staff member will automatically be checked by others in the course of recording of transaction itself.

Spicer and Pegler have defined a system of internal check as "an arrangement of staff duties whereby no one person is allowed to carry through and record every aspect of a transaction such that without collusion between two or more persons., fraud is prevented and at the same time possibilities of errors are reduced to a minimum". De Paula has defined internal check as "a continuous internal audit carried on by the staff itself by means of which the work of each individual is independently checked by other member of the staff."

Thus, under internal check system the staff duties are so arranged that no one person is allowed to record every aspect of the transactions and the entire work is distributed among the various members of the staff in such a manner that the work of one person is automatically checked by others.

The essential elements of internal check are as under-

- Existence of checks on day to day transactions.
- The check is to be carried out continuously as a part of the routine system.
- The work is divided among the staff and each staff is assigned a specific task.
- The work of each staff though independent is complementary to the work of another.

The system of internal check is increasingly recognised by the auditor specially when the size of the concern is large. The existence of effective internal check system relieves the external auditor of detailed checking to a larger extent. The extent to which an external auditor can depend upon the system of internal check is based on the procedural tests applied by him to find out the effectiveness of the system. However the auditor can not be relieved of his responsibility if he was found guilty of negligence regardless of the fact that he had tested the internal check in existence in the organisation before he had accepted it as correct.

5.6.1 Objectives of internal check

- To reduce chance of fraud and errors that may be committed by any member of the staff and make it more difficult. If any fraud is to be committed two or more persons must collude together.
- To detect fraud and errors easily and correct them promptly.
- To exercise moral pressure among the members of the staff.
- To allocate duties and responsibilities of every person in such a way that he can be taken to task for any lapse on his part.
- To increase overall efficiency of the members of the staff by assigning duties based on the principle of division of labour.

- To have an accurate and reliable record of all business transactions.

Essentials of good internal check system

- No single staff shall have absolute control over recording of all the aspects of business transactions by himself.
- The same staff shall not be allowed to have access to all books of accounts as well as physical custody of the assets.
- Each member of the staff should be made responsible for a specific work.
- All officials and employees holding responsibility towards cash, securities or stock should be encouraged to proceed on annual leave to prevent the concealed fraud.
- The duties of the members of the staff should be changed from time to time.
- Attempt should be made to introduce mechanical devices to prevent mis-appropriation of cash.
- Each transaction should pass through a definite route and through several hands.
- All books, vouchers, documents should be classified and made available for easy reference.
- Proper record must be maintained of the incoming and outgoing of goods from the business premises.

- Self balancing ledger system should be introduced to make the system more efficient and effective.
- No undue importance should be given to any staff member and too much reliance on any staff member should be avoided.
- Division and allocation of duties among the staff members must provide for an automatic check by others.

5.6.2 Internal check as regard cash sales

Since chances of committing fraud in connection with cash sales are greater, it calls for devising an efficient and effective system of internal check. Cash sales may be affected in various ways like a) sale at counter, b) postal sales, i.e. sales under mail order, and c) sales by representative and agents. The system of internal check to be followed in each case is discussed below.

- One salesman should be appointed to look after one counter independently and should be made responsible for sales effected in his counter.
- Each salesman must be issued with a separate cash memo book. The cash memo book must be printed in different colours to identify different counters of the business.
- Each salesman must maintain a sales sheet. He should record therein the sales effected by him. The summary of cash sales effected by him must tally with the cash memos issued by him.
- Cash memos are to be issued with carbon copies.
- The salesman must not receive cash on the cash memos issued by him.

- All payments on the cash memo of the salesman must be made by the customer at the cash counter.

Sales are to be effected in the following manner

1. Three copies of the cash memo must be issued to customer
2. The customer must present the three copies of cash memo to the cashier at the time of making payment
3. The cashier must verify the particulars and satisfy himself regarding the total payment with reference to rates and quantity.
4. The cashier on receiving the payment in cash will place a rubber stamp on all the copies of memos as "cash paid".
5. He will retain one copy with himself and hand over the other two copies to the customer.
6. The customer must present the cash memos to the delivery department to collect the goods purchased.
7. The delivery department will put rubber stamp on the memos as "goods delivered". It will retain one copy as an evidence for delivery and hand over another copy of the memo to the customer.

At the end of the day's working, the sales man, the cashier and the gate keeper should prepare the summary and submit to the manager or officer incharge. If these summaries tally, the accounts are certified as correct.

Postal sales i.e. sales under mail order

This includes following aspects:

- All sales made by post i.e. V.P.P should be recorded in a separate register to be maintained for the purpose.
- The goods returned, if any, should also be recorded in the register.
- The total amount of cash receipts including advance, if any, against the mail orders should be entered in the register and the same should be deposited into the bank.
- All the entries in the V.P.P. register should be checked by some responsible officer and special inquiries should be made in respect of those goods against which cash has not been received.
- There should be proper filing of mail orders received and the cash book should be checked with these mail orders.

Sales by representative and agents

It is the practice in big business houses to employ representative and agent to promote sales and to collect the amount due from debtors. The system of internal check to be introduced in this connection should be as follows:

1. The representatives and agents should be authorised to issue rough receipts to the customers against cash received from them. However, the final receipt should be issued only by the head office.
2. The customers should be advised to communicate directly with the head office if they do not get the final receipt within a reasonable time period.

3. The representatives and agents should be instructed to remit the amount of cash collected by them to the head office without any delay.
4. The representatives and agents must not be allowed under any circumstances to deduct their commission or any other expenditure from the amount of cash collected by them. The bill for commission and other expenses should be submitted to the head office.
5. As a matter of routine the head office should send periodical statements of accounts to the customer with a view to apprise them of the latest position.
6. The representatives and agents should be advised to submit periodical statements to the head office showing therein the amount of sales made by them, the amount of cash collected by them and the names of the defaulters.
7. The head office should issue reminders to those defaulting customers who have failed to clear their dues.
8. The representatives and agents must not be allowed to operate from a fixed place. On the contrary, they should be transferred from time to time to other place in order to increase their efficiency and to avoid the possibility of committing fraud.

5.6.3 Internal check as regards purchases

Since chances of committing fraud in connection with the purchases of goods by a big business house are greater, it calls for devising an efficient and effective control system of internal check. In this connection one should be familiar with the purchases procedure which should be as under.

- The department requiring the material should fill in the purchase requisition indicating the quantity and quality to the purchase department.
- The purchase department on the basis of the requisition will send out enquiries to the various suppliers asking for quotation.
- On receipt of quotations the order will be placed on the best vendor taking into account the quality, period of delivery, competitive prices etc.
- On receiving the order the vendor shall execute the order. The supplies will be received by the stores department.
- On receipt of goods it will be verified with reference to the order with the goods received memo issued by the stores department. If the supplies are made according to the order the delivery note and invoice sent by the supplier will be forwarded to accounts department with endorsements for the goods received and taken to stores.
- The invoice will be passed for payment by a senior officer after verifying the terms and conditions of the supply with reference to rates and quality and other expenses detailed.

Keeping the above points in view, the following system of internal check is suggested with regards to purchase:

- There should be separate purchase department.
- Purchase order are to be issued only against indents received from the various department of the business.
- All orders should be placed in writing. The order form must be preferably a printed form containing full details.

- The orders must be made in quadruplicate. One copy of the order is to be sent to the supplier. The second copy is to be sent to the concerned department which has placed the indent for supply; third copy is to be sent to account department and the fourth copy is to be retained by the purchase department for future reference.
- All orders for purchase, should be signed only by the purchase manager or the person authorised for this purpose.
- All orders should contain the seal of office.
- The goods received should be inspected with the copy of the order.
- The goods received are to be examined with delivery notes and supply invoices of the seller regarding quantity, quality and rates.
- The purchase department should make an endorsement putting rubber stamp on the suppliers bill with reference to goods received.
- After inspection and examination 'Goods Received Note' is to be prepared for each lot of purchase. The inspection note should also be attached to it.
- Endorsement must be made by the purchase manager or the authorised official (of stores department to take the goods into stock.
- The stores department should acknowledge receipt of goods and send the same to the order department.
- All packages of incoming goods are to be opened only in the presence of a responsible official.
- The stores officer on verification of the correctness of the goods received should enter them in the stock register.

- Generally a rubber stamp containing the following certificate will be placed on the suppliers bill and signed by the purchase manager

"Certified that goods are received as per Order

No,.....Dated.....and taken to stock vide Folio No,..... of stock register No,....."

- The Payment on purchases must be made only after accounts department verifies the invoice, goods received note and purchase order.
- The accounts department should impress a rubber stamp on invoices which are passed for payment.
- A separate purchase register is to be maintained by the purchase department
- Ledger clerk should have no access to physical stock register or cash to avoid manipulation of accounts.
- For inter-branch purchase or inter-company purchases transfer notes should be issued.
- All Purchases that are made by employee for the personal use must be accounted for separately.
- A separate return outward book is to be maintained to record the return of goods to suppliers.
- Credit notes are to be issued for adjusting claims. The purchase department should send a copy of credit note to accounts department.

- A purchase ledger control account is to be maintained. Ledger account should be checked periodically against the suppliers statements.
- A perpetual inventory control method should be adopted to avoid excess quantity and to maintain minimum quantity.
- Where goods are delivered directly to locations or place of work not controlled by the purchase department, the invoices are to be passed by the purchase department only after examining the certificate of receipt of stock from the authority to whom the goods are delivered.

In general the purchase department must place purchase orders on the basis of indents, record the order in the purchase day book, enter the goods received in the goods inward book and send the invoice of the supplier alongwith the inspection report and goods received notes to the accounts department for payment.

Internal check as suggested above will avoid irregularities in purchase and minimize, if not completely eliminate, manipulation of accounts by entering fictitious purchase or entering invoice twice or misappropriating the discount or commission allowed by the suppliers.

5.6.4 Internal Check as regards Sales

The organisation of the sales department depends on the system of selling and distribution of goods. Unless the department is organised properly there are greater possibilities for suppression of sales and manipulation of accounts. Goods can also be misappropriated. Hence, a well-knit system of internal check is necessary which may be in the following manner::

- 1) Sales must be executed against order received from customers.
- 2) All incoming orders shall be numbered and filled and confirmation of the orders received be sent to the customers.
- 3) Proper record is to be maintained for the orders received, order under execution/executed/refused.
- 4) The sales shall be authorised by responsible officials after scrutiny of the order and assessing the portion of supply of goods as well as the terms and conditions of sales accepted by the customer.
- 5) All sales orders shall contain invoices prepared in quadruplicate. One copy is to be retained by the sales department, one to be sent to the customer, one to the accounts department and the last copy to despatch section for despatch of goods.
- 6) Separate departments should deal with cash sales and credit sales.
- 7) In the case of credit sales a separate register should be maintained of the customers with financial standing. The credit sale is to be allowed only after scrutiny of the customer's order for supply of goods on credit.
- 8) Periodical statement of the outstanding balance due towards the customer be sent and confirmation obtained from them.
- 9) Regular reminders for payment shall be made to the customers reminding them of their dues.
- 10) Amount due from the customer shall be written off as bad unless all methods of recovery are exhausted.
- 11) The responsible official shall be entitled to treat a debt as bad.

- 12) The sales invoice clerk shall have no access to physical stock or accounting records.
- 13) The credit note shall be prepared only after ascertaining the fact from the despatch section and the sales department for the goods received back from the customers. Credit notes are to be prepared in quadruplicate. One is to be retained with the invoice department, second copy is to be sent to despatch department, third copy to the sales department and fourth copy to the customer.
- 14) In case sales are cancelled, a notice is to be given to the despatch department to stop despatch of goods.
- 15) The invoice can be cancelled only by the sales department. All sales invoices must be printed and numbered in serial order.
- 16) The sales ledger shall be maintained by a separate clerk.
- 17) Periodical statements should be sent to debtors.
- 18) In the case of credit sales regular confirmation should be obtained from the customers regarding the outstanding balances. The confirmation of balances must be verified by a senior person other than the ledger clerk.
- 19) A sales ledger control account shall be balanced with the control account periodically.
- 20) A sales ledger control account in the general ledger shall be maintained.
- 21) Credit to employees can be allowed only after proper authorization from the management.

- 22) Separate department should be set up to deal with sales on consignment, hire purchase, goods on sales or return etc.
- 23) The stock held by the agents should be verified periodically with the statements received from the agents.
- 24) The goods sent on sale or return basis but unsold on the date of the balance sheet should not be treated as sales but unsold stock.

Internal check system with regards cash received on sales is suggested under the caption "cash sales". The internal check of the sales department included the suggestions given for internal check on cash sales.

5.6.5 Internal Check as regards Wage Payment

In big organization, the work regarding the maintenance of various type of wage records, computing the amount of wages and the payment of wages to the right persons are of significant importance. It is, therefore, necessary to design a proper system of internal check regarding wages payment to minimize the dangers of fictitious names, errors in wages records and misappropriation of money. The following system of internal check is suggested:

- 1) Workers should be employed only after the written order of the Personnel Officer or the appointing authority. A copy of the appointment order be endorsed to the wage preparing section.
- 2) Separate staff should record attendance of workers, control of leave, payment of overtime and disbursement of pay packets. Each staff member shall be responsible to enter relevant information in the wage sheet. He should also put initials for the work completed by him.
- 3) The wage sheet shall contain columns for recording relevant information with regard to payment of wages such as name of the employee, designation, period for which wages are paid, rate of pay,

amount of basic pay, dearness allowance, house rent allowance, compensatory allowance and other allowance, gross salary drawn, deductions (there should be separate columns indicating the nature of deductions) and net amount payable and signature of employees, for acknowledging the payment.

- 4) Separate records should be maintained for each worker indicating the date of appointment, scale of pay, rate of pay, etc. Copies of orders relating to increase in pay, promotions and punishments, deduction in wages on account of Provident Fund, Loan, Medical, Ground Insurance etc. shall be endorsed to wage preparing section.
- 5) Separate job cards are to be maintained for recording the work performed by the worker.
- 6) Each worker is to be given a pay slip indicating the gross wages and net wages.
- 7) Separate register is to be maintained for recording the name of workers who may be allowed to work overtime. No worker shall be allowed to work overtime without the prior sanction of the proper authority.
- 8) Time recording clocks shall be installed at the main gate of the factory for recording the arrival and departure of workers.
- 9) The rosters of workers for each work should be prepared and copy of the same be sent to the wage preparing section.
- 10) Late arrival of workers shall be entered in a separate register and the same be sent to the personnel section for future reference.
- 11) Proper watch and ward arrangement is to be maintained to record the arrival of the workers and the time of leaving the factory.

- 12) The rate of wages of each worker is to be periodically checked with reference to rate card.
- 13) All calculations regarding gross wages and net wages payable after deduction are to be checked by an independent person.
- 14) In the wage sheet the names of workers, rates of pay, the period for wage to be paid shall be entered by one person. The calculations regarding gross wages payable shall be made by another person. The deductions under various heads shall be made by a third person. The net wages payable and the checking of the wages sheet with reference to leave deductions etc. should be made by a senior staff member. The wages sheet shall be signed by the authorised official.
- 15) If the wages are to be paid on the basis of piece wage system, the actual work done by each worker must be maintained on a job card to be given to each worker. These cards should be counter signed by the foreman of the department and the store department to which the goods produced are delivered.
- 16) The wage sheet shall be prepared in triplicate. One copy shall be endorsed to pay master, the second copy to the account section and final copy shall be retained by the wage preparing section.

5.6.6 Internal check system and auditor

The soundness of the system of internal check and the way it is put into operation in the organisation are matter of great importance for the auditor. In case the system of internal check is effective the work of the external auditor becomes quite easy. He is relieved of the detailed and routine checking of the transaction as the internal check system takes care of the same. In case the internal check system is not effective, then the auditor should have to decide the extent of detailed checking to be undertaken in order to satisfy himself about the authenticity of the business records. It is, therefore, necessary for the auditor to study the system in force in the organisation; this he can do by applying few test checks and if the results are satisfactory he can depend on the internal check system. In case the internal check system in force is weak or defective then he should carry out detailed checking of the accounting

records. In case he does not do so he may be held liable for all the undetected errors and frauds. He should not show any negligence in his duty. He should design the audit program keeping in view the weak links of the system. He should also suggest the changes to the management strengthening the system of internal check. It should be noted that the existence of a sound internal check system in an organisation helps the auditor to a great extent in audit work, but does not reduce his legal liability at all.

5.6.7 Distinguish between internal check and internal control

Ans. Point	Internal check	Internal control
1. Meaning	It is a system of allocation of responsibility, division of work and methods of recording transactions, whereby the work of one employee is checked continuously by another.	It is the system of control established by the management in order to carry on business in an orderly and efficient manner, ensure adherence to management policies, safeguard assets and completeness of records.
	It is a part of Internal Control.	It includes Internal check and Internal audit.
2. Relation	It is arrangement of book-keeping and Clerical duties.	It includes the essence of Internal check and internal audit.
3. Essence	Checks are automatic and continuous.	It includes the implementation of Internal check and Internal audit.
		It includes Internal check and Internal audit.

4.How are they implemented.	Checks are objective.	
5. Nature		

5.6.8 Audit in respect of computer environment (E.D.P. audit).

The principal object of the audit is to ensure that the accounts on which the auditor is reporting show a true and fair view of the state of affairs at a given date and of the results for the period ended on that date. The essential features of an audit appropriate for medium or large sized concerns are :-

- a) An evaluation of the system of accounting and internal control to ascertain whether they are appropriate for the business and properly record all transactions
- b) The making of such tests and enquiries as are considered necessary to determine whether the systems are being operated correctly.
- c) An examination of account in order to verify :-
 - i) The title, existence and value of the assets appearing in the balance sheet and to verify that all liabilities are correctly included therein.
 - ii) That the result shown by the profit and loss account is fairly stated.

And to ensure that such accounts are in accordance with the underlying records and comply with the appropriate statutory requirements.

The overall scope and objective of an audit does not change in an E.D.P. environment. However, the use of a computer changes the processing and storage of financial information and may effect the organisation and procedures employed by the entity to achieve adequate internal control. Accordingly, the procedures followed by the auditor in his study and evaluation of accounting system and related internal controls and nature, timing and extent of his other audit procedures may be affected by an EDP environment.

The prime objective of EDP audit is to determine whether computer system safeguard assets, maintain data integrity, achieve organizational goals effectively and consume resources efficiently. A proper system of internal control is necessary to ensure that the objectives are met. It may be remembered that the overall objectives and scope of an audit does not change in an EDP environment. However, the use of a computer changes the processing and storage of financial information and may affect the organisation and procedure employed by the entity to achieve adequate internal control.

The auditor should take the following steps in addition to the normal audit procedure while auditing the computerised accounts.

- 1) Computerised accounting involves the code list for various types of accounts. The auditor should obtain the list of such codes and ensure that they are correctly used.
- 2) In manual accounting procedure each and every stage of recording the transactions is visible viz Preparing vouchers, passing entry, posting in ledger, casting, balancing, grouping, pre-paration of trial balance and final accounts. However, when the accounts are computerised it is not possible for the auditor to check each and every stage of recording the transactions as every thing is done by the computer behind the screen. Therefore, in such a situation it becomes necessary for the auditor to ensure that the functioning of the computer is correct and reliable. For this purpose he should select a sample of some transactions for processing and should compare the results obtained through computer processing with predetermined result.
- 3) In case of computerised accounts, the records of transactions are stored on floppy disks as back up data. These disks are affected by

heat, dust etc. The auditor should ensure that proper precautions have been taken by the client for the safe custody of such disks.

- 4) He should ensure that client has made a proper arrangement for protecting the computer data from "Virus".
- 5) He should ensure that there is proper control over the use of computers by the various users through "Passwords"
- 6) He should ensure that there is proper maintenance of computers by doing servicing at regular intervals. This will reduce the chances of break down and losses of records.
- 7) The accuracy of computer output depends upon the correctness of input. He should ensure that there is a proper system for checking of the output with the inputs on a regular basis.
- 8) Lastly, he should ensure that changes in software programs are carried out by authorised person only and such changes are properly noted for future reference.

5.7 INTERNAL CONTROL

MEANING & PURPOSE

Control is a basic human requirement and it has existed throughout the ages in different facets of human activity. Business as such is a complex process and has grown even more complex with the technological advancement of the society. The formalization of the concept of internal control in the sphere of business administration is a comparatively recent phenomenon.

In the sphere of a business, control is an accepted device for optimum utilization of the resources and opportunities for maximisation of profits. All operations of a business are carried on with the help of human agents and equipment; both these factors need supervision so that the

tasks assigned to them are properly carried out and avoidable wastes and losses do not occur to eat up the fruit of the enterprises.

The internal control required by a sole proprietor of small business is not identical with that required for a large industrial organization. A small trader having a grocery shop hardly needs more than one or two assistants. He decides work to be done by the assistants. He always knows his own stock, cash and bank position. He has the knowledge of daily sales. He himself knows the sources for purchases. He keeps the record of the debtors and creditors. The assistants merely help him in delivering goods to customers or to arrange the goods in proper order.

From the above, it can be observed that control is entirely centralized with the owner and there is no significant delegation of duties. However, as the business grows in size it soon reaches a stage where the owner can no longer keep himself intimately informed about the detailed operations of his business, activities of the employee and their discharge of their responsibilities. To cope with the increasing size and volume of business, he has to employ more and more people and for systematically carrying on the business, he has to specify the tasks for each person. For remote operations he has also to rely upon these people, for carrying out the work, for the custody of the materials, documents and equipments entrusted to them. He has also to ensure that the equipment and facilities are properly maintained. For this purpose, he has to give shape to a form of organization from which he would be in a position to know the board details of the work involved and the persons responsible for such work. Also, he has to work out a plan of delegation of duties and authority for the simple reason that, for anything and everything. People need not come to him for advice or decision, because, under such circumstances, he would not be able to find time to apply his mind to matters of more importance.

Human behavior is such that if it is not under some sort of regulation or control, it often tends to depart from the proper path. It needs to be kept under systematic watch not only for ensuring that the employee does his work, but also to see that he does it in the manner laid down for the purpose and handles the materials and equipments with proper care.

REVIEW OF INTERNAL CONTROL

A review of internal control can be done by a process of study, examination and evaluation of the control system installed by the management. The first step involves determination of the control and procedures laid down by the management. By reading company manuals, studying organization charts and flow charts and by making suitable enquiries from the officers and employees, the auditor may ascertain the character, scope and efficacy of the control system. To acquaint himself about how all the accounting information is collected and processed and to learn the nature of controls that makes the information reliable and protect the company's assets, calls for considerable skill and knowledge. In many cases, very little of this information is available in writing; the auditor must ask the right people the right questions if he is to get the information he wants. It would be better if he makes written notes of the relevant information and procedures contained in the manual or ascertained on enquiry.

To facilitate the accumulative of the information necessary for the proper review and evaluation of internal controls, the auditor can use one of the following to help him to know and assimilate the system and evaluate the same:

- (1) Narrative record;
- (2) Check list;
- (3) Questionnaire; and
- (4) Flow chart;

(1) The narrative record is a complete and exhaustive description of the system as found in operation by the auditor. Actual testing and observation are necessary before such a system is in operation and would be more suited to small business. The basic disadvantages of narrative records are:

- 1. To comprehend the system is operation is quit difficult.
- 2. To identify weaknesses or gaps in the system
- 3. To incorporate charges arising on account of reshuffling of manpower, etc.

(2) A check list is a series of instruction and/or answer. When he completes instruction, he initials the space against the instruction. Answers to the check list instruction are usually Yes, No or Not applicable. This is again an on the job requirement and instructions are framed having regard to the desirable element of control. A few examples of check list instruction are given hereunder:

1. Are tenders called before placing orders?
2. Are the purchases made on the basis of a written order?
3. Is the purchase order form standardized?
4. Are purchase order forms are pre-numbered?
5. Are the stock control accounts maintained by persons who have nothing to do with:

- (1) Custody of work;
- (2) Receipt of stock;
- (3) Inspection of stock; and
- (4) Purchase of stock?

The complete check list is studied by the principle/manager/senior to ascertain existence of internal control and evaluate its implementation and efficiency.

(3) Internal control questionnaire is a comprehensive series of questions concerning internal control. This is the most widely used from for collecting information about the existence, operation and efficiency of internal control in an organization.

An important advantage of the questionnaire approach is that oversight or omission of significant internal control review procedures is less likely to occur with this method. With a proper questionnaire, all internal control evaluation can be completed at one time or in sections. The review can more easily be made on an interim basis. The questionnaire form also provides an orderly means of disclosing control defects. It is the general practice to review the internal control system annually and record the review the detail. In the questionnaire, generally questions are so framed that a 'Yes' answer denotes satisfactory position and a 'No' answer suggests weakness. Provision is made for an explanation or further

details of 'No' answers. In respect of questions not relevant to the business, 'Not applicable' reply is given.

The questionnaire is annually issued to the client and the client is requested to get it filled by the concerned executives and employees. If on a perusal of the answers, inconsistencies or apparent incongruities are noticed, the matter is further discussed by auditor's staff with the client employees for a clear picture. The concerned auditor then prepares a report of deficiencies and recommendation for improvement.

(4) A flow chart is a graphical presentation of each part of the company's system of internal control. A flow chart is considered to be the most concise way of recording the auditor's review of the system. It minimises the amount of narrative explanation and thereby achieves and consideration or presentation not possible in any other form. It gives bird's eye view of the system and the flow of transactions and integration and in documentation, can be easily spotted and improvements can be suggested.

It is also necessary for the auditor to study the significant features of the business carried on by the concern: the nature of its activities and various channels of goods and materials as well as cash, both inward and outward, : and also a comprehensive study of the entire process of manufacturing, trading and administration. This will help him to understand and evaluate the internal controls in the correct perspective.

ADVANTAGES

Auditors' right to rely on Internal Control: The duty of safeguarding the assets of a Company is primarily that of the Management and the Auditor is entitled to rely upon the safeguards and Internal Controls instituted by the Management, although he will, of course, take into account any deficiencies he may find therein while drafting his Programme.

Audit Assurance: The Auditor needs reasonable assurance that the accounting system is adequate and that all the accounting information which should be recorded has infact been recorded. -

Integral part of Audit Programme: The examination and evaluation of the Internal Control System is an indispensable part of the overall Audit Programme.

Audit Planning: The Auditor should gain an understanding of the accounting system and related Internal Controls and should study and evaluate the operations of these Internal Controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures.

Role of review: The review of Internal Controls will enable the Auditor to know –

(a) Whether errors and frauds are likely to be located in the ordinary course of operations of the business;

(b) Whether an adequate Internal Control System is in use and operating as planned by the Management;

(c) Whether an effective Internal Audit department is operating;

(d) Whether any administrative control has a bearing on his work (e.g. when there is a weak control over

Worker recruitment and enrolment, there is a likelihood of including dummy names in the wages sheet which is relevant for the Auditor); (e) Whether the controls adequately safeguard the assets; (f) How far and how adequate is the Management effectively involved in discharging its function of correct recording of transactions is concerned;

(g) How reliable the reports, records and the certificates to the Management can be; (h) the extent and depth of the examination that the Auditor needs to carry out in the different areas of accounting;

(i) What would be the appropriate audit technique and audit procedure in the given circumstances; (j) what* are the areas where control is weak and where it is excessive; and (k) whether some worthwhile suggestions can be given to improve the control system.

(ii) AUDITORS DUTIES

Role of the Auditor vis-à-vis Internal Control can be summarized as under -

Management Responsibility: The duty of safeguarding assets of a Company is primarily that of Management. The Auditor is entitled to rely upon • safeguards and Internal Controls instituted by the Management.

Necessity for Evaluation: The Auditor is interested in ascertaining that transactions are executed in accordance with the Management's authorisation, all transactions are recorded properly and assets are adequately safeguarded. Therefore, the examination and evaluation of the Internal Control System is an indispensable part of the overall audit Programme.

Assurance: The Auditor needs reasonable assurance that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded in a correct, proper and timely manner. Internal Control normally contributes to such assurance.

Audit Planning and Programme: The Auditor should gain an understanding of the accounting system and related Internal Controls. He should study and evaluate the operations of these Internal Controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures. He can formulate his entire audit programme only after he has had a satisfactory understanding of the Internal Control System and its actual operation.

Review: If the Auditor reviews the Internal Control System of the client, he will be in a position to bring to the Management's notice, the weaknesses in the system and suggest measures for improvement. During the course of his audit, he may also ascertain how far the weaknesses have been removed.

Audit Procedure: Proper understanding of the Internal Control System enables the Auditor to decide upon appropriate audit procedure to be applied in different areas. In areas where Internal Control is considered weak, he might extend certain tests to cover a large number of transactions or other items than he otherwise would examine and at times may perform additional tests to gain necessary satisfaction.

Test Checking: In deciding upon a plan of selective checking (test checking or sample checking), the existence and operation of Internal Control System is of great significance.

Reporting: Under CARO, the Statutory Auditor of a Company has to report on the following aspects relating to Internal Control

(a) Is there an adequate Internal Control System commensurate with the size of the Company and the nature of its business, for the purchase of Inventory and Fixed Assets and for sale of goods and services?

(b) Whether there is a continuing failure to correct major weakness in Internal Control System?

A senior assistant of X & Co. Chartered Accountants while auditing the Internal Control System of T Ltd. When the Partner asked the reason, he stated that the controls were developed by the General Manager (Finance) of T Ltd., who is also a Chartered Accountant and who had written a few books on internal control and therefore there is no need to review the same. State your viewpoints.

1. A proper understanding of the Internal Control System enables the Auditor to decide upon the nature, extent and timing of the appropriate substantive audit procedures to be performed.
2. Although Internal Control is Management's responsibility, the Auditor-
 - (a) Should independently gain an understanding of the accounting system and related Internal Controls and
 - (b) Should study and evaluate the operation of those Internal Controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures.
3. Where the Auditor concludes that he can rely on certain Internal Controls, his substantive procedures would normally be less extensive than would otherwise be required. It may also differ as to their nature and timing.
4. Where Internal Control is weak, the Auditor might choose such an auditing procedure / test that might not be required otherwise. He might extend certain tests to cover a large number of transactions or other items than he otherwise would examine at times and perform additional tests for his satisfaction.
5. Just because the Internal Control was developed by a Chartered Accountant who had also authored a book on Internal Control is of no significance and does not absolve the Statutory Auditors' duties. The Auditor must independently understand and evaluate the Internal Controls to develop a proper audit Programme.

REVIEW OF INTERNAL CONTROLS

INHERENT LIMITATION OF INTERNAL CONTROL

Internal control can provide only reasonable, but not absolute, assurance that the objectives stated above are achieved. This is because there are some inherent limitations of internal controls, such as:

- (a) Management's consideration that a control be cost effective;

- (b) The fact that most controls do not tend to be directed at transactions of unusual nature;
- (c) The potential for human error;
- (d) The possibility of circumvention of controls through collusion with parties outside the entity or with employees of entity;
- (e) The possibility that a person responsible for exercising control could abuse that authority, for example, a member of management overriding a control;
- (f) The possibility that procedures may become inadequate due to changes in conditions and compliance with procedures may deteriorate;
- (g) Manipulations by management with respect to transactions or estimates and judgements required in the preparation of financial statements.

INTERNAL CONTROL SAMPLES FOR SALES & DEBTORS, PURCHASES & CREDITORS, WAGES & SALARIES

Sales and debtors

The primary Internal Control measures in relation to Sales & Debtors are -

- j. All documents like Invoices, Delivery Challans, etc. should be serially numbered and missing documents promptly investigated.
- Despatch, sales and invoicing functions are to be segregated.
- Delivery Challan shall be verified by the carrier before dispatch.
- 4. Delivery Challan shall be verified with customer's Purchase Order before dispatch and serially filed.
 - 5. Customers' acknowledgement for goods despatched must be promptly obtained.
 - 6. Invoices prepared for all deliveries are to be sent to customers within a reasonable time.
 - 7. Prices on invoices must be as per standard-price list and all unusual discounts / price reductions should be duly authorised.
 - 8. Proper recording of returned goods should be made and Credit Notes duly authorised and verified with *j* related invoices.
 - 9. Adequate records shall be maintained for part deliveries.
 - 10. Listings in Sales Ledger balances shall be regularly balanced with Control Account.

11. Cheque received by post are to be recorded and bearer cheques must be stamped "A/c Payee only".
12. Record of receipts shall be duly verified with the bank pay-in-slip after deposit and also with the Cash Book.
13. Duties of personnel responsible for recording Sales Ledgers, receipts of cash and issue of receipts shall be segregated.
14. Cash takings/collections have to be matched with invoices.
- J 5. Segregation of duties shall be defined between persons recording transactions and extracting balances.
16. Listings of Sales Ledger Balances shall be reconciled periodically with Control Accounts, by independent persons.
17. Ageing analysis shall be prepared and checked. Old balances should be followed up.
18. Statements shall be regularly sent, reconciliation with customer balances prepared at regular intervals and reconciling items shall be followed up.
19. Credit limits shall be checked before orders are accepted.

Important Internal Control measures in relation to Purchase & Creditors are -

Orders shall be supported by authorised requisitions and duly approved by a responsible official.

Tenders should be invited before placing orders.

Purchase orders have to be pre-numbered and serially controlled.

Goods Receiving Department should be adequately staffed to inspect, record and store goods received.

Goods Received Notes have to be pre-numbered and serially controlled.

The following duties should be segregated-

- (a) Preparing Goods Received Notes;
- (b) Recording goods received on Stock Records;
- (c) Custody and authorizing issue of stores;
- (d) Verification of Goods Received Notes with Invoices.

Invoices shall be verified with rates on Purchase Orders and calculations should be checked before posting.

Goods Received Notes lying unmatched with invoices shall be duly followed up and liabilities for goods

Received at year-end should be duly recorded.

Invoices should be recorded in an Invoice Register only upon receipt.

Suppliers' Statements shall be regularly reconciled.

Listings in Purchase Ledger Balance shall be reconciled periodically with the respective Control Accounts.

DISTINGUISH BETWEEN

INTERNAL CHECK	INTERNAL CONTROL
(1) Internal check means the arrangement of work different employees in such a manner that work of any person is automatically checked by another person is doing his duty.	(1) Internal control is the whole system of controls, financial and otherwise, established by the management in order to carry on the business of the company in an orderly manner, safeguard its assets and secure as far as possible the accuracy and reliability of its records.
(2) It on going continuous process.	(2) Internal control is a wider term which includes internal check, internal audit, etc.
(3) It is applicable to both, small & large organizations.	(3) Generally it is more applicable to large organizations where there are many departments.
(4) Relatively it is cheaper.	(4) Relatively setting up of internal control system is costly and time consuming.

INTERNAL TEST CHECK V/S INTERNAL CHECKS

PARTICULARS	TEST CHECK	INTERNAL CHECK
1. MEANING	it stands for the method of auditing when instead of a complete examination of all the transaction recorded in the books of account only some of the transaction are selected and verified.	It refers to a system of book-keeping and arrangement of staff duties in the organization in such a manner that no one person can completely carry through a transaction and record every aspect thereof.
2. INSTITUTED BY	It is an audit procedures performed by the auditor in respect of only selected group of transactions.	It is a series of procedures laid down by the management.
3.OBJECTIVE	The purpose is to aid auditors to check and draw conclusions about the voluminous transactions.	Its objective is to facilitate management functions.
4. FRAUD & ERRORS	It helps the auditor to unearth frauds and errors without checking all the transactions.	It is instituted to prevent frauds and errors.
5. MGMT CONTROL	Management has no control over the test checks carried out by the auditors.	Internal controls are subject to review, appraisal and changed by the management.

INTERNAL AUDIT**MEANING:**

It is a review of the operations and records, sometimes continuously undertaken, within a business, by specially assigned staff. But internal audit must not be confused with internal check. Internal check consists of a set of rules or procedures that are part of the accounting system, introduced so as to ensures that accounts of a business shall be correctly maintained and the possibility of occurrence of frauds and errors eliminated. On the other hand, internal audit is a through examination of the accounting transactions as well as that of the system according to

which these have been recorded, with a view to reassuring the management that the accounts are properly maintained and the system contains adequate safeguards to check any leakage of revenue or misappropriation of property or assets and the operations have been carried out in conformity with the plans of the managements. However, the routine process by which an internal audit is carried out is broadly the same as those followed for professional audit. But internal audit often differs in its scope and emphasis: it is more managerial and accounting; also its form is varied, depending on the size of the organization. For instance, whereas a professional auditor is primarily concerned with the legality or validity of transactions entered into by a business an internal auditor in addition is expected to ensure that the standards of economy and efficiency are being maintained. On that account, the internal auditor must ascertain that orders for the purchase of stock are placed only after inviting tenders, sales are effected at the highest ruling rates, standard procedures as regards requirement of staff are followed, losses in manufacturing process suffered during the period under review are not higher than those in the earlier periods and so on. He must further confirm that there has been no leakage of stocks or of any other assets, reconciling the physical balance. The nature and extent of checking, that he should carry out, also would depend on the size and type of the business organization.

BASIC PRINCIPLES OF ESTABLISHING INTERNAL AUDIT

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

1. Independence : the internal audit department should have an independent status in the organization. He may be required to report directly to the board of directors.
2. Objectives: the objectives of the internal audit function should be made very clear and unambiguous. The objectives should be properly communicated so that internal audit is not viewed as "over-the-shoulder check" by other departments.
3. Clarity in Scope: the scope of internal audit department must be specified in a comprehensive manner. The department must at all times, have authority to investigate from the financial angle, every phase of organizational activity under any circumstances.

4. Definition of Duties: The internal audit Department's duty is to review operations as part of the internal control system. It should not be involved in performance of executive actions.
5. Internal Audit Department: The size and qualification of staff of the internal audit department should be commensurate with the size of the business. The cost of internal audit department should not exceed the benefits expected to be derived from it.
6. Reporting: The Programme of internal audit should be time-bound. There should be provisions for periodic reporting on various operational and other aspects.
7. Follow Up and Review: There should be sufficient scope for the follow up actions on the various points raised in internal audit report. Top management should take active part in ensuring compliance with actions points raised in the report.
8. Relationship with statutory auditor: The copy of the internal audit report should be made available to the statutory Auditor, who can deal with the same in the manner as he deems fit.

OBJECTIVES

- (1) To verify the accuracy and authenticity of the financial accounting and statistical records presented to the management.
- (2) To ascertain that the standard accounting practices, as have been decided to be followed by the organization, are being adhered to.
- (3) To establish that there is a proper authority for every acquisition, retirement and disposal of assets.
- (4) To confirm that liabilities have been incurred only for the legitimate activities of the organization.
- (5) To analyse and improve the system of internal check; in particular to see (1) that it is working; (2) that it is sound; and (3) that it is economical.
- (6) To facilitate the prevention and detection of frauds.
- (7) To examine the protection afforded to assets and the uses to which they are put.

- (8) To make special investigation for management.
- (9) To provide a channel whereby new ideas can be brought to the attention of management.
- (10) To review the operation of the overall internal control system and to bring material departures and non-compliances to the notice of the appropriate level of management; the review also generally aims at locating unnecessary and weak controls for making the entire control system effective and economical.

As per SAP-7 The scope and objectives of internal audit vary widely and are dependent upon the size and structure of the entity and the requirements of its managements.

Normally, however, internal audit operates in one or more of the following areas:

- (a) Review of accounting system and relating internal controls: the establishment of an adequate accounting system and related controls is the responsibility of managements which demands proper attention on a continuous basis. The internal audit function is often assigned specific responsibility by management for reviewing the accounting system and related internal controls, monitoring their operation and recommending improvements thereto.
- (b) Examination for management of financial and operating information: This may include review of the means used to identify, measures, classify and report such information and specific inquiry into individual items including detailed testing of transaction, balances and procedures.
- (c) Examination of the economy, efficiency and effectiveness of operations including non-financial controls of an organization: Generally, the external auditor is interested in the results of such audit work only when it has an important reliability of the financial records.
- (d) Physical examination and verification: The would generally include examination and verification of physical existence and condition of the tangible assets of the entity.

EVALUATION OF INTERNAL AUDIT BY STATUTORY AUDITOR**USEFULNESS OF INTERNAL AUDIT****INTERNAL AUDIT V/S EXTERNAL AUDIT**

(1) The role of internal audit function within an entity is determined by management and its prime objective differs from that of the external auditor who is appointed to report independently on financial information. Nevertheless, some of the means of achieving their respective objectives are often similar and, thus, much of the work of the internal auditor may be useful to the external auditor in determining the nature, timing and extent of his procedures.

(2) The external auditor should, as part of his audit, evaluate the internal audit function to the extent considers that it will be relevant in determining in nature, timing and extent of his compliance and substantive procedures. Depending upon such evaluate, the external auditor may be adopt less extensive procedure than would otherwise be required.

(3) By its very nature, the internal audit function cannot be expected to have the some degree of independence as is essential when the external auditor expresses his opinion on the financial information. The report of the external auditor is his sole responsibility, and that responsibility is not by any means reduced because of the reliance he place's on the internal work.

DISTINGUISH BETWEEN:

INTERNAL CHECK	INTERNAL AUDIT
(1) Internal check is not a specific check, but the duties of different persons are so arranged that a person's work is automatically checked by another person while carrying out the normal duty.	(1) Internal audit is specifically done to check that the accounts are properly maintained and the systems are in control.
(2) Internal check does the preventive job i.e. internal check is derived so that frauds and errors are prevented.	(2) Internal audit does the detective job of identifying frauds and errors and rectifying them.
(3) It is more of process in a day to day functioning of the business.	(3) It is specific defined job.
(4) All the persons in the organization are involved to maintain the internal check system.	(4) Specific persons are appointed to the internal audit.



VOUCHING

STRUCTURE :

- 6.0 Objective
 - 6.1 Vouching
 - 6.2 Importance of vouching
 - 6.3 Test Checking
 - 6.4 Test Checking / Auditing in depth
 - 6.5 Exercises
 - 6.6 Audit Of Expenditure Purchase
-

6.0 OBJECTIVES

After studying the unit the students will be able to

- Understand the meaning of Vouching
 - Know the objectives of Vouching
 - Explain the importance of Vouching
 - Know how to audit the various items of income and expenditures
-

6.1 VOUCHING

Meaning: Vouching means the examination of documentary evidence in support of entries to establish the arithmetic accuracy. When the auditor checks the entries with some documents it is called vouching. Vouching is the acid test of audit. It tests the truth of the transaction recorded in the books of accounts. It is an act of examining documentary evidence in order to ascertain the accuracy and authenticity of the entries in the books of accounts.

According to **Dicksee** "Vouching consists of comparing entries in the books of accounts with documentary evidence in support thereof."

According to **Joseph Lancaster** "it is often thought that vouching consists of the mere examination of the vouchers or documentary evidence with the book entries. This is, however, quite wrong, for vouching comprises such an examination of the ledger entries as will satisfy the auditor, not only that the entry is supported by the documentary evidence but it has been properly made upon the books of accounts."

From the above it becomes clear that vouching means testing the truth of entries appearing in the primary books of accounts. In short, vouching means to examine the evidence in support of any transaction or entry recorded in the books of accounts. Vouching does not merely see that the entries and transactions are supported by proper documentary evidence. The auditor should be satisfied that they are properly maintained, they are supported by all evidence and they are correctly recorded in the books of accounts.

Voucher

Any documentary evidence supporting the entries in the records is termed as a voucher. Any document, which supports the entries in the books of accounts and establishes the arithmetical accuracy, is called a voucher.

Examples of vouchers:

A bill, a receipt, an invoice, goods received note, salaries and wages sheets, goods inward and outward register, stores records, counterfoil of a cheque book, counterfoil of pay-in-slip book, bank statement, bank pass book, delivery challans, agreements, a material requisition slip, copy of purchase order, minute book, memorandum and articles of association, partnership deed, trust deed, prospectus etc. are the examples of vouchers.

6.2 IMPORTANCE OF VOUCHING

- Ensures genuineness of the transactions
- Enables to know transactions
- Helps to know relevance of the transaction
- Facilitates proper allocation of capital & revenue, expenditure
- Detects frauds and errors
- Decides authenticity of transactions
- Ensures proper accounting
- Compliance with law
- Ensures proper disclosure

The special considerations to be borne in mind by the auditor in the course of vouching.

1. Date of the voucher
2. The name of the party
3. Tick and audit rubber stamp
4. Authorisation by the authorised person
5. Revenue stamp of Re. 1 if it exceeds Rs.5000/-
6. Transaction relates to business
7. Revenue and capital
8. Amounts in words and figure
9. Account head
10. No assistance of member of clients staff to be taken for checking receipts
11. Not to accept receipted invoice
12. Missing vouchers

13. Important documents
14. Vouching of cash transaction
15. Proper filing
16. Signature of payee
17. Nature of payment
18. Noting in the audit note book
19. Alteration
20. Voucher control number

Objectives of vouching

The basic objectives of vouching are as under:

1. To ensure that all the transactions are properly recorded in the books of accounts.
2. To see the proper evidence supports all the entries of the transactions.
- 3 To make it sure that fraudulent transactions are not recorded in the books of accounts.
- 4 To see that all transactions relating to business are recorded in the books of accounts.
5. To see that all transactions are properly authenticated by a responsible person.

Auditing Techniques

1. To an auditor, auditing techniques are the working tools used and applied for identification and examination of those evidences which have been traced by audit procedures.
- 2 Distinction: The dictionary meaning of the word 'technique' is the 'method of performance or execution' and that of 'procedure' is

'method of conducting an affair' or 'course of action taken or an act performed'. In other words, we can state that an all-inclusive list of techniques can be outlined (even with an addition of new or improved method or technique), whereas an all-inclusive list of procedures is difficult to be prepared as these are keyed to the objectives to which they relate. Techniques are more or less rigid and limited, but procedures can be many and varied depending on objective considerations for the acts to be performed or actions to be taken. On the same analogy, we can draw distinctions between auditing procedures and auditing techniques as follows:

- An all-inclusive list of audit procedures cannot be prepared as these are addressed to the varying audit objectives; but such list can be outlined for audit techniques.
- Auditing procedures are ways of applying (auditing) techniques to particular phases of a particular audit.
- The procedures (of audit) adopted in different engagements result from the judicious application of the available techniques (of audit).
- Audit procedure, in fact, is concerned with the general assertions like: existence or occurrence, rights and obligations, completeness, valuation or allocation, and presentation and disclosure that may be made regarding an account; whereas audit techniques are concerned with the examination of those evidences which have been traced as such by audit procedures.

Principal Procedures of Auditing: An all-inclusive list of audit procedures is difficult to prepare. Judgment, with a tempering of experience, remains the basis for the determination of the type and extent of audit procedures. However, the following may be cited as the principal audit procedures:

1. Reviewing, testing and evaluating the internal accounting controls relating to inventories, purchases, payroll, sales invoice preparation, stock valuation, depreciation accounting and analysis, routing of invoices, etc.
2. Inspecting, counting and calculating the different assets relating to cash, stocks, investment, plant and equipment, furniture; and determining that the inventory is calculated properly at the lower of cost or market price in accordance with generally accepted accounting principles consistently applied; and obtaining confirmation in regard to the validity of debtors and creditors balances, etc.
3. Obtaining the proof of accuracy - A copy of final inventory listing can be obtained and its clerical accuracy checked and tested; obtaining the earnings records of employees and checking the same for accuracy with the original copies of appointment-cum-increment letters; Similarly, appropriation of profit and the board's resolutions.
4. Reconciling, comparing and confirming - Sales invoices may be reconciled with the total charges to customers. The reconciliation between the cost account records and the books of financial accounts is an illustration. The Bank reconciliation statement provides a good measure of confirmation. The fact that the inventory belongs to the client and that any lien on the inventory is disclosed properly can be compared and confirmed from the minutes of the board of directors for indications of pledges or assignments.
5. Observation and inquiry about any excess, slow-moving, obsolete, or unassailable inventory.
6. Accounting of all pre-numbered inventories tags before and after the physical stock-taking.
6. Verification as to the evidences relating to the ownership of assets and existence of assets and liabilities, as a part of auditing practices and procedures, is the principal duty of the auditor before he certifies that the assets and liabilities that appear in the balance sheet exhibit 'true and fair view' of the state of affairs of the business.

7.

6.3 TEST CHECKING

Meaning.

Carrying out detailed check of each and every transaction of a large business shall be time consuming for the auditor. In auditing the accounts of a business, every single copy is not usually checked by the auditor; what is usually done in practice is that a representative number of entries of each class are selected and checked and if they are found correct, the remaining entries are taken to be correct. This is known as Test Checking. In those organizations, where satisfactory internal check system is in existence, the auditor need not carry out detailed checking. He may adopt Test checking. It is a system of sampling employed by the auditor for the purpose of reducing the volume of detail checking involved in the audit. If, in Test Checking, he finds that the records checked by him are correct then no further detail checking need be carried out.

Test Checking v/s Statistical Sampling

Selection of items for the purpose of checking can be done in two ways: (i) Judgment (ii) Statistical Sampling.

When the judgment method is applied, the method of checking is called test checking. When sampling techniques are applied it is called statistical sampling.

Precautions To Be Taken - While adopting the test check, the auditor must take the following precautions:

1. Entries selected for test checking must be representative of all transactions.
2. The selection of the items should be at random.

3. It cannot be adopted in case of vouching the cash book.
4. Client's staff should not come to know of the entries selected for test checking.
5. Period selected for test checking should differ from book to book and year to year.
6. He should not adopt test checking where the law requires thorough audit.
7. A number of entries of the first and last month of the year must be checked thoroughly.
8. Test should be so devised that a sizeable portion of the work done by each employee is checked.
9. Control accounts or impersonal ledger should not be subject to test checking.
10. Auditor should select the test independently without regard to the suggestions of the member of the client's staff.
11. Bank statement and entries for cash withdrawal and cash deposits should be checked in full.

The extent of the test checking will depend upon the judgment and wishes of the auditor but it must be remembered that time unnecessarily spent in routine checking is a waste of resources. Caution must also be taken to see that the test checking may not become insignificant in extent or automatic and unrepresentative. Test checking will be of no use unless the representative items selected for checking are chosen with great intelligence and imagination.

Advantages of Test Check

1. Volume of work is considerably reduced.
2. There is a saving in terms of time, cost and energy
3. The extra time available can be utilised for concentrating on areas of considerable importance,
4. If done carefully, test checking can be quite effective.

Disadvantages of Test Check

1. The auditor always is under fear whether he has missed out certain important items or that errors have remained undetected while test checking.
2. Where the client's staff is aware that the auditor resorts to test checking, the staff may become careless.

Auditor's Liability :

If any errors are found in the accounts the auditor cannot take the shield against the fact that he conducted test check. The auditor should very carefully select the items for test check and ensure on the whole that the accounts show a true and fair view of the Profit/Loss in the case of the Profit & Loss Account and of the state of affairs of the organisation in the case of Balance Sheet.

SURPRISE CHECKS

To avoid audit procedures from becoming routine, mechanical and predictable, surprise checks are desirable. Surprise checks involve visits by auditor to the client's office/factory without prior intimation. The element of surprise is in respect of both time and scope. Items checked

during such surprise checks are selected without prior notice to the client's staff.

Such checks are very effective in case of verification of cash, stock, investments, verification of books of prime entry. It helps in ascertaining whether the system of internal control is operating efficiently and thus prevent and detect errors and frauds in accounts.

USE OF TICKS

Ticks are used to keep a control on the work done by the auditor

Use of ticks should be done with great care while conducting an audit. Firstly the colour of the tick should be determined so that it is unique and will not be confused with that of the client's staff or internal auditors. Secondly the types of ticks to be used should be selected. The ticks should be placed at the right places so that the matter remains legible and the records do not become shabby.

Care should be taken to see, that the use of different ticks does not become known to the clients staff.

6.4 AUDITING IN DEPTH

Taylor and Perry have defined Auditing in Depth as : “the examination of the system applied within a business entailing the tracing of certain transactions from their origin to their conclusion, investigating at each stage the records created and their authorization”.

Audit in depth does not mean 100% checking. It is a detailed examination of the selected transactions from the beginning to the end. Thus, it is used along with test checking. For example, if the auditor has decided to check 25% of purchase transactions, these transactions should be checked in depth. Auditor should check the Purchase Requisition, Tenders, Purchase Orders, Purchase Bills, Goods Received Note, Inspection Note, Purchase Journal, Stock Register, Bin Card and so

on. Thus, the auditor should check the purchase transaction right from the beginning to the end. This enables him to evaluate the accounting system and internal controls.

CHECK YOUR PROGRESS

1. What do you mean by Audit Procedures ? Describe in brief different types of Audit Procedures.
2. Distinguish between Audit Procedures and Audit Techniques. Describe briefly different audit techniques.
3. What are the general steps and procedures followed by an auditor while conducting audit?
4. Write short notes on (a) Test check (b) Auditing in Depth (c) Surprise Checks (d) Use of Ticks in Auditing.
5. In audit what do you mean by Test Check' method of checking? What Precautions should be taken by the auditor so that standard of audit can be maintained by checking selected items of similar nature?

6.5 AUDIT OF INCOME

Cash sales

1. The cash sales register should be fully checked with the carbon copies of the cash sales bill. Particular attention should be given to first and last month of accounting year.
2. A summary of daily cash should be checked.
3. The auditor should be more careful where cash memos are issued even where cash is not received.
4. A certain representative item should be subjected to vouching in depth to get an idea about reliability of internal control.
5. Salesman's summary, gatekeeper's summary and cashier summary should also be compared.
6. Dates of cash sales bills and the date on which the receipt are recorded in the cash book must be the same. If the dates differ, the same should be inquired into.

7. Where cash sales bills are cancelled, all the copies, including original copy dully cancelled, should be kept in record.
8. Where it is a policy of the company to allow a discount, it should be seen that uniform policy is followed.
9. If the sales are made by the salesman, their statements should be verified and reconciliation should be made with the record of cash received.
10. Verify the entries in the cash book and the corresponding effect in sales A/c in the ledger.

Sales on approval

Document to be seen	Aspect to be verified / Auditor's duties
Sale or return day book	- Examine the sale or return day book for the manner of accounting. - Check actual movement of goods from dispatch register/ goods outward book. - Note the period of approval in the case of different goods/ customers. - Verify whether goods returned have been properly reversed in the day book.
Order book or confirmation book	Examine this register to verify sale confirmed by customers and goods held by customers at their end as sale or return stock.
Sales register	Ensure that sales have been recognised whenever- (a) approval is received from the party; or (b) goods are appropriated by the party; or (c) period of approval has expired and goods have not been returned.
Stock registers and statements	- Ensure that closing stock includes goods lying with customers in respect of which period of approval has not expired. - Ensure that goods validly returned by customers are duly accounted in stock.

Consignment sales

Document to be seen	Aspect to be verified/ Auditor's duties
Consignment agreement	Ascertain and note the following terms and conditions- - Commission due- manner of payment, adjustment, etc. - Risk of bad debts- in case of del—credere commission, consignee has to bear the risk of bad debts; else bad debts are borne by the consignor. - Reimbursement of consignment expenses- eligible expenses, extent of

	reimbursement.
Goods outward book	Verify goods despatched by reference to the proforma invoice, consignment day book, goods outward book, transport documents, acknowledgement of the goods by the consignee and the account sales.
Stock registers	• Ensure that the stock lying with consignee at the year end is be taken in the balance sheet at cost on a consistent basis and credited to the consignment a/c to arrive at the result of consignment transactions. • Ensure that no profit is taken for the profit on goods remaining in the hands of the consignee.
Account sales	• Verify whether consignment sales are accounted by crediting consignment account and debiting the consignee's account. • See whether the summery of transactions reported i.e. sales made, expenses incurred, commission due, remittance made, balance stock, and amount due from / to either party is properly disclosed in the general ledger.
Form F	For goods sold through agents In the course of inter-state trade or commerce, verify whether form F has been obtained under the CST Act.
Consignment account	• When the goods are consignment above cost, ensure that necessary adjustments to remove the loading are made at the end of the year. • Verify whether necessary adjustments are made at the year – end in respect off unsold goods, commission and expenses incurred by the consignee.
Confirmation	Obtain confirmation of the account balance from the consignee.

Sales return

1. Check the total of Sales Return Journal and find the amount recorded in profit and loss account.
2. Check every item of sale return with the credit notes sent to customer.
3. Check the entry in gate-keeper record for return inward movement of goods and check the internal control. Verify the entry in stock register.
4. Compare the extent of earlier year sales and return with that of the current year.

5. The sales return in the beginning of the year and of the end of the year should be carefully scrutinized.
6. Enquiry should be made if there is a wide gap between the original transaction and the return of goods
7. If the goods are return for unacceptable quality, enquiry about the steps taken after the return of the goods and verify the documentation.

Recovery of bad debts written off

1. Ascertain from the trail balance, the amount under consideration, and it should be taken to Profit and Loss Account.
2. Check the journey entry passed for the same and its authorization.
3. If the amount is received from a party under liquidation through his liquidator/ official receiver, check the letter from the person and check the amount which is received along with the year in which the original debt was written off.
4. Trace the amount in the bank statement.
5. Check the correspondence with the party and with the official receiver/ liquidator.

Rental receipts

1. Check the nature of the agreement of know the condition on which an asset is given on the rent
2. From the original documents, check the rates, periods, mode of payment i.e. cash or cheque.
3. Check the outstanding rent for last year and find out which of the receipts are for last year and how much rent still outstanding.
4. Check the entries in the cash with pay in slips and the receipts issued.
5. Check the outstanding rent at the end of the year and see that provision has been made for the same. Next year's record may be verified to find the receipt of the same.

Interest and dividend received

1. First check the income stated in the current year's profit and loss account.
2. Ascertain the amount received on account of last year and find the outstanding balance receivable.
3. From cash book vouch the entries for income received.
4. Check the Tax Deducted at Source (T.D.S.) calculation and verify the effect given in the ledger.
5. Compare the income received in total with that of the last year and enquire about any significant variation.
6. Get a list of investments and check whether the income on all the securities and investments has been received. If any securities are pledged with bank, get a certificate from bank.

7. Ascertain the income for the year, still to be received and check whether provision has been made for the same.
8. In case of interest received check the calculations.
9. For interest from bank, verify the entry in the bank statement. For fixed deposits, check whether any F.D has matured or any F.D. newly kept.

Royalties received

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

6.6 AUDIT OF EXPENDITURE PURCHASE

PURCHASE RETURN

Purchases Returns

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

SALARIES & WAGES

Salaries and Wages

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

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

- (a) Appointment, promotion, transfer and discharge of employees.
- (b) Recording attendance of workers engaged on the time basis, as well as particulars of jobs performed by piece workers.
- (p) Arrangement for the preparation of wages and salaries bills and their analysis.
- (d) Sanctioning the disbursement of wages and salaries.
- (e) Arrangement for disbursement of wages and salaries for workers and employees not present on the pay day.
- (l) Custody of the wages records.

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

- (a) Mechanical recording of attendance of workmen by time recording clocks installed at the factory gate, as well as in each department and the reconciliation of the total labour force with the total of workmen in different departments; also the recording of attendance of the staff departmental!}' in separate registers.
- (£>) Preparation of wages and salary bills by members of the staff, who are not connected with maintaining a record of engagement of workers, recording of their attendance or fixation of their wages.
- (c) Rotation of duties of different clerks employed for preparation of wages and salaries bills so that calculations, additions and extensions are not carried out by the same clerk every month. Also, signing of the statement by persons who have prepared them and

indication by each person so employed of the nature of work carried out by him.

- (d) Verification of salaries and wages bills in case of newly appointed persons by reference to orders for appointment, promotions or transfer made during each month and of those payable to old employees by reference to old records and on reference to the record of attendance.
- (e) Verification of the amount of total wages paid with the amount adjusted in costing record.
- (f) Checking and authorising the overtime and piece work payment by officers who not associated with the Wages Department.
- (g) Withdrawal by a single cheque from the bank of the exact amount of wages and salaries payable as are entered in the wages and salaries bill, depositing in the bank the undisbursed amounts.
- (h) Recording of unclaimed wages and salaries immediately in the Unpaid Wages and Salaries Register, and their subsequent payment on the employee's claim to them.
- (z) Payment of advances in lieu of wages and salaries to persons who go on leave on short notice before the end of the month through the Petty Cash.
- (l) Disbursement of wages in the presence of an official who is in a position to identify the worker and ensure that wages are not being paid to persons other than the workmen except under a proper authority.

RENT

Document to be	Aspect to be verified / Auditor's Duties
Rental Agreement	Examine the Rent Agreement and note aspects like - (a) period of lease; (b) rent payable; (c) manner of payment; (d) amenities and other charges
Payment Vouchers	• Verify the Payment Vouchers and check whether the payments have been made. per the terms of the agreement. • Trace the payment entries into the Bank Statement. See whether proper receipts have been obtained from the owner of the property.
TDS File	• In case of rent payments exceeding Rs. 1, 20,000 per annum, see whether tax has been deducted at source at the appropriate rates, and remitted to the authorities.
General Ledger / Financial Statements	* Ensure that any payment in the nature of Deposit / Additional Deposit has not been¹ Wrongly charged to revenue. • Where the Deposit given to the Landlord bears any interest, see whether Interest Income has been recognised in the P & L Account. • Scrutinise the Ledger and see whether proper accounting entries have

INSURANCE PREMIUM

Document to be seen	Aspect to be verified / Auditor's Duties
Insurance Policy / Cover Note	- Examine the insurance policy;/ cover note and note aspects like – (a) asset covered by the policy; (b) amount of premium; (c) time period of insurance, etc. - See whether "No Claim Bonus", whether applicable, has granted in the policy to the insured..
Payment vouchers	- Verify the payment vouchers and trade the payment entries into the blank statement. Compare the same with receipt issued by the insurance company. - Examine cases of insurance premium payments where insurance policy is taken out by arrangement with the bank e.g. in case of machineries and other assets obtained by way of bank loan.
Staff insurance policy records	where insurance premium relates to staff, examine whether the same has been properly recovered monthly / periodically from their pay bills.
General ledger / financial statements	scrutinize the ledger and see whether proper accounting entries have been passed in respect of prepaid insurance as at the beginning of the year / unexpired insurance premium at the end of the year etc.

Document to be	Aspect to be verified / Auditor's Duties
Internal Control Manual	- Obtain a complete list of Telephone Connections in the name of the Company and examine the nature of connections i.e. landline, mobile phones, WLL etc. - Examine the Internal Control System over the use of telephone by staff, particularly in respect of STD / ISD Calls.
Bills and Statements of Account	- Obtain the Telephone / Mobile Phone Bills for the period and verify if the bills are addressed in the name of the Company. - Note that the Telephone Bills relate to the period under audit. - Scrutinize the Nominal Ledger to check whether the bills for all the 12 months have been properly taken into account.
Deposit Receipts	Verify whether any deposit has been paid to the Telephones Department / Company and see if the same has been properly accounted in the books of
	In case of telephone expenditure of branch, check the same with respect to supporting documents and returns and see if the same has been accounted
Payment Vouchers	- Trace the payments into the Bank Statement and examine whether there is any abnormal time lag between the due date of bill, date of payment and date of debit of cheque in Bank Pass Book. - Check if any adjustments have to be made against the amount of the bill in respect of credits of previous bills remaining with the Telephone Department / Company. - Examine if the cost of any new telephone instrument purchased has also been included in Telephone Expense Account.
Personal Expense Element	Note that personal Telephone Expenses of the Directors, Partners etc. have not been debited to the Profit and Loss Account, except in cases where the expenditure is attributable to business purposes.

Staff Recovery Register	In case Mobile Phone Charges paid by the Company on behalf of their staff, see whether recoveries have been made from such employees for amounts in excess of the permissible limits.
Service Tax Returns	See whether Service Tax Input Credit has been availed by the Company on the basis of the Telephone Bills / Connections in the name of the Company.
FBI Returns	See whether the liability in respect of Fringe Benefit Tax on Telephone Expenses has been properly computed and remitted to the authorities.
General Ledger / Financial Statements	• Verify whether year-end adjustments have been properly accounted in respect of Outstanding Telephone Expenses. • Compute the percentage of Telephone Expenditure to Total Turnover and compare ' the same with that of previous year to ensure reasonableness.

Document to be	Aspect to be verified / Auditor's Duties
Internal Controls	• Examine the Internal Control in respect of Petty Cash Payments, and note the authorization procedure in respect of Postage and Courier Expenditure / Use of Postage Stamps / Prepaid Post Covers, etc.
Petty Cash Book	• Examine the Petty Cash Book and test-check the entries relating to Postage
Despatch Register	Cross-check a few cases of Postage / Courier Expenses with the Despatch Register™ Outward Mail Register, to see whether any mail
Acknowledgements	ff-sSa Where Postage Expenses are recorded in respect of Registered Post
Agreement with Courier Company	• Where¹ agreements are entered into" with a Courier Company / Agency settlement of bills on a monthly basis, see whether the internal control procedure[^] for authorizing payments (at the month-end) is operating effectively. See whether TDS has been deducted at source and remitted
General Ledger / Financial Statements	• Verify whether year-end adjustments have been properly accounted in respect of Postage Stamps in Hand. • Compute the percentage of Postage Expenditure to Total Turnover and compare tell same with that of previous year to ensure

PETTY CASH EXPENSES

1. Identify the persons who handle Petty Cash.
2. Verify the ceiling limit of disbursement through Petty Cash.
3. Note the limit of Imp rest System.
4. See whether petty cash payments are regularly checked by a responsible official.
5. Examine Reconciliation Statements prepared regularly for Petty Cash, based on vouchers.
6. Verify the Cashbook for the transfer of Cash under Imp rest system to Petty Cash.

7. *Scrutinise the Petty Cash Vouchers along with Invoices, Bills, Receipts signed by the recipients.*
8. *Trace the postage expenses along with entries in Mail Outward Register. Compare with previous periods and obtain satisfactory explanations for abnormal movements.*
9. *Check the castings of columns, totals and main totals.*
10. *Trace the postings from the Petty Cash Book into the Nominal Ledger Head of Account.*
11. *Verify the petty cash physically available on a certain date, by way of surprise check.*
12. *Examine the Suspense Vouchers / IOU's and ensure that they are reversed within a reasonable time.*
13. *Conduct a Surprise Check of Petty Cash balance and compare the same with the Petty Cash Book.*

TRAVELLING COMMISSION ADVERTISEMENT

Demanded for all items of expenses incurred, except those which are capable of independent verification. As regards traveling expenses claimed by directors the auditor should satisfy himself that these were incurred by them in the interest of the business and that the directors were entitled to receive the amount from the business.

The voucher for travelling expenses should normally contain the undermentioned information:

(i) Name and designation of the person claiming the amount. (ii) Particulars of the journey. (iii) Amount of railway or air fare.

(iv) Amount of boarding or lodging expenses or daily allowance along with the dates and times of arrival and departure from each station.

(v) Other expenses claimed, e.g., porter age, tips, conveyance, etc.

If the journey was undertaken by air, the counterfoil of the air ticket should be attached to the voucher; this should be inspected. For travel by rail or road, the amount of the fare claimed should be checked from some independent source. Particulars of boarding and lodging expenses and in the case of halting allowance the rates thereof should be verified. The evidence in regard to sundry expenses claimed is generally not attached to T.A. bills. So long as the amount appears to be reasonable it is usually not questioned. All vouchers for travelling expenses should be authorised by some responsible official. In the case of foreign travel or any

extraordinary travel, the expenses, before being paid, should be sanctioned by the Board.

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



VERIFICATION AND VALUATION OF ASSETS AND LIABILITIES

STRUCTURE :

- 7.0 Meaning of verification
- 7.1 Points to be considered
- 7.2 Scope of verification
- 7.3 Object of verification
- 7.4 Advantages of verification
- 7.5 Techniques of verification
- 7.6 Verification of assets
- 7.7 Valuation of assets
- 7.9 Verification of assets – Illustrations
- 7.10 An Auditor is not a valuer
- 7.11 Verification of Liabilities :
- 7.12 Difference Between vouching and verification
- 7.13 Stock verification
- 7.14 Valuation of Stock-in-trade
- 7.15 Verification and Valuation of goods on Consignment
- 7.16 Exercises

7.1. MEANING OF VERIFICATION :

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

Thus, verification includes verifying :-

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

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

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

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

1. They exist.
2. They belong to the client.
3. They are in the possession of the client or the persons authorized by him.

4. They are not subject to undisclosed encumbrances or lien.
5. They are stated in the balance sheet at proper amounts in accordance with sound accounting principles, and
6. They are recorded in the accounts.

7.2 POINTS TO BE CONSIDERED :

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

1. **Existence** : The auditor should confirm that all the assets of the company are physically existing on the date of balance sheet.
2. **Possession** : The auditor has to verify that the assets are in the possession of the company on the date of balance sheet.
3. **Ownership** : The auditor should confirm that the asset is legally owned by the company.
4. **Charge or lien** : The auditor has to verify whether the asset is subject to any charge or lien.
5. **Record** : The auditor should confirm that all the assets and liabilities are recorded in the books of account and there is no omission of asset or liability.
6. **Audit report** : Under CARO the auditor has to report whether the management has conducted physical verification of fixed assets and stock and the difference, if any, between the physical inventory and the inventory as per the book.
7. **Event after balance sheet date** : The auditor should find out whether any event after the date of balance sheet has affected any items of assets and liabilities.

7.3 SCOPE OF VERIFICATION

Verification includes information on the following :-

1. That the assets were in existence on the date of the balance sheet
2. That the assets had been acquired for the purpose of business only
3. That the assets had been acquired under a proper authority
4. That the right of ownership of the assets vested in the organization
5. That the assets were free from any charge and
6. That the assets were properly valued and disclosed in the balance sheet.

7.4 OBJECTS OF VERIFICATION :

Following are the objects of verification of assets and liabilities

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

7.5 ADVANTAGES OF VERIFICATION

Advantages of verification are as under :-

1. It avoids manipulation of accounts
2. It guards against improper use of assets
3. It ensures proper recording and valuation of assets
4. It exhibits true and fair view of the state of affairs of the company.

7.6 TECHNIQUES OF VERIFICATION :

1. Inspection : It means physical inspection of the assets i.e. company cash in the cash box, physical inventory, inspection of shares certificates, documents etc.
2. Observation : The auditor may observe or witness the inspection of assets done by others.
3. Confirmation : It means obtaining written evidence from outside parties regarding existence of assets.

7.7 VERIFICATION OF ASSETS

The term 'verification' signifies the physical examination of certain class of assets and confirmation regarding certain transactions. Sometimes verification is confused with vouching but they differ from each other on the nature and depth of the examination involved. Vouching goes to prove the arithmetical accuracy and the genuineness of the transactions, whereas verification goes to enquire into the value, ownership, existence and possession of assets and also to confirm whether they are free from any mortgage or charge. The fact of the presence of any entry regarding the acquisition of asset does not prove that the particular asset actually exists on the Balance Sheet date, rather it purports to prove that the asset ought to exist; on the other hand, verification through physical examination and confirmation proves whether a particular asset actually exists without having any charge on the date of the balance Sheet.

Verification of assets involves the following steps:

1. Enquiry into the value placed on assets;
2. Examination of the ownership and title deeds of assets;
3. Physical inspection of the tangible assets; and
4. Confirmations regarding the charge on assets;
5. Ensuring that the assets are disclosed, classified and presented in accordance with recognized accounting policies and legal requirements.

The scope of verification is wide and consequently verification is an important part of the auditor's duties. An auditor should put all his endeavor to satisfy himself whether a particular asset is shown in the Balance Sheet at proper value, whether the concern holds the title to the asset and the asset is in the sole possession of the concern and lastly whether the asset is free from any charge. If the auditor fails to perform his duty, he will be held liable. In case of *London Oil Storage Co. Ltd. Vs. Sear Hasluck & Co.* (1904) Chief Justice Alverstone remarked : `It is the duty of the auditor to verify the existence of the assets stated in the Balance sheet and he will be liable for any damage suffered by the client if he fails in his duty.

Besides the legal importance, verification also plays an important role to guard against improper valuation of assets like stock-in-trade which may inflate or deflate the profit position of the concern. Improper valuation of assets may also conceal the actual position of the business as reflected in the Balance Sheet.

However, it is not possible on the part of the auditor to physically verify each and every asset because time may not permit him to do so, or he may not have sufficient technical knowledge of the assets concerned. It was decided in the case of *Kingston Cotton Mills*: that it is not a part of an auditor's duty to take stock. No one contends that it is. He must rely on other people for the details of the stock-in-trade.

Again, while going through the decision of *Mc Kesson and Robins* case in 1939, we find that the auditor should physically verify some of the assets. If possible, title documents like negotiable instruments, shares, debentures, securities, etc. are to be thoroughly examined on the last day of the accounting period. He should satisfy himself that the transactions, if

any, having bearing on the Balance Sheet date and date of audit are bonafide and are supported with proper evidence. The auditor is also supposed to verify stock-in-trade with reference to the purchase book, the stock records, the gatekeeper's book, etc. though law does not specially compel him to take stock-in-trade.

7.8 VALUATION OF ASSETS

(i) Meaning :

Valuation of assets means determining the fair value of the assets shown in the Balance Sheet on the basis of generally accepted accounting principles. The valuation of assets is very important because over-statement or under-statement of the value of assets in the Balance sheet not only distorts the true and fair view of the financial position but also gives wrong position of profitability.

The valuation of the assets is the primary duty of the officials of the company. The auditor is required to verify whether the value ascertained is fair one or not. For this, he may rely on the technical certificate issued by the experts in the field.

Valuation of assets means not only checking value of the assets owned by an organization as on Balance Sheet date, but also critical examination of the value of these assets

(comparative analysis of different assets).

The auditor has also to see that the principle of valuation of assets is consistently adopted and is based on established principles of accountancy. For the purpose of convenience, those assets are classified as under to determine their value.

1. Fixed Assets
2. Current Assets or Floating Assets
3. Wasting Assets
4. Intangible Assets
5. Fictitious Assets.

1. **Fixed Assets :** Fixed Assets are usually valued at 'going concern value' which means cost less depreciation. Cost here means purchase price of the assets plus all incidental manufacturing, buying and installation expenses incurred to bring the assets in use. Depreciation is the provision made for the reduction in the value of the assets on account of their usage, natural wear and tear and obsolescence etc. The depreciation provided should be fair, otherwise the value of fixed assets may not be fair. What is a fixed asset depends on the nature of the business organization.

2. **Current Assets or Floating Assets :** These are usually converted into cash at the earliest opportunity in the process of business activity, e.g. stocks, bills receivables, sundry debtors, etc. Based on conservatism principle, usually current asset are valued at original value (cost price) or market value (realizable value) whichever is lower. Because they are intended to be converted into cash at the earliest possible time, hence what value we may realize is important. This method is adopted to strengthen the financial position of a concern by indirectly providing for expected loss by way of fall in the market value of the assets. This principle is held by the conservatism convention of accounting, i.e. do not expect profits but provide for anticipated losses.

3. **Wasting Assets :** Wasting Assets means those which lose their value gradually upon their use, e.g. a mine, a quarry etc. To value these assets firstly we should determine the usefulness of the assets in terms of units of production etc. and as per their actual use the value is to be reduced on proportionate basis. If in a particular period this type of asset is not used then the value may not diminish also. Thus, these assets are to be reduced on the basis of consumption. But sometimes it may be difficult to adopt this method, then the 'cost less depreciation' principle may have to be applied.

4. **Intangible Assets :** Usually intangible assets like goodwill, patent rights, know how, etc. are valued on cost basis. But if the same are acquired by a non-cash transaction, then the fair market value is to be taken as the value of intangible assets. Auditor should also see the period of time and till it is fully written off, they are shown as assets because they do not have any realizable value. They are to be valued at actual cost less amount written off as depreciation upto Balance Sheet date.

5. **Fictitious Assets** : Certain lumpsum expenses giving benefit for more than one year when incurred are written off over a period of time, and till it is fully written off, it is shown as an asset in the Balance Sheet e.g. preliminary expenses, discount on issue of shares etc. These are all fictitious assets because they do not have any realizable value. They are to be valued at actual cost less amount written off upto the Balance Sheet date.

7. 8.1 Methods of Valuation

The following are the various principles of valuation of assets

- (1) **Cost Price (Going Concern Value)** : Under this method actual cost of assets are reduced by the depreciation provided. Usually this method is applied to value fixed assets.
- (2) **Market Value** : This refers to the market value of the asset i.e. the price at which the asset is being transacted in the market. This is applied to value the current assets only when this is lower than cost of the asset. Usually market value is adopted to value items having perishable nature.
- (3) **Scrap Value** : Assets which are useless for the enterprise may be sold as scrap in the market. The value for which such assets can be disposed of as scrap, is called as scrap value of assets.
- (4) **Replacement Value** : This represents the value at which the existing assets can be replaced. That means the price to be paid to acquire such type of assets in the market on the date of the balance Sheet.
- (5) **Realisable Value** : The value that can be obtained if the asset is sold in the market i.e. anticipated selling price. Usually, expenses such as commission, brokerage etc. are deducted from it.

7.8.2 Auditor's position regarding valuation of assets :

So far as the valuation aspect of audit is concerned, the auditor's position is somewhat different from the other aspects of audit. It has already been pointed out that the auditor is not supposed to have technical knowledge regarding the valuation of assets. Therefore, he has to depend upon the valuation made by the directors, experts, surveyors, etc., to a great extent. But does it relieve him from liability if certain assets are overvalued or undervalued by the directors, experts or surveyors etc? The reply is definitely no, because the auditor cannot give a guarantee for absolute correctness or the state of affairs when he has to depend upon others, and also where assets are valued according to the estimated depreciation. He has to see that the management tries to show the fairest possible estimate of the position of the state of affairs of the concern. Under these circumstances, the auditor should see that assets are valued according to certain accepted principles of accountancy. He should check the estimation in a reasonable manner. The auditor in any case should thoroughly examine the available papers and documents to arrive at the correct value of assets. In case of a little suspicion as regards the valuation of assets he should probe into the matter.

7.8.3 Distinction between verification and valuation :

1. **Meaning** : verification establishes existence, ownership and acquisition of assets whereas valuation certifies correctness of the value of assets and liabilities.
2. **Time** : Verification is done at the end of the year whereas valuation is done during the year.
3. **Personnel** : Verification is done by auditor whereas valuation is done by the proprietor himself.
5. **Evidence** : The title deeds, receipts of payments constitute documentary evidence for verification whereas certificate given by the proprietor is the documentary evidence for valuation.

7.9 VERIFICATION OF ASSETS – ILLUSTRATION :

(i) Cash in hand and at bank :

Cash in hand includes all the following :

(a) Cash in hand :

1. Special care is necessary with regard to verification of cash balances. There can be no certainty that the cash produced for inspection was in fact held by the custodian.
2. For this reason, the cash should be checked not only on the last day of the year, but also checked again sometime after the close of the year without giving notice of the auditor's visit either to the client or to his staff.
3. If there is more than one figure for cash balance e.g. when there is a cashier, a petty cashier, a branch cashier and in addition, there are imprest balance with employees, all of them should be checked simultaneously, as far as practicable, so that the shortage in one balance is not made good by transfer of amount from the other.
4. It is desirable for the cashier to be present while cash is being counted and he should be made to sign the statement prepared, containing details and the cash balance counted. If he is absent at the time the cash is being verified, he may subsequently refute the amount of actual cash on hand which may put the auditor in an embarrassing position.
5. If the auditor is unable to check balance on the date of the Balance Sheet, he should arrange with his client for all the balance to be banked and where this cannot conveniently be done on the eve of the close of the financial year, it should be deposited the following morning. The practice should also be adopted in the case of balance at the factory, depot or branch where cash cannot be checked at close of the year.
6. Should this not be possible, the auditor should verify the receipts and payments of cash upto the date he counts the cash. This should be

done soon after the cash balances have been counted. The cash book of the day on which the balance is verified should be signed by the auditor to indicate the stage at which the cash balance was checked.

7. If any cheques, or drafts are included in cash balance the total there of should be disclosed.
8. If there is any rough Cash Book or detail of daily balance are separately kept, the auditor should test entries from the rough Cash Book with those in the Cash Book, to prove that, entries in the Cash Book are correct.
9. If the auditor finds any slip, chit or I.O.U's in respect of temporary advances paid to the employees, included as part of the cash balance, he should have them initialed by a responsible official and debited to appropriate accounts.

(b) Cash in Transit (Remittance in Transit)

1. This refers to amount sent by Branch/Depots/Agents etc. to Head Office but physical cash/cheques not yet received by H.O. or vice versa.
2. Such remittance in transit should be verified from subsequent period cash book/pass book as to whether actually it is received or not.
3. Reconciliation of H.O./Branch Accounts should also be checked.
4. If amount is deposited into bank, pay-in-slip can also be verified.
5. See that entry for remittance in transit is passed by only one party and is reversed in the next year.

(c) Petty Cash

1. Petty Cash in hand should be verified with Petty Cash Book
2. Also check up the balance of Petty Cash Account in General Ledger.

3. Vouch the transaction of last month property to ascertain that fictitious payments are not entered into
4. Some of the points given for verification of cash in hand will be applicable for Petty Cash also.

(d) Bank Balance :

1. To verify cash at bank, the auditor should examine the bank pass book and compare it with the balance as shown by the bank column of the cash book.
2. Check bank reconciliation statement with bank statement / pass book of subsequent period.
3. The auditor should get a certificate regarding the balance at the bank directly from the bank.
4. Ensure that the balance as shown by the cash book is brought into the balance sheet as 'Cash and Bank' and not 'Balance as shown by the pass book'.
5. The auditor should also see that the 'cheque outstanding' and 'cheques not yet collected' are genuine and not made up in order to conceal the deficiency. If some of these cheques are more than six months old, he should make inquiries, and have them reversed in the books of accounts.
6. Cash in Fixed deposits with the bank can be verified by examining the deposit receipt, or getting a certificate from the banker.
7. If there are more than one bank account such as 'Dividend Account', 'Interest Account' etc. all such accounts should be checked and the balances should be verified upon the same date. Information regarding their balance should also be obtained from the bank directly.
8. If the bank account shows an adverse balance and the client has deposited any security for the overdraft, the auditor should enquire from the bank the particulars of the security and the amount of the interest charged.

(ii) Bills Receivable

1. The auditor should examine the Bills Receivable Book with the Bills Receivable not matured but in hand on the date of the Balance Sheet.
2. When any bills are in the process of collection the details of the same have to be verified with bank certificates.
3. If the Bills Receivables in hand are many, auditor should make a list of bills for his convenience.
4. If there are any bills that have been discounted, and still not matured, he has to examine the details of the same very carefully and should confirm with the bank because they are to be shown as contingent liabilities by way of a note in the Balance Sheet.
5. While examining the Bills, the auditor has to pay special attention to see that they are properly drawn, stamped and duly accepted.
6. He has to check whether any bills is overdue. If so, auditor should ask for the details of the action initiated, etc. If there are any bills which are doubtful of recovery, he should see whether any adequate provision has been made for the anticipated loss on account of bad debts.
7. He has to see that in case of dishonoured bills, the same is not shown as Bills Receivable. the auditor has also to check up whether noting formalities have been properly complied with or not.
8. In case the auditor has visited his client after the Balance Sheet date, many of the bills due on the Balance sheet date might have matured or honoured. Hence the auditor has to vouch such bills with Cash Book or Pass Book and reconcile the balance.
9. If the bill has been renewed after the Balance Sheet date, then also the value of the original bill due on Balance sheet date should be shown as Bills Receivable and interest on renewed bills properly accounted.
10. If the bills endorsed have been dishonoured, the original drawee is to be debited and endorsee is to be credited.

(iii) Loans advanced

Loans may of different types like :

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

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

1. Verify whether object clause of the Memorandum provides for granting of such loans.
2. Examining whether a proper loan ledger has been maintained and it is up-to-date or not.
3. Examination of the security lodged against each loan. The loan agreement is to be scrutinized regarding the rate of interest. Due dates of instalment, penalty, interest, etc.
4. He should ascertain whether any loan is doubtful of recovery in which case a provision for the expected loss is to be made.
5. Except in case of a banking or finance company, auditor has to ascertain whether the purpose of advancing is connected with business or not. Section 227(4A) of the Companies Act, 1956 requires an auditor to report whether the parties to whom the loans are given are regular in payment of interest and principal and the terms of the loan are not prima facie prejudicial to the interest of the company.

(a) Loans against the security of Land and building

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

3. The auditor, if required, has to examine the valuer's certificate in order to ascertain the value and sufficiency of the security.
4. The auditor has to confirm that the property is properly insured and insurance premiums have been paid in time.
5. The auditor has to examine the title of the Borrower to the property, etc.
6. If the mortgage is a second mortgage, the auditor has to confirm that the same is brought to the knowledge of the first mortgagee. In this case he has to take the acknowledgement of title deeds from the first mortgagee.

(b) Loans against the security of goods.

1. The auditor has to examine the nature of the goods and confirm that the goods are really belonging to the borrower. He should see whether the loan is granted against railway receipt, lorry receipt, dock warrant, godown keeper's receipt etc.
2. In case goods are stored in the godown, he has to see that the rent of the godown is paid in full and the goods are fully insured.
3. The auditor should examine the value of the goods by comparing them with the present market value. Regarding quality and quantity, he may rely on the inspector's reports.
4. If the goods are of perishable nature, the auditor has to examine the turnover of the stock of the client.

(c) Loans against the security of stocks and shares

1. He should call for a statement of stocks and shares given as security and confirm that all of them are fully paid up.
2. He should see whether an instrument of transfer is properly stamped and is properly executed.
3. He should see that their value is properly disclosed as per the prevailing market rates.

4. He has to ensure that there is a sufficient margin on the loans advanced.
5. He has to see whether the charge is properly registered or not.

(d) Loans against the security of insurance policies :

1. The auditor should see that the policy has completed at least two years.
2. The auditor should confirm that all the premiums have been properly paid and the policy is in force by examining the latest premium receipt.
3. The auditor should ascertain that due notice of assignment has been given to the insurance company.
4. The auditor should see that the loan has been advanced on the basis of surrender value of the policy as certified by the insurance company.
5. The auditor has to ensure that the premium, if any, paid up by the lender to keep the policy in force is properly debited to the Loan Account of the borrower together with the usual interest.

(e) Loans against the personal security of the borrower

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

(iv) Sundry Debtors :

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

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

- (a) Direct confirmation of balances from debtors by sending confirmatory letters.
 - (b) Year-end Scrutiny of ledgers.
 - (c) Verification of the position of debts considered bad or doubtful.
 - (d) Compliance with legal requirement or presentation.
2. The auditor should arrange to send the letter of confirmation of balances by the client as per client's records and see that the reply of confirmation is forwarded to his office directly. Usually this should be sent within 15 or 20 days of close of the year under the supervision of the audit staff. After the reply is received, the same should be tallied with the balances shown in the Debtors Ledger and difference properly reconciled.
3. After the said procedure is carried out, he should carry out a thorough scrutiny of the debtor's individual accounts. Wherever the number of debtors is very large, Test Checks can be applied.
4. While scrutinizing the ledger, the auditor should focus the light on discounts, returns, cash received, rebates allowed, goods returned etc.
5. On ascertaining the balances of the debtors as genuine and correct, the auditor has to verify the debtors to find out bad or doubtful debts to make a provision for the same. If the debts are bad and irrecoverable or doubtful and they are not provided for properly, the financial statements will not portray a 'True and Fair' view. Hence, appropriate provision is to be made by considering the age of the debtor, scrutiny of payments received, management opinion and any other information like financial position of debtors, etc. If the auditor fails in verifying the appropriateness of the provision made, he shall be held liable for negligence.
6. After ascertaining the position of bad or doubtful debts, he should see that the legal requirements of Schedule VI to the Companies Act, 1956 are complied with. For this purpose, the debtors are to be classified as :
 - (a) Outstanding for a period of more than six months ; and

(b) Other debts.

7. Over and above this, other requirements like debts considered as good and which are fully secured, debts due from the officers, directors, managers of the company, etc., are to be ascertained for disclosure.
8. If the customers have purchased the goods on hire purchase system and some of the instalments are not due, the same is not to be shown as 'stock out on hire purchase'.
9. Likewise, if the goods are sold on 'return or approval' basis, such customer cannot be shown as a debtor at the close of the year.
10. Further, whenever there are credit balances in some debtors account, the same are not to be deducted from other debtors debit balances and net balance is not to be shown in the assets side, but former is to be shown as Sundry Creditors.

(v) Patent and Trademarks :

1. The ownership of patent rights is verified by inspection of certificate issued for grant of patent, by the prescribed authority.
2. If it has been purchased, the agreement surrendering it in favour of the client should be examined.
3. If there are a number of patents held by the client, obtain a schedule giving the full details thereof or verify with reference to the register maintained by the client.
4. It must be verified that patent rights are alive and legally enforceable and renewal fees have been paid on due dates and charged to Revenue Account. The last renewal receipt should be examined to ascertain that the patent has not lapsed.

5. See that the patents are properly registered in the name of the client only.
6. See that the cost of patent is being written off over its useful period of life.
7. In case the patent is acquired, cost paid for the same and all relevant expenses are to be capitalized.
8. If the patent is created by the client by the research experiments and laboratory work, only the actual expenses incurred for it in the process are to be capitalised.

(vi) Copyrights

1. The auditor has to examine the written agreement of assignment alongwith the royalty paid to the authors etc., for such copyrights.
2. He has to see that such assignments are properly registered.
3. If the client is the owner of many copyrights, the auditor should ask the client to prepare a schedule of copyrights and get the detailed information to confirm that the same is shown in the Balance Sheet.
4. Regarding the value of copyrights, it should be remembered that this asset has no value in the long run. Hence, value is determined on revaluation basis and period of copyrights.
5. If any copyrights does not command the sale of any books, then the same should be written off in such year. The auditor has to verify the same in detail.

(viii) Know-how :-

1. Know how is recorded in the books only if it has been paid for. If it is developed in house, it cannot be capitalised. The auditor should keep his in mind while verifying know-how.

2. Know-how can be of two types :

- (a) Relating to manufacturing process – The auditor should ensure that the expenditure is written off in the year of payment itself.
- (b) Relating to design, plans of plants, building etc. - The auditor should ensure that the expenditure is capitalized and depreciation is charged on the capitalized figure.
In case lumpsum payment is made for both types of know-how, both the types should be segregated on a reasonable basis.

Under the Income-Tax Act, cost of Know-how can be deducted subject to the rules laid down.

The auditor should keep this fact in mind while computing the tax liability for the year under audit.

(viii) Investments :

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

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

2. Add to the above list, purchase made during the year and delete the investments sold during the year with all the above details.
3. Balance this schedule and compare the balance with general ledger and Balance sheet.
4. Check the market value of investments with reference to stock exchange quotations or other suitable method, on Balance Sheet date and see that the values are disclosed in the Balance sheet.
5. Inspect the certificates or securities physically on the Balance Sheet date.
6. Compare the income received with amount due and adjust the accrued income.
7. Confirm the uncalled liability on partly paid shares held as investment shown as contingent liability by way of a note to the Balance Sheet.
8. See that adequate provision is made for any shortfall in the book value of investment shown in the Balance Sheet.
9. See that, regarding the investment in subsidiaries, disclosure requirement of section 212 of Schedule VI of the Companies Act, 1956 are complied with.
10. For investment in the capital of partnership, the partnership deed and copy of accounts of partnership firms, is to be verified. Also adjust the share of profit and loss for the partnership period.
11. Investments which stand in the name of persons other than that of the company are to be confirmed with appropriate sanction.
12. For investment lodged with others as security or lying with banks or share brokers, obtain a certificate from the parties concerned.

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

(ix) Leasehold Property :

Normally the lease or right to use the property is granted for certain number of years. At the expiry of the period of lease, the rights go back to the original lessor. Various steps involved in the verification of leasehold rights are stated below.

1. Inspect the lease agreement to ascertain the amount of premium paid, period of lease, other terms and conditions, like maintenance, insurance, etc.
2. See that the lease is properly registered with the Registrar because a lease for a period exceeding one year is not valid unless it has been granted by a registered document.
3. Ascertain those conditions, the failure of which might result in the forfeiture or cancellation of lease, and see whether they have been properly complied with.
4. See whether sub-lease is valid as per lease agreement, in case if it is granted, by referring to sub-lease agreement.
5. See that the premium paid and acquisition expenses of lease are being amortised (written off) over the period of lease adopting a suitable basis.
6. In case, any provision is to be made under the dilapidation clause for payment on the expiry of the term of lease, see that the same is properly and continuously provided.
7. In case of leasehold land, if any building is constructed by the lessee, see the position and ascertain the correct method of presentation of such expenditure for disclosure in the Balance Sheet.

(x) Goodwill

1. Whenever the company has purchased or acquired a running business and has paid for it an amount, in excess of the book value of its net assets, the excess is called 'Goodwill'. It can be verified from the vendor's agreement and the auditor has to see whether there is a specific sum which is paid or whether it is the excess of price paid over the tangible assets and see that it is properly recorded.
2. When the company has written up the values of all its assets on a revaluation and has raised a Goodwill Account in the books, the Goodwill appears in the Balance Sheet. In this case, the auditor has to see the basis of valuation and get satisfied about the same. If he is not satisfied, the fact should be reported to the shareholders.
3. He has to see that such excess is credited to a Capital Reserve or Revaluation Reserve and no dividend is being declared from it.
4. He has also to see the disclosure requirement of Schedule VI and ensure that the fact are disclosed for 5 years subsequent to the date of revaluation.
5. Sometimes, Goodwill which is written off earlier may be brought back in the books of account to adjust the debit balance of Profit and Loss account. In this case, the auditor should investigate the fact and satisfy in full before approving such method of creating Goodwill. He should also refer to the board resolution. In case he is not satisfied, the fact should be reported to the shareholders.
6. If Goodwill has been created by any other means, the auditor should see that all relevant facts are properly disclosed and are supported by documentary evidence.

(xi) Plant and Machinery :

1. Now-a-days as per provision of Section 227(4A) of the Companies Act, 1956 every company is required to maintain a Fixed Asset Register showing full particulars including cost, location, depreciation, details of purchase, expenses capitalised, etc. Therefore, the auditor should ask for such a register maintained by the client and see that all items of plant and machinery are recorded properly giving full details.
2. As per the provision of the same section, all fixed assets are required to be physically verified by the management. Therefore, the auditor should enquire whether such physical verification was undertaken or not. If yes, he should ask for necessary papers pertaining to the same. If there is any discrepancy, reasons for the same should be asked.
3. Any new purchase made during the year are to be verified with reference to purchase invoice and other papers regarding installation of the same.
4. Total value of plant and machinery as shown by Fixed Asset Register should tally with ledger account maintained in the financial books.
5. Where any item of plant and machinery is sold, scrapped or transferred the auditor should check relevant entries for the same and verify that they are removed from the Fixed Assets Register.
6. The auditor should verify that adequate depreciation is provided on all items of plant and machinery and method of depreciation is consistently followed from year to year.
7. Auditor should see that the entire plant and machinery stands in the name of the client and are free from any charge or encumbrances. If plant and machinery is mortgaged, then he has to verify that the documents are properly executed and mention of mortgage is made in the Balance Sheet.

(xii) Furniture and Fixtures :

1. The auditor has to see that a proper record showing quantitative details of furniture and fixtures owned by the client is maintained.
2. The auditor has to see that all expenses incidental to the purchase of furniture and fixtures is capitalised along with the purchase price paid for it.
3. The auditor has to enquire whether the furniture and fixtures have been properly insured or not.
4. The auditor has to see that adequate provision for depreciation on furniture and fixtures is made.
5. The auditor if possible can go for physical verification of furniture on test check basis or he can rely on the management certificate to that effect.
6. He has to further see that any damaged or unusable furniture, if existing, is fully written off in the books.

(xiii) Freehold Property (Land & Buildings) :

1. The auditor has to examine the title deeds of the property owned by the client and confirm that the same is freehold.
2. If the property has been purchased during the year, the auditor has to examine the correspondence with the broker, or solicitor in details.

3. When a building has been constructed on the freehold property, the same is to be verified from builder's bill or architect's certificate.
4. Where the title deeds are deposited with the mortgagee on a mortgage, then a certificate from him to that effect is to be obtained for verification.
5. If the title deeds are deposited with the bankers or solicitors for safe custody, the auditor should get a certificate from them to confirm the fact.
6. If required, the auditor should ask the solicitor of the client to confirm the validity of the title deeds relating to the property.
7. The auditor has to see that the conveyance of the property is in the name of the client and the same is properly registered.
8. The auditor has to ensure that the property is properly insured.
9. The auditor should see that separate account for land and building is maintained. Because on land, usually no depreciation is provided.
10. In case there is appreciation of land and buildings value by revaluation, the auditor has to see the basis of revaluation and confirm that the same is properly disclosed in the Balance Sheet, to comply with the generally accepted accountancy principles and also the provision of Companies Act, 1956.

(xiv) Motor Cars :

1. In respect of motor vehicles mileage or usage method is better because the time of total mileage that the particular vehicle will give, can be ascertained without much difficulty and the mileage in

a particular year can also be known, so proportionate cost of the asset can be written off over the mileage traveled. For example, if the total mileage of a vehicle costing Rs. 80,000 is 1,60,000 miles and in a year suppose 15,000 miles are traveled, then the depreciation for that vehicle would be:

$$80000 \times \frac{15000}{160000} = \text{Rs. } 7,500$$

2. Where number of motor cars is large, it would be advisable if the client maintains a motor vehicle register. Where no such register is maintained, the balance of Motor Car account in the General Leger should indicate the registration number and cost of each vehicle.
3. The auditor should examine the registration book to see whether the description agrees with the details given by the client. The auditor should see that the person in whose favour registration is made holds it on behalf of the client and gives a confirmation that he holds it and there is no charge on it.
4. Many a times, vehicles are purchased by the client for the purpose of employees who pay a certain sum of money every month from the salaries. When all the money has been paid, the client transfers the car in the employee's name. The auditor should check the relevant records for recovery made and the transfer price.
5. Sometimes cars are owned by employers and given to employees and cost of maintenance is borne by the client and the auditor in these cases affirms that whenever the client owns a car, he should provide depreciation on it.
6. Similarly, when the car is sold as scrap to the employees the auditor should compare the written down book value with the scrap price realized and see that the balance is charged to revenue account.

(xv) Loose Tools, Patterns, Dies, etc.

Auditor's duties with regard to the verification and valuation of such assets may be stated as follows:

1. Since the duration of the usefulness of such assets is very low, there is no need of maintaining separate accounts for each of them. The auditor in this case should see whether proper supervision has been exercised over these assets, as there is every possibility of pilferage of such small assets.
2. The auditor should collect a list of small tools, dies, moulds, rigs, etc. from a responsible officer and examine the same very carefully. He should also see that such a list has been certified by a responsible officer.
3. As regards the valuation of small tools, the auditor should see that in the case of the concern which manufactured its own tools, the tools are not to be valued in excess of the cost.
4. Generally, these types of assets appear to be either lost or consumed very rapidly. So the conventional method of depreciation should not be applied in their cases. The suggestion as given by Montgomery in this connection may be stated. "Charging the cost of replacement of such items to maintenance in lieu of depreciating them is usually a satisfactory alternative". The auditor should see whether the above mentioned suggestion has been accepted or not.
6. The auditor should also see whether such an asset has been properly shown in the Balance Sheet.

(xvi) Assets Acquired on Hire Purchase Agreement

1. Assets purchased on hire purchase basis :

The auditor should take the following steps:

- a) verify the minutes book of board meetings and see that there is proper resolution passed by the board to approve the purchase of asset on hire purchase books.
- b) Examine the hire purchase agreement carefully and note down the terms and conditions of the agreement.
- c) Ensure that installments due are paid and the charges are charged against current profits.
- d) See that the depreciation is charged on cash price of the asset.
- e) See that the amount due to the hire vendor is shown as a current liability on liability side.
- f) For new purchase, check bill agreement or other supporting.

(xvii) Live Stock

- a) Check entries in Live Stock Register and compare them with ledger and financial statement.
- b) Book value in respect of animals which are dead or not useful should be written off.
- c) See whether management has taken physical count on regular occasions.

(xviii) Stores and Spare Parts

1. The asset known as stores and spare parts consists of materials which are means for consumption in the business and not for resale. Lubricants, dyes, fuel, etc., are examples of stores, while spare parts of machinery are preserved to maintain it in proper order.
2. The asset as such should be clearly shown in the Balance Sheet.

3. The auditor should obtain an inventory of stores and spare parts duly certified by a responsible officer. He should count the stock himself and thus verify the existence by personal inspection, if possible.
4. It is to be remembered that the stores consumed are debited to the Manufacturing Account and spare parts used are debited to the Machinery Account.
5. The asset is to be shown at cost price in the Balance Sheet. It is not a depreciable asset by use and provision for depreciation is not necessary.
6. However, the loss on account of breakage or waste on being worn out should be duly written off.
7. The asset should be revalued annually.

(xix) Contingent Assets

Some of the examples of contingent assets may be the following :

- (a) Option to apply for shares in another company on favourable terms;
- (b) Refund of octroi paid for goods sent out later on;
- (c) Claim for money from a previous endorser of a bills receivable discounted but might be dishonoured;
- (d) Uncalled share capital;
- (e) Legal action for infringement of a copyright, etc.

Usually, contingent assets are not shown at the foot of the Balance Sheet on the assets side and the Companies Act does not require the contingent assets to be disclosed as such.

(xx) Remittance in Tansit

The question of remittance-in-transit will arise where there is a head office and branch office and head office sends cash for meeting the day-to-day expenses. If at the end of the year probably in the last week, cash might have been sent by the head office but not received by the branch office or alternatively branch might have sent its collection from customers to the head office but the head office might not have received it before the end of the accounting period, then it is a case of “Remittance in Transit.”

- (a) To verify this item the auditor should call for the bank statements of head office and branches and reconcile them. Any cash received by the branch or head office in the first week of the new accounting year might have been in transit on the last day of the previous year. For the purpose of recording such cash in the balance sheet an entry is passed in the books as :

Cash in transit A/c Dr.

To Branch A/c. or Head Office A/c.

- (b) Verify cash in transit from the Cash Book/Pass Book or subsequent period as to whether actually it is received or not.
- (c) Check the statement of Reconciliation of H.O. and Branch Accounts.
- (d) Verify pay-in-slip, if the amount is deposited into the bank.
- (e) See that the entry passed as per item no. (a) is reversed in the next year.

(xxi) Miscellaneous Expenditure

According to Schedule VI of the Companies Act, 1956, Miscellaneous Expenditure (to the extent not written off) are as follows :

- (a) Preliminary Expenses.
- (b) Commission or Brokerage on underwriting or subscription of Shares or Debentures.
- (c) Discount allowed on issue of Shares or Debentures
- (d) Interest paid out of capital.
- (e) Development and other expenditure

(a) Preliminary, Expenses

1. These are the expenses incurred for creating or incorporating a company i.e. legal expenses for drafting Memorandum of Association, Articles of Association, Stamp fees, etc.
2. Auditor should check the prospectus or the statement in lieu of prospectus for amount of preliminary expenses.
3. Contract with promoters, vendors, underwriters should be checked.
4. Board of Directors authorization for payment of expenses should be checked. Receipts should be obtained for payments.
5. Actual expenditure for preliminary expenses should not exceed amount mentioned in prospectus or statement in lieu of prospectus. Such excess should be approved by shareholders in general meeting.

6. Preliminary expenses can be written off against Share Premium Account (Section 78), if any.
7. Preliminary expenses should be written off in a reasonable number of years (usually 3 to 5 years).
8. Preliminary expenses to the extent not written off should be shown under Miscellaneous Expenditure, on the Asset side of the Balance Sheet.
9. Preliminary expenses written off during the year should be shown separately in the Profit & Loss Account.

(b) Commission or Brokerage on Issue of Shares or Debentures (Sec. 76) :

1. Such commission should be allowed by Articles of Association.
2. Rate of commission should not exceed 5% of the share issue price or rate prescribed under Articles of Association, whichever is lower.
3. Rate of commission should not exceed 2.5% of the debentures issue price or rate prescribed under Articles of Association whichever is lower.
4. Amount of commission payable should be mentioned in prospectus or statement in lieu of prospectus.
5. Copy of contract should be filed with the Registrar.

6. However in case of brokerage (i.e. percentage of commission payable to brokers who deal in shares and procuring of shares, etc.) above mentioned restriction of 5% or 2.5% is not applicable.
7. Actual payment should be authorized by Board of Directors.
8. Commission on issue of shares or debentures can be written off against Share Premium Account (Section 78) if any.
9. Such commission or brokerage should be written off in a reasonable number of years (usually 3 to 5 years).
10. Commission or brokerage to the extent not written off should be shown under Miscellaneous Expenditure on Asset side of the Balance Sheet.
11. Commission or brokerage written off during the year should be shown separately in Profit & Loss Account.

(c) Discount allowed on Issue of Shares or Debentures (Sec.79) :

Auditor should verify :

1. Such discount should be approved by ordinary resolution in general meeting as well as it should be authorized by the Company Law Board.
2. Rate of discount cannot exceed 10% unless higher percentage is approved by Company Law Board.
3. Such shares cannot be issued within one year from certificate of commencement. Further such shares should be issued within two months from the date on which issue is sanctioned by Company law Board.

4. Prospectus should contain particulars regarding discount.
5. Discount on issue of shares or debentures can be written off against Share Premium Account (Section 78) if any.
6. Such discount should be written off in a reasonable number of years. (usually 3 to 5 years).
7. Such Discount to the extent not written off should be shown under Miscellaneous Expenditure on Asset side of the Balance Sheet.
8. Discount on issue of share or debenture written off during the year should be shown separately in Profit & Loss Account.

(d) Payment of interest out of Capital (Section 208)

Auditor should verify :

1. Such interest is allowed when construction work started by the company cannot be completed for some years, e.g. construction of plant and machinery, etc.
2. Such interest should be authorized by Articles of Association or by special resolution. Further the Central Government approval is necessary for payment of such interest.
3. Rate of interest cannot exceed 4% p.a. It cannot be paid after the half year immediately succeeding half year in which construction work was completed.
4. Actual payment of interest should be checked with entries in bank statement.

5. Payment of interest out of capital according to Section 208 does not amount to reduction of capital.
6. Such interest can be debited to cost of construction or it can be treated as deferred revenue expenditure which would be shown under 'Miscellaneous Expenditure'.
7. In case such interest is transferred to 'Miscellaneous Expenditure', it should be written off in a reasonable number of years (i.e. 3 to 5 years)
8. The amount written off during the year should be shown separately in Profit & Loss Account.

(e) Development and other expenditure

Auditor should verify :

1. Board of Directors approval for such expenditure.
2. Receipts should be obtained from persons to whom payment is made.
3. Deferred Revenue Expenditure should be written off as early as possible (usually 3 to 5 years)
5. The amount written off should be shown separately in Profit & Loss Account.
- 6.

Examples of other expenditure.

- (a) Heavy advertisement expenditure for introducing a product.
- (b) Research and development expenditure etc.

7.10 AN AUDITOR IS NOT A VALUER

Valuation of assets means determining the fair value of the assets as on the date of the balance Sheet. Verifying such value of assets is an important part of the auditor's duties. As the assets are belonging to the proprietors, it is their basic duty to see that the value of assets is properly determined on the basis of generally accepted accounting principles. What the auditor is required to do is satisfy himself that all the assets are shown at their "full and fair value". Auditor need not himself value the assets. But he has just to see whether the value that have been placed are true, correct and fair. As such he has to apply his skill, intelligence and tactfulness to confirm the values of the assets as indicated. Usually assets are valued by specially qualified persons like valuers and surveyors. Hence he can rely on the certificate issued by those professionals, but must disclose the fact of this in his report. An auditor is not supposed to have special technical knowledge in respect of valuation of assets. But he should always try to examine the value of assets himself with the help of supporting evidence available with the company. He has also to depend many a times upon the valuation made by the directors, partners and proprietors of the organization.

Therefore, we say that "An auditor is intimately connected with values". Because, it is the duty of the auditor to decide the value of the asset himself only he has to see whether the value decided upon is correct, fair and true. Because, if the assets are not properly valued, Balance Sheet will not give a true and fair view of the state of affairs of a concern. Though auditor is not a valuer he is liable for improper valuation of assets if the same is not verified by himself i.e. negligence in the verification of the value of assets makes an auditor liable for negligence. Hence, whenever he feels that the value of any asset as disclosed is not proper or fair he should mention the fact in his report and disown the responsibility. Mere informing the directors or proprietors regarding irregularity does not absolve him from his liabilities. Though the auditor is not the guarantor of the value of asset, he has to be careful while certifying the Balance Sheet and Profit and Loss Account, because third parties place their reliance on the audited Balance sheet to take their

important decisions. Therefore, auditor has to take sufficient precautions while accepting the valuation of assets. If he checks the value of the assets intelligently and with utmost care he cannot be held liable for negligence.

As the auditor is liable to an unlimited extent for indeterminate period of time to an indefinite class of people, he has to be very careful while accepting the valuation of assets. Hence, he is not a valuer, but surely connected with values intimately.

7.11. VERIFICATION OF LIABILITIES :

Meaning : The verification of liabilities implies an enquiry into the nature, extent and existence of liabilities.

It involves ensuring the following:

1. That all the liabilities have been clearly stated on the liability side of the Balance Sheet.
2. That all the liabilities relate to the business itself.
3. That they are correct and authorized.
4. That they are shown in the Balance sheet at their actual figures.

It is an important duty of an auditor to verify the liabilities appearing in the Balance Sheet of the company. The object of verification of liabilities is to ascertain whether there is any improper inflation or deflation of values or improper creation of an imaginary liability in the books. This form of manipulation is done in most cases to inflate or deflate the profits of the concern and thus make the position of the business appear stronger than what actually is, to create a secret reserve. As a result of such manipulation, the Profit and Loss Account and the Balance Sheet prove to be incorrect and thus the Balance Sheet does not

exhibit a true and fair view of the state of affairs of the concern. So, the auditor must take all possible steps to ensure that all liabilities are recorded properly in the books of accounts of the business. It is advisable that the auditor should, besides verifying the liabilities as shown in the Balance Sheet, get a certificate from the management that all liabilities of any nature have been included in the books of accounts and the contingent liabilities have been shown by way of a foot-note to the Balance Sheet or have been provided for.

ILLUSTRATIONS

(i) **Share Capital** : Though capital is not a liability of the company the auditor is required to verify it so that he can report on the genuineness of the balance sheet.

The duties of the auditor can be enumerated as follows :

1. If it is the first year of existence of the company

- (a) He should examine the Memorandum of Association and Articles of Association
- (b) He should check the Cash Book, Pass Book, Director's Minute Book to find out the number of shares, the various classes of shares, the amount received thereon and the amount due from the shareholders.
- (c) If some shares have been allotted to the vendors, he should examine the agreement between the vendors and the company.
- (d) In case shares are issued at a premium he should ensure that the premium on issue should be credited to a separate account.
- (e) Allotment and call money should be verified.

- (f) He should check the forfeiture and reissue of shares, if any
- (h) He should ensure that all the relevant provisions of the Companies Act are complied with.

(2) If it is not the first year of the company

- (a) The share capital would be the same as in the previous year unless there are some alterations or addition by way of fresh issue or otherwise. He should ensure that the relevant legal provision are fulfilled.
- (b) Similarly for reduction of share capital, he should see the provisions of the Act as specified in Sec. 100.
- (c) In case bonus shares are issued, the auditor should check whether the permission from concerned authorities is taken, whether proper resolution is passed and whether the capitalization entries are correctly passed.
- (d) In case rights shares are issued the auditor should check the bank book, bank statements. He should ensure that the required resolutions are passed and that the permission of the concerned authorities is taken, with particular reference to Sec. 81.

(ii) Reserves and Surplus : Reserves may be general or specific in nature. Sinking fund, Capital Redemption Reserve, Reserve for Contingencies are specific reserves.

Auditor's duty in verification of reserves is as follows :

- (1) He should check the Profit and Loss Appropriation account for transfer to reserves, to see the provisions of transfer of profit to reserve are complied with.

- (2) He should check the board resolution for transferring the profit to the respective reserves.
- (3) He should ensure that the movement in the reserve accounts i.e. additions to/deductions from previous year's balance are properly disclosed as per the requirements of the law.
- (4) Ensure that reserves are properly utilized as required by law.
- (5) See that the reserves are properly disclosed in the balance sheet as per the law.

(iii) Loans Borrowed

For verification of loans, the auditor should consider the following points :

- 1. The auditor should examine the Memorandum and Articles of the Company to find out the powers of the Company to borrow money.
- 2. The auditor should examine the agreement and correspondence regarding the loan.
- 3. The auditor should vouch the receipts of cash on account of loan, with the receipts issued in respect of the loan and the corresponding entries in the cash book.
- 4. The auditor should examine the certificate of registration issued by the Registrar of Companies, if the loan has been secured by mortgaging any property.
- 5. The auditor should vouch the payment of interest with the counterfoils of the receipts issued to the vendors and the corresponding entries in the Cash Book.

6. He should also check the repayment of loan with the counterfoils of the cheque books, the bank pass book and the cash book.

In addition to the above, the auditor may ask for a confirmatory letter from the party who has advanced the loan to ensure that the interest on loan is not due and the recoupments of loan are recorded in the books of account correctly.

In the case of bank overdraft, the agreement with the bank and the security offered should be examined by the auditor.

(iv) Trade Creditors :

1. The auditor should ask for a schedule of creditors and check the same with the purchase ledger as that is already examined by him.
2. He should ensure that all purchase made during the year especially at the end of the year are included in the accounts of the creditors.
3. In case of suspicion about any creditors, the auditor with the consent of the client can ask the statement of account to be sent and verify the same by scrutinizing ledger accounts.
4. He should see the various debts given for discount, goods returned etc, and confirm that the same are genuine.
6. The auditor should ask for the reason for not paying any overdue creditors.

(v) Contingent Liabilities

Contingent liabilities are those liabilities which may or may not arise in the future for payment. The auditor's duty is to see that all known and unknown liabilities have been brought into the accounts at the date of the Balance Sheet and have been shown in the Balance Sheet separately as such.

1. **Liabilities on Bills Receivable discounted and not matured :** If the bills receivable are discounted with a bank and the money so received from it is made use of, the entire money will be refunded to the bank if the acceptor does not make payment on the date of its maturity. This is why such a contingent liability is distinctly shown in the Balance Sheet by way of a footnote.
2. **Liabilities for calls on partly paid shares :** The amount called on shares held and paid should be verified from the cash book and the liability for the amount uncalled should be ascertained.
3. **Liability under a guarantee :** The auditor should ascertain the liability for a guarantee given by the client for a loan or overdraft to his friend or partner. In case of non payment of such a loan, the possible liability should be ascertained.
4. **Liability for cases against the company not acknowledged as debts :** It is a liability in a disputed case where damages may have to be paid. A contingent liability should be ascertained and a note should be made at the foot of the Balance Sheet.
5. **Liability in respect of arrears of Dividend on Cumulative preference Shares :** The auditor should examine the Articles of Association which should lay down rules in this regard and due provision should be made for such a liability.

Auditor's duty : The auditor should very carefully check the various contingent liabilities named above. There may be some such liabilities for which no provision has been made in the books but merely a note has been made at the foot of the Balance Sheet, e.g. Bills Receivable which have been discounted and which have not matured at the date of the Balance Sheet, arrears of fixed cumulative dividends, etc. For liabilities in respect of which provision has to be made in the Balance Sheet, viz a suit, etc., the auditor should examine such cases and ascertain the amount to be specifically reserved for the purpose. The auditor should examine the Director's Minute Book, correspondence made with the legal advisers and the information obtained from the officials of the business. He has to ensure that proper provision has been made for all such liabilities and if he is not satisfied, he should mention the fact in his report. It is to be remembered that the requirements of the Companies Act regarding the contingent liability should be complied with in the Balance Sheet on the liabilities side.

(vi) Provision for Taxation :

1. In case of a limited company it is compulsory that the taxation provision is to be made. But it cannot be ascertained accurately because the final liability on this account can be known only when the assessment is completed. Therefore, a fair estimate for providing this liability is necessary. Hence, the auditor has to verify the calculation done to arrive at the provision expected to be made.
2. However, when finally the assessment is over, the auditor should see that the excess or short provision is properly adjusted in the books.
3. Where any appeal is pending and the liability challenged, the same is a contingent liability. Hence the same is to be properly ascertained and disclosed in the Balance sheet.

(viii) Employees' deposits :

Normally, in commercial and industrial ventures, the employees who deal with cash or stores are required to deposit cash security as a safeguard against some possible mis-appropriation or pilferage. Sometimes, the employees instead of paying cash, endorse trustee securities in favour of the employers. It should be remembered in this connection that :

1. Such a security in cash or in securities should be deposited separately in the bank.
2. It should be shown distinctly on the liabilities side of the Balance Sheet.
3. He should verify the amount of deposits by reference to the certified schedule received from the client.

(viii) Reserve for Bad and doubtful Debts

The verification should be done as follows :

1. The auditor should obtain a certificate from some responsible officer of the business and then check the amount provided for bad and doubtful debts.
2. The schedule of debtors should be compared with the balance of ledger accounts to ascertain the possible amount of bad and doubtful debts.
3. The adequacy of such a reserve has specially to be checked. He should examine the nature, the circumstance of a particular business and the necessary rules in practice in this connection.

(ix) Bills Payable :

The auditor should verify the Bills Payable in the following ways:

1. The Bills Payable Book should be checked with the Bills Payable Account.
2. The Bills Payable already paid should be checked from the Cash Book and the returned Bills Payables should be examined.
3. To verify the Bills Payables which have not yet matured at the year end, the auditor should examine the Bills Payable book and should check the Cash Book of the succeeding years to see whether any payment has been made in respect of such bills. In case of any doubt, the auditor may ask the drawers for the confirmation of the bill.
4. The auditor should see if any charge has been created on the assets of the concern by accepting the bill and he should see that the facts are disclosed in the Balance Sheet.

(x) Proposed Dividend :

1. The auditor should ensure that the dividend proposed complies with the provisions of the Companies Act, the decisions of the Court, especially in the matters of provision for depreciation, distribution of capital profits, transfer to reserves etc.
2. The auditor should verify the board resolution and the entry in the Profit and Loss Appropriation account.
3. The auditor should ensure that as per the requirements of the Companies Act, 1956 gross dividend has been provided for.

4. To ensure completeness, the auditor should cross-check the names in the dividend list with those in the register of shareholders.

(xi) Outstanding Expenses :

The auditor should obtain a certificate from a responsible officer to the effect that all the outstanding expenses have been included in the current year's accounts. The amount paid on various accounts should be verified from the entries in the Cash Book. It should be ensured that the outstanding expenses included that part which is unpaid at the date of the Balance Sheet. The following points should be noted.

1. He should carefully note that all expenses, e.g. rent, rates, interest, wages, salary, audit fee, legal expenses, etc., have been accounted for in the books.
2. He should check entries in the books passed on the basis of invoices to ensure that they are not related to the year under audit.
3. He should compare all the paid and unpaid expenses of the current year with those of the previous year to see that there is not much difference.
4. It should be ensured that all outstanding wages and salaries have subsequently been paid.

(xii) Bank Overdraft

The verification of bank overdraft will be on the same lines as that of loans and advances. The difference is that it is the financial assistance obtained from the bank. The auditor should examine the Bank Pass book and call for a statement of mortgaged assets. It is to be remembered that the assets so mortgaged should be clearly stated as such in the Balance Sheet.

(xiii) Debentures :

1. The auditor has to examine the provisions regarding the power of the company to issue debentures as contained in Memorandum and Articles of Association.
2. If the debenture is issued as mortgage debenture, he has to verify the registration certificate issued by the Registrar.
3. He should carefully examine the terms of debentures issue as contained in Trust Deed and ensure that the same have been properly complied with.
4. The auditor should vouch the cash received on this account with the cash book.
5. The auditor should verify whether the interest on debentures is paid or provided, properly at regular intervals intervals or not.
6. In case the debentures have been redeemed during the year the same is to be confirmed with the Minutes of Board of directors. Counterfoils of the cheque books. Bank Pass book and Cash book, returned debenture certificate etc.
7. If the debentures have been issued as a collateral security, then he should see that the fact is properly disclosed in the Balance Sheet.

(xiv) Unclaimed Dividend

For verifying unclaimed dividend, the auditor should follow the following procedure.

1. See that the Bank Account from which dividend is paid is properly reconciled. See that dividend account is opened for each year to avoid mistake of one year's dividend getting mixed up with next year's dividend. See that no entries remain in these Bank Accounts reconciliation like accounts debited by bank but not accounted in books, etc. because then the Unclaimed Dividend shown in the books will be wrong.
2. See that wherever dividend is declared on shares, where calls are in arrears and directors have decided to adjust the dividend payable against calls in arrears, the appropriate entries have been booked.
3. See that a full list of shareholders who have not claimed dividend is prepared. This is necessary firstly to prove that there are no mistakes committed while reconciling the Bank Account and secondly to prove the accuracy of the Member's Register. The auditor should compare this list with the Member's Register to see that unclaimed dividend for every shareholder is matching with the number of shares held by him as per Share Register. This will also disclose if any dividend is paid to a shareholder who has already transferred his shares provided he has not encashed his dividend warrant.
5. See that if the statutory time limit of 3 years is over, the money being in Unclaimed Dividend Account is transferred to the Central Government with details of shareholders who have not claimed the dividend.

(xv) Calls in Arrears :

The auditor should verify Calls in Arrears as under :

1. Find out whether calls in arrears are arising on account of capital issued during the year or is continuing on account of capital issued in earlier years.
2. If it is on account of capital issued during the year, see that correct amount has been arrived at towards call in arrears by referring to the application form money paid towards application, shares allotted, total share money payable, calls made, calls money payable and calls paid. For this he will have to conduct share allotment audit to arrive at all the relevant data.
3. In case calls are in arrears from earlier years, see that reminders have been sent to the shareholders for payment of calls. If the Board has decided to charge interest on such calls in arrears see that reminder contains the request to pay the calls in arrears with interest. If any part of the calls in arrears have been received during the year on which interest was payable see that such call moneys are received with interest.
4. If any transfer application has been received for shares on which some calls are in arrears, see that no transfer has been effected without arrears having been paid first.
5. If the Directors have declared dividend, see that dividend payable on such shares is proportionately reduced and if the directors have decided to appropriate dividend on such shares where calls are in arrears see that dividend is not physically paid out but appropriate accounting entries crediting calls in arrears and debiting dividend payable is passed.
6. See that, if the Board has passed any Resolution forfeiting shares on which calls are in arrears, the same is reflected properly in the accounts by passing of necessary entries and such shares are not

continued to be shown as part of capital at full value and calls in arrears continued to be deducted therefrom.

(xvi) Fixed Deposits :

The auditor should keep in mind the following points while conducting a fixed deposit verification –

1. Fixed Deposits should be accepted according to Section 58A of Companies Act, 1956 and Reserve Bank of India's guidelines.
2. Fixed deposits from director for less than six months (but exceeding 3 months) should not exceed 10% of paid up share capital and free reserves.
3. Total fixed deposits should not exceed 25% of paid-up share capital and free reserves.
4. Fixed deposit should not be accepted if the period exceeds 36 months.
5. Interest on fixed deposits can not exceed 15% p.a.
6. Brokerage can be paid subject to limits mentioned below.
 - (a) Upto 1 year – not to exceed 1% of amount of deposits.
 - (b) 1 to 2 years – not to exceed 1.25% of amount of deposits
 - (c) 2 to 3 years – not to exceed 1.50% of amount of deposits.
7. Liquid assets should be maintained at not less than 10% of deposits maturing 31st March.

8. Receipts should be issued to the deposit holders.
9. Fixed Deposit Register should be maintained.
10. Return of fixed deposits should be sent to the Registrar before 30th June. In case it is not sent, auditor should mention it in the Auditor's Report as per Section 45 MA of Reserve Bank of India Act, 1934.
11. Interest accrued but not due should be provided and it should be shown under Current Liabilities.
12. Fixed Deposits received along with accrued and due interest would be shown under 'Unsecured Loans'.

7.12 DIFFERENCE BETWEEN VOUCHING AND VERIFICATION

Point of Difference	Vouching	Verification
1. Meaning	The act of examining the vouchers is known as vouching. A voucher is any documentary evidence in support of a transaction entered in the books of account. Vouching involves establishing the arithmetical accuracy	Verification can be explained as establishing the truth or securing some kind of confirmation with respect to the assets and liabilities appearing in the Balance Sheet of a concern. Verification goes beyond vouching. It seeks to establish that assets as stated in the Balance Sheet of a

2. Nature & Purpose	and the authenticity of the transactions of a concern. Vouching proves that an asset ought to exist.	concern exist in fact and that the liabilities are properly disclosed. Verification proves that an asset does exist.
	It is done during the whole year.	It is done at the end of the year.
	Certifies correctness of records.	Certifies correctness of assets and liabilities.
3. Time	It is done by the junior staff of the auditor under the supervision of a senior person.	It is done by the auditor himself assisted by senior.
4. Utility		
5. Personnel		

7.12.1 EXERCISES

1. What do you mean by "Verification"? What are the points to be considered by an auditor during such Verification?
2. Why should an auditor verify assets which are shown in the balance sheet?

3. What is Verification? How does it differ from Vouching?

4. What is Valuation? Discuss – “Auditor is not a Valuer, but he is intimately connected with values”.

5. How would you verify the following – (1) Plant & Machinery (2) Building (3) Motor cars and Vehicles (4) Freehold Land (5) Leasehold Land (6) Assets on Hire Purchase (7) Goodwill (8) Patents (9) Know-how (10) Wasting Assets (11) Miscellaneous Expenditure not written-off (12) Deferred Revenue Expenditure (13) Fictitious Assets (14) Investments (15) Immovable Properties (16) Investment in Partnership Firms (17) Debtors (18) Bills Receivable (19) Loans given (20) Loans Given against security (21) Cash (22) Bank Balance (23) Share Capital (24) Loan Taken (25) Loans Taken against Security (26) Secured Loans from Banks (27) Loans taken against Mortgage of Property (28) Secured Debenture (29) Creditors (30) Bills Payable (31) Provision for Income-Tax (32) Unclaimed Dividends (33) Contingent Liabilities (34) Proposed Dividends (35) General Reserves (36) Capital Reserve (37) Sinking Fund,

6. How would you check the valuation of the following :
 - (1) Tangible fixed Assets (2) Wasting assets (3) Freehold Land (4) Leasehold Land (5) Building (6) Plant & Machinery (7) Goodwill (8) Deferred Revenue Expenditure (9) Investments (10) Securities against Loans.

7.13 STOCK VERIFICATION

(i) Meaning of Stock-In-Trade

According to Accounting Standard 2, Stock is a tangible property held for -

- (a) sale in the ordinary course of business or
- (b) in the process of production for such sale or
- (c) for consumption in the production of goods (i.e. consumable stores).

(ii) Verification of Stock

Verification of stock means physical counting, measuring and to verify so as to determine the quantity of stock to be considered for stock valuation.

Verification of Stock-in Trade is more difficult than of any other asset due to the following reasons –

- (a) It is subject to frequent changes and constitutes the largest current asset of the business.
- (b) Numerous methods of pricing the stock-in-trade are in existence.
- (c) The determination of its value directly influences the sales and income of the year.
- (d) It is exposed to greater risk of defalcation or manipulation

(iii) Objectives of verification of stock-in trade are :

- (a) Ascertainment of the correct profit/loss made during the accounting year.
- (b) Disclosure of True and Fair financial position of the business.
- (c) Preparation of correct statement of claims for loss of stock, if any, due to fire, flood etc.
- (d) Determination of the value of stock on consignment.
- (e) Determination of value of stock sold on `Sale or return basis`.
- (f) Ascertainment of ownership of stock.
- (g) Ascertainment of the fact whether the stock is free from any charge.

7.13.a Auditors duty as regards verification of stock :

As the correctness of the profit of a business depends to a great extent on the accuracy of the valuation placed on the closing stock, it will be readily appreciated that the verification of this asset forms one of the most important part of an auditor's duty. While verifying the stock-in-trade the auditor has the following duties –

- (a) Ascertain the method of stock-taking and the basis of valuation.

- (b) Ensure that the stock-sheets have been subjected to a good internal check, e.g. they are certified as to have taken prices, extension and additions while determining the stock and also generally approved as correct by managing director.
- (c) Check calculations and additions.
- (d) Check a few of the important items with actual invoices as to prices.
- (e) Examine some of the quantities in stock-sheets with those shown by the stock books, if such stock books are kept.
- (f) Ascertain that the stock is valued on the same basis as in the previous year.
- (g) Ascertain that obsolete and unsaleable stock is shown at fair market prices.
- (g) Compare the percentage of gross profit on turnover with that of the previous period and also enquire into the cause of any notable fluctuation.
- (i) Ensure that the goods entered as sold and not delivered are not included.
- (j) Ensure that the goods bought and not entered in the invoice book are included.
- (k) (i) Ascertain that the value of unfinished goods is taken at actual cost and the basis of valuation is the cost of the materials consumed and the wages spent thereon upon the date of the Balance Sheet. Sometimes a percentage is added in the above to

cover the factory cost, such as foreman's wages, fuel, power, lighting, heating, depreciation of plant etc.

- (ii) In case of finished goods, a reasonable percentage in respect of office cost has also to be added to the works cost.

- (l) See that the goods sold on approval basis are properly included in closing stock.
- (m) See that the stock held does not include goods held on consignment as an agent.
- (n) Examine carefully the stock sheets and ensure that the stock includes only the goods dealt with by the client and does not include any asset purchased.
- (o) Confirm that stock has been valued at cost or market price, whichever is less.
- (p) Obtain from a responsible officer of the organization a certificate regarding the procedure followed in valuation of stock.
- (q) Obtain a certificate from client certifying that :
 - (i) Physical verification of stock is done.
 - (ii) All goods included in the stock are property of the company.
 - (iii) Cut off procedure is properly followed. (Cut off is a transaction which separates one accounting year from the next accounting year. Last document nos. of goods

received notes, goods accepted notes, debit and credit notes etc. should be obtained at the time of stock-taking).

- (iv) The basis of valuation is the same as was followed in the previous year.

7.13.1 Auditor's duty regarding verification of stock based on case laws

Case I : Kingston Cotton Mills Co. Ltd. (1896)

It was held that it is not part of an auditor's duty to take stock. Auditor can rely on other people for details of stock-in-trade. In the same judgement, Justice Lopez observed that 'An Auditor is not bound to be a detective'. It was held that in the absence of suspicious circumstances auditor can rely on certificate given by the company.

Case 2 : Irish Woollen co. Ltd. v/s Tyson & others (1900)

It was held that there was certainly no duty on the auditor to take stock.

Case 3 : Westminster Road Construction Co. (1932)

It was held that the auditor is liable for damages for not detecting the overvaluation of work-in-progress even though sufficient information was available to him. He will be guilty of negligence if he fails to take notice of all available evidence.

Case 4 : Mckesson and Robbins (1939)

It was held that the auditor should verify inventory either by test or by observation or by combination of these two methods. Auditor was held liable for certifying a Balance Sheet in which stock-in-hand represented was totally non-existent.

Position in India :

- (a) In the case of audit of a limited company the auditor has to report whether the company final accounts are in agreement with the books.

Also under Schedule VI to the Companies Act, 1956 the auditor should ensure that the closing stock is disclosed under the head Current Asset as under :

Stores and spare parts

Loose tools

Stock-in-trade

Work-in-progress.

- (b) According to CARO physical verification should be conducted by management at reasonable periods for finished goods, stores, spare parts and raw materials.

Therefore, primary duty of verification is on the management but as per Mckesson and Robbins case the auditor should test check

or by observation or by combination of these two methods ensure that stock-sheets include proper quantity.

- (c) U/s 209(1)(b) of the Companies Act, 1956 proper books of accounts should be maintained by the company for all sales and purchases of goods.
- (d) U/s 541(2) of the Companies Act, 1956 if proper books of account at the time of winding up are not kept and if annual stock-taking statement and statement of goods sold and purchased for two years immediately preceding the starting of winding up is not kept then the auditor shall be held liable if he fails to point out this fact in his audit report.
- (e) According to the Statement on Auditing Practices issued by the Institute of Chartered Accountants of India (ICAI) the auditor is expected to verify the inventories in the following manner :
 - 1. Obtain a certificate from the management regarding physical inventory. However, the auditor must take reasonable care to satisfy himself that -
 - (i) The procedures of stock taking were reasonable and would justify the certificate given by the management and
 - (ii) The procedures were actually followed.
 - 2. The auditor should check the original physical stock sheets. If possible he should be present at least for sometime during the stock taking and conduct a few sample checks.
 - 3. The auditor should ensure that the book stocks were adjusted for any excess or shortage found on physical verification.
 - 4. In respect of stocks which are not lying with the concern (goods sent for processing, goods on consignment etc) the auditor must obtain and examine the confirmations from the parties holding the stock.

Thus, the above decisions settled the principles as under :

- (a) The stock basically belongs to the shareholders and hence it is the duty of the management to physically verify them. Most of the time an auditor has no requisite staff or technical qualification to verify them properly. Hence, the auditor is not responsible for not verifying physical stock of a company existing at the Balance sheet date. In other words, it is not a part of auditor's duty to take stock.
- (b) An auditor can rely on the certificate given by the management regarding the verification and valuation of stock existing on the date of the Balance Sheet, after properly scrutinizing the relevant documents available in this matter (as seen in the case of Mckesson and Robbins).

After this discussion the professional bodies of accountancy of the world have opined that though it is not the duty of the auditor to take stock he should ensure that verification of stock has taken place properly either by presenting himself on the date of verification of stock or by actually taking the stock on the date of the Balance Sheet or by ensuring that physical stock-taking was carried out by his client properly.

Therefore, mere reliance on the certificate of management without resorting to any type of test check or evaluation cannot save an auditor from the charge of negligence.

7.14 VALUATION OF STOCK-IN-TRADE

(i) Meaning :

Valuation of stock-in-trade means finding out the proper value of the closing stock for recording in the books and disclosure in the account.

(ii) Auditor's duty as regards stock valuation

1. The auditor should ensure that there is no change in the method of valuation.
2. In case there is a change in method of valuation of stocks as compared to the previous year, the auditor should disclose this fact in his report and ensure that the method is proper and recognized.
3. The auditor should ensure that the stock is valued and recorded according to the generally accepted principles of evaluation. He should ensure that the valuation is done in confirmation with the guidelines issued by the ICAI.
4. The auditor should check the computational accuracy of stocks by testing a few calculations involved in valuation.
5. The auditor should ensure that there is no over/under valuation of stock which will distort the true and fair view of the accounts.
6. The auditor should see that as required by the Schedule VI to the Companies Act, 1956, the values of stores and spare parts, loose tools, stock-in-trade and work-in-progress must be disclosed separately.

7. Under MAOCARO, 1988 a company auditor has to report whether
 - (a) He is satisfied on the basis of the examination of stocks, that such valuation is fair and proper in accordance with normally accepted accounting principles.
 - (b) The basis of valuation of stocks is same as in the proceeding year. If there is any change in the basis of valuation the auditor has to report the effect of such change.
 - (c) Any unserviceable or damaged stores, raw materials or finished goods were determined on physical verification and the provision for loss made and
 - (d) In the case of a trading company any damaged goods have been determined and the provision for loss made.
8. As required by CARO, the auditor should ensure that the valuation of stocks is fair and proper in accordance with the normally accepted accounting principles. The principles are laid down by the ICAI viz.
 - a. Statement on Auditing Practices.
 - b. Accounting standards – 2, Valuation of Inventory

The auditor should ensure that the provisions of the above statements are taken care of while valuing stock.
8. The auditor should see that accounting policy for valuation of inventories including the methods used is disclosed in the final accounts.

7.15 VERIFICATION AND VALUATION OF GOODS ON CONSIGNMENT

Meaning of Consignment Sale –

It is a transfer of goods by principal (i.e. consignor) to the agent (i.e. consignee) at another place for sale on commission basis.

Verification and Valuation of stock on Consignment :

- (i) Unsold stock should be physically verified by the management.
- (ii) Auditor should obtain a certificate from consignee for unsold stock.
- (iii) Account sale from consignee should be checked to find out how much quantity should remain with the consignee.
- (iv) Goods sent on consignment basis cannot be treated as sale. Revenue cannot be recognised until goods are sold to the third party.
- (v) Further, consignee should not be debited for goods sent to him by consignor.
- (vi) Unsold stock should be valued at lower of cost and market value. Cost should include non-recurring expenses of consignor and consignee. Valuation of closing stock at cost should include loading, carriage, insurance, freight, octroi, unloading charges etc. However, selling and distribution expenses should not be included in cost.

- (vii) Normal loss on consignment should be segregated from abnormal loss. Cost of item should be increased for normal loss, e.g. evaporation etc. However, abnormal loss e.g. theft, fire etc. should be transferred to Profit and Loss Account.
- (viii) In case goods are sent at invoice price, stock reserve should be created for unsold stock.

7.15 VALUATION OF

1. Goods on Approval :

(a) Goods sent on approval basis

When goods are sent to the customer on approval basis, the property in the goods remains with the sender till the customer approves them. If the customer does not communicate his decision within the prescribed time, it is assumed that the goods are sold to him.

On the Balance Sheet date if the customer has some time left to communicate his decision or has already communicated his unwillingness to accept the goods then the property in the goods remains with sender and the goods will be included in the stock of the sender. These goods will be valued at cost. Damages, if any, caused during the course of transit should be reduced and adjusted. Such goods cannot be valued at a price higher than the market price.

(b) Goods received on approval basis :

Goods received on approval cannot be included in the closing stock of the receiver unless he has approved such goods and recorded the same in his books of account. These goods should be valued at cost plus incidental expenses on purchase.

7.15.02 Goods in Tansit**(a) Goods in Transit Outward**

When Goods sold are in transit and the seller has already invoiced them and the sales invoice is recorded in his books of account, the goods do not belong to the seller.

b) Goods in Transit Inward.

Till the goods are received they cannot become the property of the purchaser. But if the risk has already commenced and if the purchaser is responsible soon after their dispatch by the seller, the purchaser has to pass the entry in his books. The goods would still be in transit and should be recorded as such. Such goods should be valued at cost plus incidental expenses incurred.

7.16 EXERCISES :

1. What do you mean by verification of stock. State the auditor's duties in this respect ?
2. What is stock valuation ? Explain the duties of the auditor in this respect.
3. Write short notes on valuation of :-
 - (a) Goods Sent on consignment
 - (b) Goods in transit
 - (c) Goods on approval.

4. Define Stock-in-Trade. Discuss the objectives of Stock Verification.
5. Discuss the position of the statutory auditor in regard to existence and valuation of stock.

AUDITING TECHNIQUES:- VERIFICATION

5.1 AUDIT OF ASSETS

BOOK DEBTS/ DEBTORS:

The term 'book debts' suggests particularly amounts recoverable from customers, but in practice it is applied to a wide range of claims which a business may carry as an asset in its books. Advances or loans cannot, however, be included under this head.

Verification of debtors may be carried out by employing the following procedures:

- (a) Examination of records;
- (b) Direct confirmation procedure (also known as 'circulation procedure')
- (c) Analytical review procedures.

The nature, timing and extent of audit procedures to be performed is, however, a matter of professional judgement of the auditor. The general procedure is as under:

Examination of Records

- (z) The auditor should carry out an examination of the relevant records himself about the validity, accuracy and recoverability of the debtor balances. The extent of such examination would depend on the auditor's evaluation of the efficacy of internal controls.
- (it) The auditor should check the agreement of balances as shown in the schedules of debtors with those in the ledger accounts. He should also check the agreement of the total of debtor balances with related control account. Any differences in this regard should be examined.
- (Hi) Verification of subsequent realizations is a widely used procedure, even in cases where direct confirmation procedure is followed. In the

case of significant debtors, the auditor should also examine the correspondence or other documentary evidence to satisfy himself about their validity and accuracy.

- (z'v) While examining the schedules of debtors with reference to the debtors' ledger accounts, the auditor should pay special attention to the following aspects :
 - (a) Where the schedules show the age of the debts, the auditor should examine whether the age of the debts has been properly determined.
 - (/?) Where the amounts outstanding are made up of items which are not overdue, having regard to the credit terms of the entity.
 - (c) Whether transfers from one account to another are properly evidenced.
 - (d) Whether provisions for allowances, discounts and doubtful debts should recognise that even though a debtor may have confirmed the balance due by him, he may still not pay the same.
 - (v) The following are some of the indications of doubtful and uncollectible debts, loans and advances :
 - (a) The terms of credit have been repeatedly ignored.
 - (b) There is stagnation, or lack of healthy turnover, in the account.
 - (c) Payments are being received but the balance is continuously increasing.
 - (d) Payments, though being received regularly are quite small in relation to the total outstanding balance.
 - (e) An old bill has been partly paid (or not paid), while later bills have been fully settled.
 - (f) The cheques received from the debtors have been repeatedly dishonoured,
 - (g) The debt is under litigation, arbitration, or dispute.
 - (h) The auditor becomes aware of unwillingness or inability of the debtor to pay the dues, e.g. a debtor has either become insolvent, or has closed down his business, or is not traceable.
 - (z) Amounts due from employees, which have not been repaid on termination of employment.
 - (;) Collection is barred by statute of limitation.
 - (vi) Bad debts written off or excessive discounts or unusual allowances should be verified with the relevant correspondence. Proper authorization should be inspected.

- (vit) In the case of claims made against insurance companies, shipping companies, railways, etc., the auditor should examine the correspondence or other available evidence to ascertain whether the claims have been acknowledged as debts and there is a reasonable possibility of their being realized. If it appears that they are not collectible, they should be shown as doubtful. Similar considerations apply in respect of claims for export incentives, claims for price escalation in case of construction contracts, claims for interest on delayed payments, etc.
- (vz'z'z) The auditor should examine whether contingent liability, if any, in respect of bills accepted by customers and discounted with the banks is properly disclosed. He should also examine whether adequate provision on this account has been made, where required.

Direct Confirmation Procedure

- (z) The verification of balances by direct communication with debtors is theoretically the best method of ascertaining whether the balances are genuine, accurately stated and undisputed, particularly where the internal control system is weak. The utility of this procedure depends to a large extent on receiving adequate response to confirmation requests. Therefore, in situations where the auditor has reasons to believe, based on his past experience or other factors, he may limit his reliance on direct confirmation procedure and place greater reliance on the other auditing procedures.
- (z'r) The auditor employs direct confirmation procedure with the consent of the entity under audit. There may be situations where the management of the entity requests the auditor not to seek confirmation from certain debtors. In such cases, the auditor should consider whether there are valid grounds for such a request. In appropriate cases, the auditor may also need to reconsider the nature, timing and extent of his audit procedures including the degree of planned reliance on management's representations.
- (z'z'z) The confirmation date, the method of requesting confirmations, and the particular debtors from whom confirmation of balances is to be obtained are to be determined by the auditor.
- (z'v) The debtors may be requested to confirm the balances either (a) as at the date of the balance sheet, or (b) as at any other selected date which is reasonably close to the date of the balance sheet. The date should be settled by the auditor in consultation with the entity.
- (v) The form of requesting confirmation from the debtors may be either (a) the 'positive' form of request, wherein the debtor is requested to respond whether or not he is in agreement with the balance shown, or (b) the 'negative' form of request wherein the debtor is requested to respond only if he disagrees with the balance shown.
- (vi) The use of the positive form is preferable when individual account balances are relatively large, or where the internal controls are

weak, or where the auditor has reasons to believe that there may be a substantial number of accounts in dispute or inaccuracies or irregularities. ,,,.,.

- (vii) The negative form is useful when internal controls are considered to be effective, or when a large number of small balances are involved, or when the auditor has no reason to believe that the debtors are unlikely to respond. If the negative rather than the positive form of confirmation is used, the number of requests sent and the extent of the other auditing procedures to be performed should normally be greater so as to enable the auditor to obtain the same degree of assurance with respect to the debtor balances.
- (viii) In many situations, it may be appropriate to use the positive form for debtors with large balances and the negative form for debtors with small balances.
- (ix) Where the number of debtors is small, all of them may be circularized, but if the debtors are numerous; this may be done on a sample basis. The sample list of debtors to be circularized, in order to be meaningful, should be based on a complete list of All debtor accounts. While selecting the debtors to be circularized, special attention Should be paid to accounts with large balances, accounts with old outstanding balances, and customer accounts with credit balances. In addition, the auditor Should consider accounts in respect of which provisions have been made or balances have been written off during the period under audit of earlier years and request Confirmation of the balance without considering the provision or write-off. The auditor may also consider including in his sample some of the accounts with *nil* Balances. The nature of the entity's business (*e.g.*, the type of sales made or services rendered) and the type of third parties with whom the entity deals, should also be Considered in selecting the sample, so that the auditor can reach appropriate conclusions about the debtors as a whole.
- (x) In appropriate cases, the debtor may sent a copy of his complete ledger account for a specific period as shown in the entity's books.
- (jci) The method of selection of the debtors to be circularized should not be revealed to the entity until the trial balance of the debtors' ledger is handed over to the auditor. A list of debtors selected for confirmation should be given to the entity for preparing requests for confirmation which should be properly addressed and duly stamped, The auditor should maintain strict control to ensure the correctness and proper despatch of request letters. In the alternative, the auditor may request the client to furnish duly authorised confirmation letters and the auditor may fill in the names, addresses and the amounts relating to debtors selected by him and mail the letters directly. It

should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client.

- (xii) Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample. The entity should be asked to investigate and reconcile the discrepancies. In addition, the auditor should also consider what further tests he can carry out in order to satisfy himself as to the correctness of the amount of debtors taken as a whole.

Analytical Review Procedures •

In addition to the audit procedures discussed above, the following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to debtors, loans and advances :

- (a) comparison of closing balances of debtors, loans and advances with the corresponding figures or the previous year;
- (b) Comparison of the relationship between current year debtor balances and the current year sales with the corresponding budgeted figures, if available;
- (c) Comparison of actual closing balances of debtors, loans and advances with the corresponding budgeted figures, if available;
- (d) Comparison of current year's aging schedule with the corresponding figures for the previous year;
- (e) Comparison of significant ratios relating to debtors, loans and advances with similar ratios for other firms in the same industry, if available;
- (f) comparison of significant ratios relating to debtors, loans and advances with the industry norms, if available.

It may be clarified that the foregoing is only an illustrative list of analytical review procedures which an auditor may employ in carrying out an audit of debtors, loans and advances. The exact nature of analytical review procedures to be applied in specific situation is a matter of professional judgement of the auditor.

STOCK – AUDITOR’S GENERAL DUTIES

Patterns, Dies, Loose Tools, etc.

Several entities have large investments in such assets which have a relatively short useful life and low unit cost. Evidently, it is a difficult matter, under the circumstances, to prepare a separate account for each such assets although a careful control over such property is necessary.

On these considerations, some entities charge off small tools and other similar items to Production Account as and when they are purchased and do not place any value on the unused stock on the Balance Sheet. Nevertheless, a record of issues and receipts of tools to workmen is kept, as a check on the same being pilfered and a memorandum stock account of dies and patterns is also maintained. In other concerns, the cost of tools, dies, etc. purchased is debited to appropriate assets account, and an inventory of the unused items at the end of the year is prepared and valued; the sum total of opening balance and purchase reduced by the value of closing stock, as disclosed by the inventory, is charged off to Production Account in respect of such assets. On the other hand, some concerns carry such assets at their book values at the end of the first year and charge off the cost of all the purchases in the subsequent year to the Production Account on the plea that they represent cost of replacement.

The most satisfactory method, however, is that of preparing an inventory of serviceable articles, at the close of each year, and revaluing the assets on this basis, the various articles included in the inventory being valued at cost. Care, however, should be taken to see that the inventory does not include any worn out or defective articles the life of which has already run out.

EMPTYES & CONTAINERS QUOTED INVESTMENT AND UNQUOTED INVESTMENT.

Trademarks and Copyright

The existence of a trademark is verified by an inspection of the certificate as regards grant of the trademark. Where it has been purchased, the agreement surrendering it in favour of the client should be examined. It must also be observed that the rights are alive and legally enforceable.

Copyrights are also acquired by surrender of rights and they also should be verified similarly. The auditor should obtain a schedule of trademarks and copyrights and verify that renewal fees have been paid and charged to revenue. The last renewal receipt should, in each case, be examined to ascertain that the trade mark has not lapsed. Copyrights and trademarks are generally revalued at the cost of each financial period. The auditor should see that revaluation has been made on a fair and reasonable basis. Where he finds that any publication has ceased to command sale, he should have the amount of its copyright written off to revenue.

Patent Rights

The ownership of a patent is verified by inspection of the certificate issued in respect of grant of the patent. If it has been purchased, the agreement surrendering it in favour of the client should be examined. It must also be observed that the rights are 'alive' and legally enforceable and renewal fees have been paid on due dates by being charged to revenue and to the Patent Account. The last renewal receipt should be examined to ascertain that the patent has not lapsed. If a number of patents are held, a schedule thereof should be obtained. Since the amount paid in respect of each patent should be amortised over its life or a lesser period if its commercial life is shorter, it should be seen that the rate at which the value of each patent is being written off is adequate; its value would be completely written off by the time it would cease to have a commercial value. If the patent has been created by the client by research, experiments and laboratory work, the auditor should ascertain that only the actual cost incurred in the process has been capitalized. However, in all cases the registration cost should be capitalised.

Know-how

Know-how in general is recorded in the books only when some consideration in money or money's worth has been paid for it. Know-how is generally of two types :- (i) relating to manufacturing process; and (ii) relating to plans, designs and drawings of buildings or plant and machinery.

Know-how related to plans, design and drawings of buildings or plant and machinery is capitalised under the relevant asset heads. In such a case depreciation is calculated on the total cost of those assets, including the cost of the know-how capitalised. Know-how related to manufacturing

processes is usually expensed in the year in which it is incurred.

Where the amount paid for know-how is a complete sum in respect of both manufacturing process and related to plans, designs etc. such amount should be apportioned amongst them on a reasonable basis.

Where the consideration for the supply of know-how is a series of recurring annual payments as royalties, technical assistance fees, contribution to research, engineering, etc. are charged to the profit and loss account each year.

Plant and Machinery

In the absence of a Plant Register containing detailed particulars of various articles of machinery and equipment, showing separately original cost, addition to and sales from it from time to time. It is not normally practicable for the auditor to verify the existence of such assets. The auditors should therefore insist on a Plant Register being maintained where the value and variety of machinery and plant are substantial in comparison with the total assets of the business.

Where such a register is kept, it is customary to prepare at the end of each year a statement from the Plant Register showing opening balance, sale and addition thereto during the year in respect of various items of machinery and plant. Its total is then reconciled with the balance in the General Ledger.

The cost of addition, if any, is verified with the invoice of machinery supplied together with evidence in respect of other incidental expenses chargeable to the account, including installation expenses. If any of the addition represents the cost of machinery manufactured by the concern with its own material and by its own labour, the basis on which the expenditure has been allocated should be verified. In addition, a certificate is obtained from the engineer responsible for the manufacture of the plant confirming the total cost of manufacture.

In case any item or machinery has been scrapped, destroyed or sold the auditor should ascertain that the profit or loss arising thereon has been

correctly determined which has either been disclosed in the Profit and Loss Account or credited to the Capital Reserve. In appropriate circumstances, a certificate should be obtained from a senior official that this has been done.

Though it is the duty of the management to ensure that fixed assets are in existence, the auditor also should, periodically, physically examine various items of plant and machinery and other fixed assets, say, once in every three or five years, depending upon the size of the concern.

Certain companies, for convenience of inspection attach to each unit of plant and machinery a metallic disc bearing the number at which it is shown in the Plant Register.

When an asset has been revalued, depreciation should be provided on the revised value and not on the historical value.

Land and Buildings

Sometimes the two assets are shown together in the Balance Sheet. Nevertheless, their ledger accounts should always be separated particularly in view of the fact that buildings are subject to depreciation while land in general is not.

The land holdings should be verified by an inspection of the original title deed to ensure that the land described therein covers all the lands the cost of which is debited in the books of the concern. The auditor however, not being competent to verify the regularity of the title of the concern to the land, is not responsible for doing so. Therefore, generally, a certificate should be obtained from the legal adviser of the client confirming the validity of his title to the land. The auditor should, however, verify that the conveyance deed has been duly registered as required by section 17(1) of the Registration Act, 1908 also that particulars required to be endorsed thereon according to section 58 of the same Act have been duly made and verified. He should, in addition, generally ascertain that *prima facie* the title of the client does not appear to be defective.

If the property is mortgaged, the title deed would be in the possession of the mortgagee or his solicitors. A certificate to this effect should be obtained from them. It should also be ascertained whether there is any

second or subsequent mortgage. If ground rents, outstanding for recovery, are included in the Balance Sheet as an asset, the auditor must examine the counter parts of leases granted and also verify that the ground rents which were outstanding for recovery on the date of the Balance Sheet have since been recovered. If there has been any sale of land or building, it should be verified that the amount of profit or loss resulting on sale has been correctly adjusted in the accounts.

The cost of buildings, as is entered in the books, should be depreciated at appropriate rates, depending upon the quality of their structure and the use which is being made of them. The cost of fittings and fixtures to the building should be adjusted separately in the account from the cost of buildings, since these suffer higher rate of wear and tear than the brick and mortar structure and therefore, have to be depreciated at a higher rate.

If the values of land and buildings are not separately recorded in the books of account, the same should be separated for purposes of calculation the amount of deprecation. This should be done with the assistance of a valuer, unless the same can be achieved on the basis of some documentary evidence available in the record.

Since buildings are continually repaired and there is only a thin margin of differentiation between the expenditure of their improvement and that on repairs, it is necessary for the auditor to scrutinise closely the expenditure on repairs so as to exclude from its expenditure that could legitimately be considered to have added either to the life or the utility of the asset. Such an expenditure should be added to their cost while the amount incurred on current repairs is written off.

It is not customary to write up the book values of land and buildings even though their market values have increased but, where this has been done it will be necessary for the auditor to verify that the appreciation adjusted has been disclosed as required by the law. On the same consideration, no notice need be taken of any fall in the market value of such an asset until the same has crystallized by the asset being sold.

The land holding in the case of real estate dealer will be a current asset and not a fixed asset. The same should, therefore, be valued at cost or market value whichever is less. The amount of profit or loss arising on sale of plots of land by such a dealer should be verified as follows:

- (i) *Each property account should be examined from the beginning of the development with special reference to the nature of charges so as to find out that only the appropriate cost and charges have been debited to the account and the total cost of the property has been set off against the price realized for it.*
- (if) *This basis of distribution of the common charges between different plots of land developed during the period, and basis for allocation of cost to individual properties comprised in a particular piece of land should be scrutinized.*
- (lit) *If land price lists are available, these should be compared with actual selling prices obtained. And it should be verified that contracts entered into in respect of sale have been duly sanctioned by appropriate authorities.*
- (iv) *Where part of the sale price is intended to reimburse taxes or expenses, suitable provisions should be maintained for the purpose.*
- (v) *The prices obtained for various plots of land sold should be checked with the plan map of the entire tract and any discrepancy or unreasonable price variations should be inquired into. The sale price of different plots of land should be verified on a reference to certified copies of sale deeds executed.*
- (vi) *Out of the sale proceeds, provision should be made for the expenditure incurred on improvement of land, which so far has been accounted for.*

FURNITURE & FIXTURES

5.2 AUDIT OF LIABILITIES

OUTSTANDING EXPENSES

Outstanding Expenses:

- i) Obtain the list of outstanding expenses classified by nature of expenses.
- 11) Compare current year's outstanding expenses with that of the previous year and enquire the material variations if any.
- iii) Verify carefully the estimates of outstanding expenses.
- iv) Examine the documentary evidence supporting the outstanding expenses.

- v) See that the usual outstanding expenses are paid of by the time of audit.
- vi) Make sure that provision has been made for all the usual outstanding, e.g. last Salary, wages, rent etc
- v) Examine the correspondence, minute book, etc.
- vi) Verify the service contracts made by the company and see that all outstanding arises have been provided for
- ix) See that outstanding expenses have been disclosed in the balance sheet under liabilities.

BILLS PAYABLE:-

Bills Payable

These are acknowledgements of debts payable. For their verification, it is necessary to see that bills paid have been cancelled and the liability in respect of those outstanding has been correctly ascertained and disclosed.

The steps involved in their verification are :

- (a) Vouch payments made to retire bills on their maturity or earlier and confirm that the relevant bills have been duly cancelled.
- (b) Trace all the entries in the Bills Payable Book into the Bills Payable Account to confirm that the liability in respect of the bills has been correctly recorded.
- (c) Reconcile the total of the schedule of bills payable outstanding at the end of the year with the balance in the Bills Payable Account.
- (d) Obtain confirmation from the drawers or holders of the bills in respect of amount due on the bills accepted by the client that are held by them.
- (e) Verify that the charge, if any created on any asset for the due payment of bills has been appropriately disclosed.)

6.11.4 Loans (secured and unsecured) •

A loan is usually obtained on the basis of a loan' agreement. The auditor should refer to it to ascertain the condition on which the loan has been obtained for confirming that all the conditions as regards repayments of

the loan, payment of interest thereon and provision of security have been duly complied with. Further, where practicable, he should write to the party to confirm the balance of loan outstanding at the end of the year. A loan can be raised only by a competent authority - in the case of a company by the Board of Directors, in that of a partnership by the partners acting jointly and in that of proprietor concern by the proprietor himself. In the case of a company there may exist restrictions on the loans being raised in the Memorandum or Articles of Association. The right of the Board of Directors of a public company or private company which is subsidiary of the public company, under clause (d) of sub-section (1) of section 293 of the Companies Act to borrow money is restricted to the aggregate of the paid up capital of the company and its free reserves. However, the company in a general meeting can relax such a restriction by specifying the amount upto which amounts may be borrowed by the Board of Directors. The deed of partnership in the case of a firm may also contain restrictions on the amount of loans that the partners can raise.

The auditor should therefore, examine the right of the borrowing authority to confirm that the loan or loans have been raised in the proper exercise of the authority vested in the Board of Directors or the partners as the case may be.

If the loan is secured by a charge on an asset of the company, the document through which it has been created should be inspected and particulars of the assets charged should be verified. In the case of a company, the auditor should further see that particulars of the charge have been duly entered in the Register of Charges and verify that the charges have been registered with the Registrar of Companies. It should further be confirmed that particulars of the charge have been properly disclosed in the Balance Sheet.

In view of the provisions contained in sub-section (1A) of section 227, it is necessary for an auditor to find out the purpose or purposes for which the loans have been raised; also confirm whether these have been utilized for the specified purpose or for some extraneous purposes.

CONTINGENT LIABILITIES

Accounting Standard 4 issued by the ICAI deals with the "Contingencies and Events occurring after the Balance Sheet Date". According to it "a contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence or non-occurrence, of one or more uncertain future events." The regard has to be to conditions or situation at the balance sheet date, the financial effect of which is to be determined by future events which may or may not occur.

The definition clearly envisages that either there may be contingent losses or contingent gains. As a matter of prudence, contingent gains need not be accounted for in financial statements since this may result in the recognition of revenue which may never be realised. Therefore, we have to consider contingent loss for which corresponding liability should be accounted for in financial statements. Before discussing the accounting treatment of contingent losses, let us understand contingent liabilities in clear terms.

A contingent liability is a possible liability of a presently determinable amount or one indeterminable which has arisen from past dealings or actions that may not become a legal obligation in the future. The uncertainty as to whether there will be any legal obligation distinguishes a contingent liability from an actual liability. An obligation may be a contingent liability when the very basis of the obligation is contested. For example, when a claim is made against a company in respect of infringement of a patent and the company does not possess a legitimate defence, the liability, though the amount of it is uncertain would be an actual liability, but if the claim is untenable in law, the liability would only be a contingent liability. Though both of them in actual practice are described somewhat loosely as contingent liabilities, their natures are different. In one case, the liability is admitted but its amount is uncertain while in the other, the very basis of the obligation is denied. There is another type of contingent liability, as in the case of partly paid shares, or in respect of contract for capital expenditure wherein there is an obligation to pay a certain sum of money upon which there will be acquisition of an asset of corresponding value. Contingent liabilities also arise when some of the Bills Receivable are discounted or when guarantees are given for loans granted to the third parties.

From the auditing point of view, different types of contingent liabilities are divided into two broad categories, one in respect of which a provision has been made and the other for which there is no provision. AS 4 provides guidance in respect of circumstances when provision has to be made for

contingent losses. It states that the amount of a contingent loss should be provided for by a charge in the statement of profit and loss if :

- (a) it is possible that at the date of the financial statements events subsequent thereto will confirm that (after taking into account any related probable recovery) an asset has been impaired or a liability has been incurred as at that date ; and
- (b) a reasonable estimate of the amount of the resulting loss can be made.

If disclosure of contingencies is required by following above considerations, then, the following information should be provided:

- (a) The nature of contingency;
- (b) The uncertainty which may affect the future outcome;
- (c) An estimate of the financial effect or a statement that such an estimate cannot be

Made; The Companies Act, 1956 requires disclosure of following liabilities by way of a note:

- (1) Claims against the company not acknowledged as debts.
- (2) Uncalled liability on shares partly paid.
- (3) An ears of fixed cumulative dividend.
- (4) Estimated amount of contracts remaining to be executed on capital account and not provided for.
- (5) Other money for which the company is contingently liable.

The amount of any guarantees given by the company on behalf of directors or other officers of the company shall be stated and where practicable, the general nature of each such contingent liability, if material shall also be specified.

The apprehended liabilities aforementioned usually are not easy to ascertain unless a comprehensive knowledge in regard to the working of the business is acquired from a study of the Minute Book of Directors, files of correspondence with legal advisers and on collection of information from the officials of the company in regard to indisposed

claims and legal actions pending against the company.



INTRODUCTION TO COMPANY AUDIT

STRUCTURE

- 8.0 Objectives
- 8.1 Qualification Of An Auditor
- 8.2 Disqualification Of Auditors
- 8.3 Appointment Of First Auditors
- 8.4 Appointment Of The Subsequent Auditor
- 8.5 Removal Of Auditor

8.0 OBJECTIVES

After studying the unit the students will be able to

- Know about the Qualifications of an auditor
- Understand the Disqualifications of an Auditor
- Explain how to appoint the first auditor
- Know the rules and regulations related to removal of an auditor

8.1 QUALIFICATION OF AN AUDITOR

The provision regarding qualification of auditor is governed by Section 226 of the Companies Act, 1956
Sec 226(1) states

- A person will be qualified for appointment as an auditor of a company (public or private) only if he is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949
- The same section also provides that a firm of Chartered Accountants will be qualified for appointment as the auditor of a company in its firm name provided all the partners practicing in India are qualified for appointment
- In case of the firm being appointed as auditor, any practicing partner may act in the name of the firm.

8.2 DISQUALIFICATION OF AUDITORS

The provision regarding disqualification of auditor is governed by section 226 of the Companies Act, 1956.

1. Section 226(3)

The following persons are not qualified for appointment as auditors of a company:

- a) A body corporate an officer or employee of the company

- b) A partner or employee of an officer or employee of the company
- c) A partner or employee of an officer or employee of the company
- d) A person who is indebted to the company for more than Rs. 1000

OR

A person who has given any guarantee or provided any security in connection with the Indebtedness of any third person to the company for more than Rs. 1000.

- e) A person holding any security (a security would mean an instrument carrying voting rights) of that company after a period of one year from the date of commencement of the Companies (Amendment) Act, 2000.

2. Section 226(4)

A person is not eligible for appointment as an auditor of any company if he is disqualified from acting as auditor of that company's subsidiary or holding company or of any other subsidiary of the same holding company and vice- versa.

3. Section 226(5)

If an auditor after his appointment, becomes subject to any of the disqualification mentioned in section 226(3) and section 226(4), he shall be deemed to have automatically vacated his office.

8.3 APPOINTMENT OF FIRST AUDITORS

The main points regarding appointment of the First Auditors of a company are given in **Section 224(5)**:

1. The first auditors of a company can be appointed by the board of directors within one month of the date of registration/ incorporation of the company by means of a resolution.
2. The auditors so appointed shall hold office until the conclusion of the first Annual General Meeting.
3. If the Board of Directors fails to appoint the First Auditor within one month, the company in a general meeting is empowered to make the appointment.
4. The auditors so appointed by the Board of Directors may be removed by the company at a general meeting which may appoint any other auditor.
5. An auditor cannot be appointed as First Auditor simply because his name has been stated in the Articles of Association.
6. The First Auditor need not sent an intimation by the company of their appointment and the First Auditor are themselves not required to inform the registrar of Companies about their acceptance/ refusal of such an appointment.

8.4 APPOINTMENT OF THE SUBSEQUENT AUDITOR

The main points regarding appointment of Subsequent Auditor of a company are given below:-

1. Section 224(1) empowers the shareholders to appoint auditor at each Annual General Meeting by means of a resolution.
2. Upon an auditor being appointed in the Annual General Meeting, the company is to give intimation thereof to the concerned auditor within seven days of the appointment.
3. On receipt of the intimation from the company about his appointment, the auditor is required to send a written communication to the concerned Registrar of Companies within 30 days in form no.23B indicating whether he has accepted or declined the appointment.
4. The auditor so appointed shall hold the office from the conclusion of one Annual General Meeting to the conclusion of the next Annual General Meeting.
5. The auditor will be guilty of professional misconduct if at any time he accepts audit more than the specified numbers of audit assignments of the company u/s 224 of the Act.

8.5 REMOVAL OF AUDITOR

1. The first auditor appointed by the directors may be removed by the shareholder in the first Annual General Meeting. Such Auditors can even be removed from their office before the expiry of their term of office without the permission from the Central Government.
2. In any other case, auditor can be removed only by the company in General Meeting after obtaining previous approval from the Central Government
3. An Auditor, on the expiry of the terms of his office may not be reappointed and thus removed from his office.
 - a) Resolution requiring special notice (of fourteen days) should be passed at the general meeting [Sec. 225(1)].
 - b) On receipt of notice of resolution, company shall send copy of the notice to the retiring auditor [Sec. 225(2)].
 - c) On receipt of notice, retiring auditor can send written representation of a reasonable nature to the company which should be informed to the members. Normally company has to circulate such representation to the shareholders, unless it is received too late. A notice of resolution also should be circulated, stating a fact of such a representation. If the representation is not circulated for being received too late or because of the default of the company, auditor can insist it to be read at the meeting. [Sec. 225(3)].
 - d) However, company or any other person like directors or shareholders have a right to file a petition with Company Law

Board (CLB) to refrain the

- e) auditor from making such representation, if it is to secure needless publicity or is defamatory. In such a case, on the direction of the CLB, copies need not be sent or read at the meeting [Sec. 225(3)]. These provisions apply to removal of the auditors appointed by Central Government also.
4. The other relevant provisions are that if a new auditor is appointed, the company should within 7 days, inform the new auditor. The new auditor should inform the Registrar within one month of such intimation received about his decision and he should also communication with the retiring auditor in this matter, is he accepts the post



COST ACCOUNTING

STRUCTURE:

- 9.0 Introduction
- 9.1 Objectives
- 9.2 Evolution of Cost Accounting
- 9.3 Definitions
- 9.4 Cost Accounting Profession in India
- 9.5 Objectives of Cost Accounting
- 9.6 Importance of Cost Accounting
- 9.7 Advantages of Cost Accounting
- 9.8 Financial Accounting
- 9.9 Methods of costing – Types of Costing
- 9.10 Essentials of a good costing system
- 9.11 Distinction between Cost & Financial Accounting
- 9.12 Elements of Cost
- 9.13 Summary
- 9.14 Books Recommended
- 9.15 Terminal Exercises

9.0 OBJECTIVES

The objectives of studying this unit are.

- To understand the evolution and definitions of costing.
- To study the objectives of cost accounting.
- To distinguish between Cost accounting and Financial Accounting.

- To classify cost in different ways.
 - To understand the elements of cost accounting systems.
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9.1 INTRODUCTION

Modern business needs information about activities to be planned for the future. A major function of management is decision-making. It requires selection of an optimal course of action from among a set of alternatives. Costing techniques play an important role in gathering and analyzing revenue and cost data. It also helps to control business results and to make a proper appraisal of the performance of persons working in an organisation. Cost accounting also helps in acquiring Plant and Machinery. Adding or dropping Product, make or buy decision, special pricing of products and replacement of assets.

9.2 EVOLUTION OF COST ACCOUNTING

The widespread interest in the subject of cost accounting could be said to have developed with Industrial Revolution which started in 1760. As mechanization, simplification, standardisation and mass production followed in the wake of factory system, costing had to keep pace with these developments. Until the 18th century, cost accounting was in the domain of the engineer. Its integration with financial accounting began when accountants started to audit the cost records. Under the influence of financial accountant, cost accounting came to be viewed almost exclusively as a means of inventory valuation and profit measurement. It has grown only in the 20th century as an independent discipline.

Cost accounting has found to be of assistance to management, in compiling and providing requisite statistical data. It has developed rapidly and assisted management in providing valuable information to take appropriate decision in time. Cost Accounting throws light on the excessive waste of materials, inefficient labour operations, idle machinery and many other similar factors, which are responsible for reduction in the profit of the business activities. Managements found that cost accounting could render valuable assistance in planning, controlling and coordinating the activities.

9.3 DEFINITIONS

(a) Costing:

The institute of Cost & Management Accountants (ICMA) London has defined costing as the ascertainment of costs, costing includes techniques and processes of ascertaining costs.

(b) Cost Accountancy:

The Institute of Cost and Management Accountants (ICMA) London has defined Cost Accountancy as the “application of costing and cost accounting principles, methods and techniques to the science, art and practice of cost control and ascertainment of profitability as well as presentation of information for the purpose of management decision making”. Accordingly Cost Accountancy includes costing, cost accounting, budgetary control, cost control and cost audit. Cost accounting refers to the process of determining and accounting the cost of some particular product or activity. It also includes classification, analysis and infers production of costs.

(c) Cost Accounting:

The I.C.M.A. London defines Cost Accounting as “the process of accounting for cost from the point at which expenditure is incurred or committed to the establishment of its ultimate relationship with cost centers and cost units”.

In practice, costing, cost accounting and cost accountancy are often used interchangeably. Costing refers to ascertainment of costs, accumulation and measurement of cost of activities, processes, products or services. Cost data are used to prepare the statement of cost or cost sheet. Cost Accounting is a specialized branch of accounting which assists management to control costs and to create an awareness of the importance of cost to wells- being of the business organization.

Systematic and useful cost data and reports are required to manage the business to achieve its objectives.

(d) Cost Centre:

Cost Centre is a location, person or an asset for which costs can be ascertained and used for the purpose of cost control. It is an organizational segment or area of activity used to accumulate costs. Different types of cost centers used in a manufacturing organization are personal cost centers, impersonal cost centers, operation cost centers and process centers.

(e) Cost Units;

A cost unit is a unit of quantity of product or service in relation to which cost may be ascertained. There should be a unit of activity for proper ascertainment of cost. Every organization has a unit of its own for measurement of raw materials, and finished products. Once the unit of activity is decided it becomes a cost unit for the cost accountant. The cost units should be suitable to the organization. The following are the examples of cost units in different industries :-

Nature of Industry	Cost Unit.
Cement	Tonne
Cable	Metre
Power	Kilowatt/ hour
Hospital	Per bed
Paper	Ream

9.4 COST ACCOUNTING PROFESSION IN INDIA

To develop the Cost and Management Accountancy profession, the Institute of Cost and Works Accountants of India was set up at Calcutta in 1944. It got statutory recognition in 1959. It has more than two chapters through India and around six overseas centres.

The Department of Company Affairs issued a specific order under section 233 (1) of the Companies Act, 1956 to a particular company to get its cost records audited. The order indicates the product and the period to be covered. The cost audit is conducted by a Cost Accountant holding a Certificate of Practice from the Institute. The Department of Company Affairs of the Government of India also prescribed Cost Accounting Records & Rules under Section 209(1) (d) of the Companies Act, 1956. Accordingly, more than 35 industries are required to maintain Cost Accounting records relating to Production, Work in Progress, Finished Goods, Utilities, Repairs and Maintenance, Wages and Salaries Overheads and Sales.

9.5 OBJECTIVES OF COST ACCOUNTING

The cost accounting objectives are normally used to denote activities for which costs are required to be determined separately. The activities may be function, organizational sub-division, contract or other work unit for which data are required. There is direct relationship among information needs of management, cost accounting objectives and techniques and tools used for analysis in cost accounting. Thus, cost accounting has the following objectives-

1. To determine product costs.
2. To facilitate planning and controlling of regular business activities.
3. To supply information for short and long run decisions.

9.6 IMPORTANCE OF COST ACCOUNTING

Cost Accounting is very important for a commercial organization. It is also useful for any other organization. It helps management in different fields one of such fields is presentation of information in the most useful manner. Cost Accounting is used to measure, analyse or estimate the costs. Profitability and Performance of individual products, departments and other segments of an organization, for either internal or external or both and to report to the interested parties. Cost Accounting concerns itself with the synthesis and analysis of costs. Its purpose in the modern days is to help management in the twin functions of decision- making and control. Thus, Cost Accounting is not simply cost finding but it is advising management, planning and control of organization and business operations. The Companies Act, also provides that certain companies have to maintain cost accounting records and accounts and conduct the audit of cost accounts.

9.7 ADVANTAGES OF COST ACCOUNTING

A cost accounting system when installed will result in the following:-

- i) Cost Accounting reveals areas where materials were used excessively, labour operated inefficiently and expenses incurred exorbitantly.
- ii) It suggests cost reduction programme. A continuous cost jointly with technical personnel seeking areas for effecting cost reduction brings beneficial results.

- iii) Cost account locates the specific causes for the variations in profit. It points out the losing product or operations. It indicates reasons for loss and suggests remedial measures in time.
- iv) It provides suitable data to management to select best alternatives. It may be to decide whether to buy or make a part, to operate Machine X or Y, to accept or reject an order below cost.
- v) Cost accounts give actual cost for price fixation. True demand and supply play vital role in fixing price. But cost is an essential guide here.
- vi) It provides vital data to fill in tenders. Tenders filled in with the help of marginal costing technique are successful.
- vii) Standard costing and budgetary control aid maximum efficiency.
- viii) Cost comparison helps cost control. Such comparison may be between different periods of the same department or comparable operations of different units.
- ix) Cost data are useful to outside agencies like Government, Tribunals, etc., for taking decisions on tariff regulations, settlement of disputes, variations in wage levels etc.
- x) It provides idle capacity cost to assist overcoming capacity utilization crises.
- xi) Marginal costing technique helps to take suitable short term decisions in times of trade depression.
- xii) Cost Accounting lays down cost centres and responsibility centres which ensures proper organizational structure.

- xiii) Cost accounting provides for perpetual inventory system. This enable inventory control and preparation of short term profit and loss accounts.
- xiv) Cost of closing stock of raw materials, work in progress and finished products are readily available in cost records.

All organizations will not get all the advantages listed above. However, an efficiently operated costing system with full support from management can reap most of them.

9.8 FINANCIAL ACCOUNTING

Financial Accounting is concerned with providing information to external users such as shareholders, creditors, labour unions, government authorities etc., It is oriented towards the preparation of financial statements i.e. Profit and Loss account and Balance Sheet which summarises the results of operations for selected periods of time and show the financial position at particular dates. It follows Generally Accepted Accounting Principle. Financial accounting accounts for money. Since, financial statements are general purpose in nature and only one set of accounts is prepared and sent to all, financial accounting suffers from the following limitations.

Limitations of Financial Accounting -

1. Financial accounting is mostly historical in nature.
2. It does not provide detailed cost information for different jobs, processes or departments.
3. It is difficult to know the behaviour of cost as expenses are not classified into fixed and variable.
4. It does not possess an adequate system of standards to evaluate the performance of departments and employees.
5. It does not provide necessary information to management in taking important decisions like pricing, special orders, alternative etc.
6. Annual reporting is a rule in financial accounting.

9.9 METHODS OF COSTING AND TYPES OF COSTING

Several methods or types of costing have been designed to suit the needs of individual business conditions.

There are two main methods of costing; these are :

Job Costing and Process Costing.

All other costing methods are either variants of these two methods or techniques designed for particular purposes, for specific occasions and for specific conditions.

9.9.1 Job Costing : This method is suitable for ascertaining cost of a job, a specific order or a batch of finished products.

Here the cost unit is a job comprising a specific quantity manufactured as per an order. A job may be small or big. It may be as per a customer's order or for stock for eventual sale. Other variations of job costing are given below: -

- i) **Contract Costing :-** This method is used by contractors for construction of building bridges etc. Here the unit of cost is a contract. The period of this contract normally extends beyond the current financial years.
- ii) **Batch Costing :-** This method is applicable to manufacturers producing economic batches of components for subsequent assembling. Large engineering firms use this method. Here the costing is done for a batch of the components instead of a single component.
- iii) **Multiple Costing :-** This is used in large industries such as automobile, aero plane industries etc., Here the cost of

components is calculated separately. Each component has a job sheet. Later, these are assembled to complete the cost of aeroplane or other finished product.

9.9.2 Process Costing :- This method is used by industries manufacturing products by continuous processes. Cost is ascertained for a period by process or department. As distinct from job costing, time is given more importance here. Hence, this is also called period costing. Examples of the industries using process costing are chemical industries, paper making and refineries. Other variants of process costing are:

- i) **Operation Costing :-** Operation Costing is applied where the production passes through several operations successively before the final product is made. Wastages may occur in each operation. Operation costing is used in industries such as box making, shoe making, toy making industries. Here cost unit is an operation around which costs are accumulated.
- ii) **Single or Output or Unit Costing: -** This method is applied where the production is of continuous nature and the final product is only one or the different grades of same product. Examples of the industries applying this method are mining industry, quarries and steel production.
- iii) **Operation Costing :-** This method is applied for ascertaining cost of service rendered. Examples of industries using this method are transport services, electricity and boiler house. In transport services, the unit of cost is a passenger Kilo-meter, or a Kilogram kilometer.

9.10. ESSENTIAL OF A GOOD COSTING SYSTEM

- i) The costing system should fit in the general organisation of the business. Normally no alternations in the organisation should be made to facilitate costing system. However, unavoidable changes could be made in the set up to ensure effective costing system.

- ii) All relevant technical aspects (such as nature and method of production, varieties of product) should be adequately studied for employing suitable cost control devices.
- iii) The size, lay out and organisation of the factory should be adequately described for the benefit of those operating costing system.
- iv) The procedure required to be followed for purchase, receipt, storage and issue of materials should be clearly laid down.
- v) The methods of wage payment and system of labour control should be specified.
- vi) The norms for appointment and allocation of overhead should be specified.
- vii) Forms and records of original entry should be suitably designed to ensure economy.
- viii) The forms should be got printed. It should contain full instructions. Persons who use them should be adequately trained to ensure accuracy and relevance of the data written on the forms.
- ix) An examiner should check and sign every entry in the forms.
- x) Responsibility for preparing and sending the cost reports to various levels of management at periodical intervals should be fixed and necessary instructions in this regard issued.
- xi) Full co-operation from all concerned in the management should be enlisted. The resistance from the employees should be minimum.

- xii) Cost of administering the costing system should be commensurate with the benefit available there from.
- xiii) Design the system suitably to enable exercising cost control effectively.
- xiv) The cost accounts and the Financial accounts should be interlocked. Alternatively, result of the two sets of accounts should be reconciled.
- xv) Frequency, regularity and promptness in the presentation of cost reports should be ensured.

9.11 DISTINCTION BETWEEN COST AND FINANCIAL ACCOUNTING :

Cost Accounting is a close follower of financial accounting. It is not independent of financial accounting. Though there are common grounds between the two, the important differences are given below:-

- i) **Reporting:-** The major objective of financial accounting is external reporting whereas the focus of cost accounting has been essentially internal i.e. management.
- ii) **Flexibility :-** Financial accounting is mostly historical or after the event while cost accounting is much more flexible and open minded and includes in both retrospective and anticipatory calculations.
- iii) **Nature :-** Financial accounting classifies, records, presents and interprets in terms of money transactions whereas cost accounting classifies, records, presents and interprets in a significant manner the material, labour and overhead costs involved in manufacturing and selling each product.
- iv) Financial accounting uses Generally accepted Accounting Principles while recording, classifying summarizing and reputing business transactions whereas cost accounting is not bound to

use GAAP and it can use any technique or practice which generates useful information.

- v) **Time Span** : Financial accounting data are developed for a definite period, usually a year, half year or a quarter, but cost accounting reports and statements can be prepared whenever needed.

- vi) **Accounting Method** :- Financial Accounting follows the double – entry system for recording, classifying and summarizing business transactions . The data under Cost Accounting can be gathered for small or large segments or activities of an organisation and monetary as well as other measures can be used for different activities in the organisation.

9.12. ELEMENTS OF COSTS.

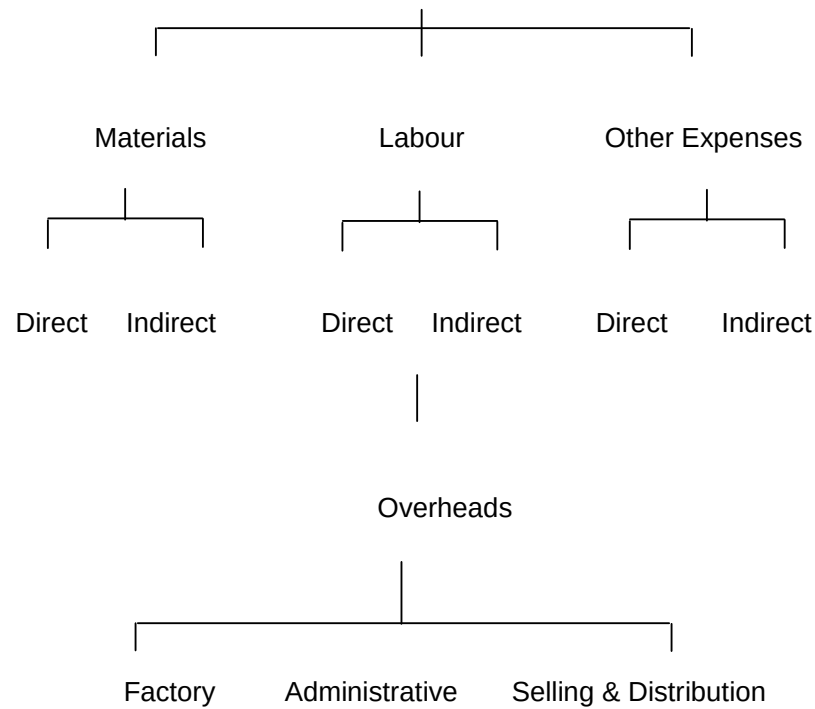
9.12.1 Composition of Elements of Costs:-

A manufacturing organisation converts raw materials into finished products. For that it employs labour and provides other facilities. While compiling production cost, amount spent on all these are to be ascertained. For this purpose, cost are primarily classified into various elements. This classification is required for accounting and control.

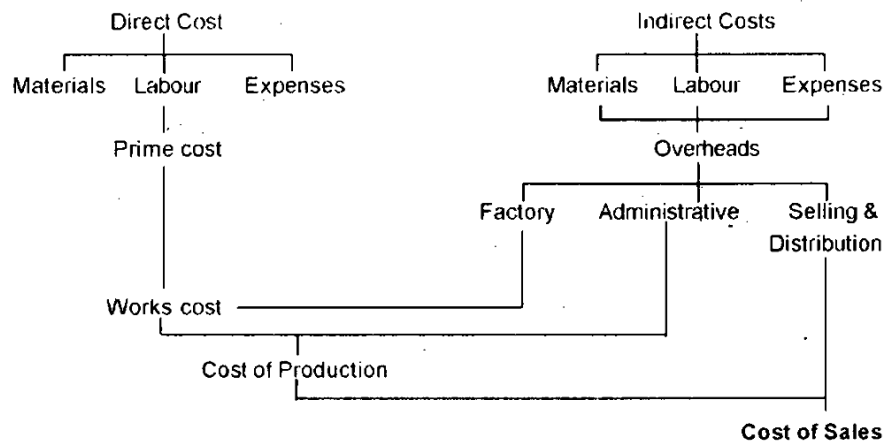
The elements of cost are (i) Direct material (ii) Direct labour (iii) Direct expenses and (iv) Overhead expenses.

The following chart depicts the broad headings of costs and this acts as the basis for preparing a Cost sheet.

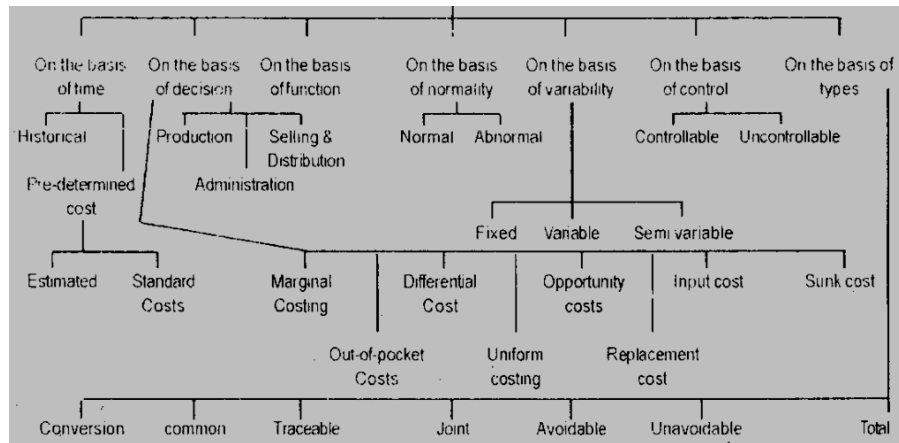
Elements of cost



Break up of cost sheet



CLASSIFICATION OF COSTS



9.12.2 Prime Cost :

The aggregate of Direct material cost, Direct labour and Direct expenses is termed as Prime Cost. Direct costs are traceable to products or jobs.

9.12.3 Direct materials

It includes cost of materials consumed in the production process which can be directly allocated to the cost center. Direct material can be identified and charged to the finished product.

Examples-

- i) Material specially purchased for a specific job or process.
- ii) Materials passing from one process to another.
- iii) Consumption of materials or components manufactured in the same factory.
- iv) Primary packing materials.
- v) Freight, insurance and other transport costs, import duty, octroi duty, carriage inward, cost of storage and handling are treated as direct costs of the materials consumed.

In certain cases direct materials are used in small quantities and it will not be feasible to ascertain their costs and allocate them directly. For instance, nails used in the manufacture of chairs and tables, glue used in the manufacture of toys. In such cases cost of the total quantity consumed for the period will be treated as Indirect costs.

9.12.4 Direct Labour

This includes the amount of wages which can be easily identified and directly charged to the product. These are the costs for converting raw material into finished products. Wages paid to workers for operating Lathe machines, Drilling machines etc. in a Tool room are Direct wages.

9.12.4 Direct Expenses

This includes expenses other than materials and labour which can be easily identified with a particular product or process. For example. Excise duty expenses. Indirect costs cannot be easily identified with a particular products or process.

9.12.6 Indirect materials

Materials which cannot be traced as part of the finished products are known as Indirect materials.

Example :

- a. Consumable stores such as lubricants, cotton wastes, tools etc.
- b. Materials of insignificant value not worthwhile to ascertain the cost separately, for charging directly such as nails (for making chair) glues (for making toys). These materials can be apportioned to or absorbed by cost centres or cost units arbitrarily.

Indirect labour is the cost which cannot be directly charged or identified to the finished product. Indirect labour is apportioned to or absorbed by cost centres or cost units suitably.

Examples:

- a. Salary to Store- keeper
- b. Wages to Time – keeper

9.12.7 Indirect Expenses :

These are general expenses not incurred for any particular product or service and not chargeable to the products directly.

Examples :

- a. Rent, Rates and Insurance of Factory
- b. Power, lighting, heating repairs, telephone expense, printing and stationery.

Overheads can be sub-divided into following main groups.

- 1. Factory or Works Overheads:** Also known as manufacturing or production overheads it consists of all costs of indirect materials, indirect labour and other indirect expenses which are incurred in the factory.

Examples :

Factory rent and insurance. Depreciation of Factory building and machinery.

- 2. Office or Administration overheads:** All indirect costs incurred by the office for administration and management of an enterprise.

Examples:

Rent, rates, taxes and insurance of office buildings, audit fees, directors fees.

- 3. Selling and Distribution overheads:** These are indirect costs in relation to marketing and sale.

Examples :

Advertising, Salary and Commission of sales agents, Travelling expenses of salesmen.

Correct Sequence:

Direct Materials

+

Direct Labour

Prime Cost (main cost of production)

+

Direct Expenses

+

Indirect Materials

+

Indirect Labour

Factory Overheads (From raw materials to finished goods)

+

Indirect Expenses

=

Works cost

+

Indirect Materials

+

Indirect Labour

Administrative Overheads

(Management and Administration of enterprise)

+

Indirect Expenses

Indirect Materials

+

Selling and Distribution Overheads

(Delivery from

Indirect Labour

warehouse to customer)

+

Indirect Expenses

=

$$\begin{array}{r} \text{Cost of Sales} \\ + \\ \text{Profit} \\ = \\ \text{Sales} \end{array}$$

9.13. SUMMARY

Cost Accounting is the process of accounting for costs from the point at which expenditure is incurred or committed to the establishment of its ultimate relationship with cost centre and cost units. Cost accounting profession got recognition in 1939 in India. It has been made compulsory for specified manufacturing companies. Cost Accounting has the objectives of determining Product costs, facilitate planning and control of regular business activities and supply information for taking short term and long-term decisions. Cost Accounting is useful in different areas such as materials, labour, overheads, stock valuation etc.

Financial Accounting is concerned with providing information to external users. It does not provide detailed cost information for different jobs, processes or departments. It also does not possess an adequate system of standards to evaluate the Performance of departments and employees. There are two major methods of costing- job costing and process costing. Job costing includes Contract, Batch and Multiple costing. Costing system should be developed in an organisation to fit in the general organisation of the business. Cost and Financial Accounting are different from each other.

9.14 TERMINAL EXERCISE

1. What is cost Accounting? What are its objectives?
2. How does cost accounting help in planning and control of operations of a business enterprise?
3. Distinguish between Cost Accounting and Financial Accounting
4. What is Financial accounting? What are its limitations?

5. What are the advantages of Cost Accounting?
6. What are the essentials of good costing system?
7. What are the various elements of costs?
8. Write short notes on:
 - a) Cost centres
 - b) Cost units
 - c) Costing methods
 - d) Cost Accounting as a Profession
 - e) Elements of costs

9.15 BOOKS – RECOMMENDED

1. Principles & Practice of Cost Accounting – N.K.Prasad
2. Wheldons Cost Accounting & Costing Methods – Owler & Brown.



COST AND COST CLASSIFICATIONS - COST SHEET

STRUCTURE

- 10.0 Objectives
- 10.1 Introduction
- 10.2 Concept of cost
- 10.3 Cost classifications
- 10.4 Cost Sheet
- 10.5 Summary
- 10.6 Books Recommended
- 10.7 Terminal exercises

10.0 OBJECTIVES

The objectives of studying this unit:-

- To understand the concept of cost
- To classify the costs
- To understand the cost sheet
- To understand the elements of cost.
- To prepare the cost sheets.

10.1 INTRODUCTION

A manufacturing organisation converts raw materials into finished products. For the purpose, it employs labour and provides other facilities. While compiling production cost, amounts spent on all these facilities are required to be ascertained. Thus, cost ascertainment involves (a) collection and classification of costs according to cost elements (b) its allocation or apportionment to cost centres or units (c) choice of an appropriate method of costing and (d) selection of an appropriate costing technique. Costs are primarily classified into various elements for accounting and control.

10.2 CONCEPT OF COST

Cost represents a sacrifice, a foregoing or a release of something of value. It is reckoned in money and usually appears as payment of money. It is money outlay for productive factors.

Costs are expenditure incurred in doing something. Costing is the process of determining the cost of doing something i.e cost of manufacturing an article, rendering service or performing a function.

Cost is composed of three elements- material, labour and expenses or overheads. Each of these costs can be further classified as (a) Direct and (b) Indirect.

Direct costs are costs which can be easily identified with a particular Product, Process or Department. Indirect costs refers to costs which cannot be conveniently identified with a particular product. Process or Department. Indirect costs are common costs like rent, repairs salaries, which are incurred for the benefit of a number of cost units or cost centres.

10.3 COST CLASSIFICATIONS

Cost items are analysed or grouped according to their common characteristics which is some independent factor. There are many objectives of cost classifications depending on the requirements of management. The different cost classifications are as follows:-

10.3.1 Cost Classification by Elements :

The constituent elements of costs are broadly classified into three distinct elements i.e. materials, labour and expenses. These three elements of cost can be further grouped into direct and indirect categories. Direct materials refer to the cost of materials which are conveniently and economically traceable to specific units of output for example. Raw cotton in textiles, crude oil in making diesel. The indirect materials refer to materials that are needed for the completion of the product but whose consumption with regard to the product is either so small or so complex that it would not be appropriate to treat it as a direct material. For example, stationery lubricants, cotton waste etc.

10.3.2 Cost Classification by Function.

A business organisation has to perform several functions such as Manufacturing, Administration, Selling and Distributing and Research and Development. Functional classification of cost implies that the business performs many functions for which costs are incurred. Expenses or Costs are usually classified by function and grouped under the headings of Manufacturing, Selling and Administrative costs in measuring net income.

Manufacturing costs are all check costs incurred to manufacture the products and to bring them to a saleable condition. This includes direct material, direct labour and indirect manufacturing costs or overheads. Administration costs are incurred for formulation of policy, directing the organisation and controlling the activities excluding the cost of research, development, production, selling and distribution. These costs include salary of executives, office, staff, office rent, stationery, postage etc. Selling costs, include the cost of creating and stimulating demand and getting customers. For example, advertisement, salary and

commission to salesmen, packing. Distribution costs include the cost of warehouse, freight, cartage etc.

Research and Development costs are incurred in the process of finding out new ideas, new processes by experiments or other means of putting the results of such experiments on a commercial basis. Functional classification of cost is important because it provides an opportunity to the management to evaluate the efficiency of departments performing different functions in an organisation.

10.3.2 Cost Classification by variability:

Cost can be classified as (i) fixed (ii) variable and (iii) semi -fixed or semi variable in terms of their variability or changes in cost behaviour in relation to changes in output or activity or volume of production. Activity may be indicated in any form such as units of output, hours worked, sales, etc. The separation of costs into variable and fixed categories is the most difficult part of the costing operation. Certain costs are easily identifiable as variable or fixed while other costs can be segregated only after careful consideration of their nature and an examination of their behaviour.

i) Fixed costs:

Fixed cost is a cost which does not change in total for a given time period despite wide fluctuations in output or volume of activity. These costs must be met by the organisation irrespective of the volume level. These costs are also known as capacity costs, period costs or stand - by costs; for example, rent, property taxes, supervisor's salary, advertising, insurance etc.

ii) Variable costs:

Variable cost are those costs which vary directly and proportionately with the output. There is a constant ratio between the change in the cost and the change in the level of output. Direct materials and labour are the examples of variable costs. Thus, all these costs which tend to vary directly with variations in volume of output are variable costs. However, it must be remembered that variable costs remain the same or approximately the same in amount per unit of production regardless of increase or decrease in volume.

iii) **Semi variable or semi fixed costs:**

There is another group of costs in between the fixed and variable costs. It is semi variable or semi fixed costs. These costs vary in some degree with volume but not in direct proportion. Such costs are fixed only in relation to specified constant conditions. Semi fixed costs are those costs which remain constant upto a certain level of output after which they become variable. For example: maintenance of building, depreciation of plant, supervisor's salary, telephone expenses etc.

10.4 COST SHEET

Cost sheet is a statement prepared to present the detailed costs of total output during a period. It provides information relating to cost per unit at different stages of total cost of production. The preparation of cost sheet is one of the important and primary function of cost accounting. Cost sheet is not an account. There is a prescribed form for preparation of cost sheet. A cost sheet is a statement of cost prepared for a given period of time in such a manner that it indicates various elements of cost as clearly as possible. The cost sheet is useful in ascertaining the total cost of production per unit, formulation of production plan, fixing up the selling price and minimize the production cost. Sometimes standard cost data are provided to facilitate comparison with the actual cost increased. The preparation of the cost sheet requires understanding of the treatment of the following items:-

- a) **Stock of raw materials :** The opening and closing stock of raw materials are to be adjusted with purchase of Raw materials in order to determine the value of raw materials consumed for the output produced. Carriage/ Freight inward and Octroi on purchase etc. also to be added to purchases. This is a part of Prime Cost.
- b) **Stock of Work in Process –** The value of stock of work in process is a part of Factory cost and therefore, it should be adjusted with factory overheads. Sale of scrap should be deducted from the factory overheads in order to determine the total factory cost.
- c) **Stock of Finished goods :-** Finished goods covers the products on which factory work has been completed. It is the cost of completed production. The opening and closing values of finished goods are to be adjusted with the total cost of production in order to arrive at cost of sales.

10.4.1 Expenses excluded from cost sheet:

There are certain expenses /costs which do not form a part of cost sheet. Some of these expenses are an apportionment of profit. Examples of these expenses are -

- i) Dividend to shareholders
- ii) Income Tax
- iii) Interest on loan
- iv) Donations paid
- v) Capital expenditure
- vi) Capital loss on sale of assets.
- vii) Commission to Partners / Managing Director
- viii) Discount on issue of shares/ debentures
- ix) Underwriting commission.
- x) Writing of goodwill/ bad debts
- xi) Provision for Taxation, Bad Debts or any kind of Fund or reserves.

10.4.2 Specimen of cost sheet.

The specimen form of a cost sheet is given below:

Cost sheet for the period

(Production ... Units)

Particulars	Total Cost Rs.	Cost Per Unit Rs.
Direct Materials		
Raw Materials		
Opening stock Materials :		
Add : Purchases		
Add : Carriage / Freight Inward -----		
Less : Closing stock -----		
Cost of materials consumed		
Direct Labour		
Direct Expenses		
	-----	-----
Prime cost		
Factory overheads		
Add: Work in Progress (Opening)		
Less : Work in Progress (Closing)		
Works /Factory cost		
Office and administrative expenses		
Cost of Production (of goods produced)		
Add: Op. Stock of finished goods		
Less closing of finished goods		
cost of production (of goods sold)		
Selling & Distribution expenses		
Cost of Sales		

Add. Profit (Loss)		
Sales		

10.4.3 Elements of Total Cost

Costs are classified under different heads which represent the successive stages through which the cost flow.

i) Prime Cost

Prime cost is the basic cost of any product. It comprises of those expenses which could be traced directly to it. The prime cost consists of cost of direct materials, direct labour and direct expenses. Direct expenses include special expenses which can be identified with product or job and are charged directly to the product as part of the prime cost. For example cost of hiring special plant or machinery, cost of special moulds, design or patterns, Architect's fees, Royalties, License fees etc.

ii) Work cost:

Works cost of a Product consists of prime cost plus the portion of works or factory expenses chargeable against the Production. Works or factory expenses include, indirect materials indirect labour and indirect expenses. Indirect materials refer to those materials that are needed for the completion of the product but the consumption of these materials is either so small or complex that it would not be appropriate to treat it as direct materials. These are supplies that cannot be conveniently and economically charged to a specific unit of output. For example, lubricants, cotton waste, works stationery etc.

Indirect labour is that labour which does not affect the construction or the composition of the finished product. This is the labour cost of production related activities that cannot be associated with or conveniently traced to specific product through physical observation. For example, Foremen's salary and salary of employees engaged in maintenance or service work. Indirect expenses covers all expenditure incurred by the manufacturer from the time of production to its completion as delivery to customer by way of rate of product. Any cannot be allocate but which can be apportioned to or absorbed by the cost cehtres cost

units are known as indirect expenses. These expenses are incurred for the benefit of more than one product, job or activity and, therefore, must be apportioned by appropriate bases to the various functions or products. For example, lighting and heating, maintenance factory manager's salary, watch and ward department's salary etc.

(ii) Cost of Production :

Cost of Production consists of works cost plus an additional amount of office and administrative expenses. It includes all expenses connected with the managerial functions such as planning, organizing, directing, co-ordinating and controlling the operations of the manufacturing business. For example, office rent, salary, lighting, stationery, repairs and maintenance and depreciation of office building, audit fees, legal expenses.

iv) Cost of Sales:

Cost of sales consists of cost of production plus proportionate selling and distribution expenses of the product. Selling expenses include the expenses incurred for creating demand for the product such as advertisement, salaries of salesmen, selling expenses and show room expenses. Distribution expenses are those expenses incurred in connection with the delivery of goods to the customers such as packing, carriage outwards, warehouse expenses.

Illustration -1

Bombay Manufacturing company submits the following information on 31-3-2010

Particulars	Rupees
Sales for the year	2,75,000
Inventories at the beginning of the year-	
- Raw Materials	3,000
- Work in Progress	4,000
- Finished Goods	1,10,000
Purchase of materials	65,000
Direct Labour	6,000

Inventories at the end of the year -	
- Raw Materials	4,000
- Work in Progress	6,000
- Finished Goods	8,000
Other expenses for the year –	
Selling expenses	27,500
Administrative expenses	13,000
Factory overheads	40,000
Prepare Statement of cost	

Solution :

Bombay Manufacturing Company

Statement of cost for the year ended 31-3-2010

	Rs.	Rs.
Materials consumed		
Opening stock:	3,000	
+ Purchases	110000	
	113000	
- Closing stock	4000	
		109000
Direct Labour		65000
Direct Expenses		6000
		180000
Prime cost		
Factory overheads	40000	
+ Work in Progress (beginning)	4000	
	44000	

- Work in Progress (Closing)	6000	38000
Works cost		2,18,000
Administrative expenses		13,000
Cost of Production		2,31,000
+ Opening Stock of finished goods		7,000
		2,30,000
- Closing Stock of finished goods		8,000
		2,30,000
Selling & Distribution expenses		27,500
cost a sales		2,57,500
Profit (Bal. Fig)		17,500
Sales		2,75,000

Illustration -2

From the following information prepare a statement showing (i) Prime cost (ii) Works cost (iii) Cost of Production (iv) Cost of Sales (v) Net profit of X Ltd. which produced and sold 1000 units in June 2009.

Rs.**Opening Stock:**

Raw Materials	24,000
Finished goods	16,000

Closing stock:

Raw Materials	20,000
Finished goods	15,000
Purchase of Raw Materials	80,000
Sales	2,00,000
Direct Wages	35,000
Factory Wages	2,000
Carriage Inward	2,000

Carriage Outward	1,000
Factory Expenses	4,000
Office Salaries	15,000
Office Expenses	12,000
Factory Rent & Rates	2,500
Depreciation - Machinery	2,500
Bad Debts	1,500

Solution**Ltd.****Cost Statement for June, 2009**

Particulars	Rs.	Total Cost	Cost per Unit
		Rs.	Rs.
Opening stock of materials	24,000		
Add: Purchase of materials	80,000		
Add: Carriage Inward	2,000		
	1,06,000		
Less: Closing stock of materials	20,000		
Cost of Materials consumed		86,000	86.00
Direct Wages		35,000	35.00
(i) PRIME COST		121,000	121.00
Factory overheads :			
Factory Wages	2,000		
Factory expenses	4,000		
Factory Rent & Rates	2,500		
Depreciation	2,500		
		11,000	11.00
(II) WORKS COST		1,32,000	132.00
Administrative Overheads :			
Office Salaries	15,000		
Office Expenses	12,000	27,000	27.00
(iii) COST OF PRODUCTION		1,59,000	159.00
Selling & Distribution Overheads :			

Carriage Outward	1,000		
Bad Debts	1,500		
		2,500	2.50
TOTAL COST		1,61,500	161.50
Add: Opening Stock of finished goods		16,000	
		1,77,500	
Less: Closing Stock of finished goods		15,000	
(iv) Cost of Sales		1,62,500	162.50
(v) Net Profit (Bal.Fig)		37,500	37.50
Sales		2,00,000	200.00

Illustration – 3

NRC Ltd., manufactured and sold 1000 Radio sets during the year 2009. The summarized accounts are given below :

Mfg. / Trading & Profit & Loss A/c

	Rs.		Rs.
To Cost of Materials	40,000	By Sales	2,00,000
To Direct Wages	60,000		
To Manufacturing Exp.	25,000		
To Gross Profit	75,000		
	2,00,000		2,00,000
To Salaries	30,000	By Gross Profit	75,000
To Rent, Rates & Taxes	5,000		
To General Expenses	10,000		
To Selling & Distribution Exp.			
	15,000		

To Net Profit	15,000	
	75,000	75,000

It is estimated that output and sales will be 1200 Radio Sets in the year 2010. Prices of Materials will rise by 20% on the previous year's level. Wages per unit will rise by 5% Manufacturing expenses will rise in proportion to the combined cost of materials and wages. Selling and distribution expenses per unit will remain unchanged. Other expenses will remain unaffected by the rise in output. Prepare cost sheet showing the price at which the Radio Sets should be sold so as to earn a profit of 20% on the selling price.

Solution

COST SHEET

	2009		2010	
	1000 Radios		1200 Radios	
	Total	Per Unit	Total	Per Unit
	Rs.	Rs.	Rs.	Rs.
Direct Materials	40,000	40.00	57,600	48.00
Direct Wages	60,000	60.00	75,600	63.00
PRIME COST	1,00,000	100.00	1,33,200	111.00
Manufacturing Expenses	25,000	25.00	33,300	28.00
WORKS COST	1,25,000	125.00	1,66,500	139.00
Salaries	30,000	30.00	30,000	25.00

Rent, Rates Insurance	5,000	5.00	5,000	4.00
General Expenses	10,000	10.00	10,000	8.00
 COST OF PRODUCTION	 1,70,000	 170.00	 2,11,500	 176.00
Selling & Distribution Expenses	15,000	15.00	18,000	15.00
 Cost of Sales	 1,85,000	 185.00	 2,29,500	 191.00
Net Profit	15,000	15.00	57,275	48.00
 SALES	 2,00,000	 200.00	 2,86,775	 239.00

Illustration – 4.:

A factory can produce 60,000 units per year at its 100% capacity.
The estimated cost of production are as under:-

Direct Material - Rs. 3 per unit

Direct Labour - Rs. 2 per unit

Indirect Expenses :

Fixed - Rs. 1,50,000 per year

Variable - Rs. 5 per unit

Semi-variable - Rs.50,000 per year upto 50%

capacity and an extra expenses of
Rs.10,000 for every 25% Increase in
capacity or part thereof.

The factory produces only against order and not for stock. If the Production programme of the factory is as indicated below and the management desires to ensure a Profit of Rs. 1,00,000 for the year, work out the average selling price at which per unit should be quoted:

First 3 months of the year 50% of capacity remaining 9 months 80% of the capacity. Ignore selling, distribution and administration overheads.

Solution :

Particular	First 3 months (7500 Units)	9 Months (3600 Units)	Total
	Rs.	Rs.	Rs.

Direct Material	22500	108000	130500
Direct Labour	15000	72000	87000
	-----	-----	-----
	37500	1,80,000	2,17,500
Add : Indirect Expenses:			
Fixed 1: 3)	37500	112500	150000
Variable @ Rs.5 b.u.	37500	180000	217500
Semi –variable			
For 3 months	12500	-----	-----
@ Rs.50,000 p.a.			
For 9 months			
@ Rs.70,000 p.a.	--	525000	65000
	-----	-----	-----
Total Cost	125000	525000	650000
Profit	--	-	100000

Sales			750000

Illustration -5

The following figures have been taken from the books of M Ltd. as on 31.12.2009

Stock of Raw Materials on 1.1.2009	Rs.	35,000
Stock of Raw Materials on 31.12.2009	Rs.	5,000
Purchase of Materials	Rs.	50,000
Factory Wages	Rs.	45,000
Factory Expenses	Rs.	17,500
Establishment Expenses	Rs.	10,000
Finished Stock on 1.1.2009	Rs.	15,000
Finished stock on 31.12.2009	Rs.	7,500
Sales	Rs.	2,00,000

The Company manufactured 4000 units during the year 2009. The company is required to quote for the price for supply of 1000 units during the year 2010. The cost of material will increase by 15% and factory labour will cost more by 10% in the year 2010 Prepare a statement showing the price to be quoted to give the same percentage of net profit on sales and was realized during 2009.

a) Cost Sheet for the year 2009

	Rs.	Rs.
Opening Stock of Materials :	35,000	
+ Purchases	50,000	
	<u>85,000</u>	
- Closing stock of Materials	<u>5,000</u>	
Materials Consumed	80,000	20.00
Factory Wages	45,000	11.25
Prime Cost	1,25,000	31.25
Factory Expenses	17,500	4.37
Works Cost	1,42,500	35.62
Establishment Expenses	10,000	2.50
Cost of Production	1,52,500	38.12
Add : Opening Stock of finished goods	15,000	
	<u>1,67,500</u>	
Less : Closing stock of finished goods	<u>7,500</u>	
Cost of Sales	1,60,000	
Profit	40,000	
Sales	<u>2,00,000</u>	

b) Statement showing quotation Price for 1000 units

		Rs.
Materials (20 x 1000) =	20,000	
+ 15% increase	3,000	23,000
Factory wages (11.25 x 1000)=	11,250	
10% increase	1,125	12,375
Prime Cost		35,375
Factory Expenses (4.375 x 1000)		4,375
Works Cost		39,750
Establishment Expenses (2.50 x 1000)		2,500
Total Cost		42,250
Profit (20% on Sale i.e., 25% of Cost)		10,563
Sales		52,813

Note : Percentage of Profit on sales earned during the year 2002 is 20%

$$= \frac{4000}{2000} \times 100 = 20\%$$

Illustration – 6.

In a factory two types of T.V sets are manufactured i.e black & white + colour. From the following particulars prepare a statement showing cost and profit per T.V Set sold. There is no opening or closing stock.

	B & W Rs.	Colour Rs.
Materials	273000	10,80,000
Labour	156000	6,20,000

Works overhead is charged at 60% of Prime cost and Office overhead is taken at 20% at Works cost. The selling price of B & W is Rs.60,00 and that of colour is 10000. During the period 200 B & W and 400 colour T.V. sets were sold. The selling expenses are Rs. 50 per T.V.Set.

Solution**B) Statement of Cost and Profit**

Particulars	B & W	Colour	
	Rs.	Rs.	Per Unit
Materials	273000	10,80,000	2700
Labour	156000	6,20,000	1550
Prime Cost	429000	17,00,000	4250
Add : Work Overheads (60% of Prime Cost)	257400	10,20,000	2550
Works Cost	686400	27,20,000	6800
Add : Office overheads (20% of Works cost)	137280	5,44,000	1360
Cost of Production	823680	32,64,000	8160
Add : Selling Expenses	10000	20,000	50
Cost of Sales	833680	32,84,000	8210
Profit (Bal. Fig)	366320	7,16,000	1790
Sales	1,20,000	40,00,000	10,000

10.5 SUMMARY

Cost is a resource sacrificed or forgone to achieve a specific objective. It is a monetary amount that is paid to acquire goods or services. Costing is the process of determining the cost of doing something. Cost is composed of three elements - materials, labour and expenses or overheads. Each of these costs can be further classified as (a) Direct (b) Indirect. Cost can also be classified on the basis of function, variability and elements. Cost sheet is a statement prepared to present the detailed cost of total output during a period. It provides information relating to cost per unit at different stages of the total cost of production. There are certain expenses which are not considered while preparing the cost sheet, such as Dividend, Income tax, Interest on loan, Donation paid, Capital expenditure, Writing off goodwill and Provisions. Prime Cost, Work Cost, Cost of Production and Cost of sales are the different elements of costs.

10.6 BOOKS RECOMMENDED:

Cost accounting & Costing methods – Wheldon

Cost Accounting –Jawahar Lal

10.7 TERMINAL EXERCISES:

1. What is cost? What are the different elements of costs?
2. Explain the significance of each of the following cost classifications:
 - a) Direct and indirect costs
 - b) Variable and fixed costs
 - c) Controllable and uncontrollable costs
3. What are the items of expenses which are excluded from cost sheet? Why?

4. The following information is supplied relating to an output for the year ended 31.12.2009.

Particulars	Rupees
Purchase of Raw materials	148000
Direct wages	132000
Rent & Rates	14000
Carriages inward	6000
Stock on 1-1-2009	
Raw materials	22000
Work in progress	18000
Finished goods	30000
Stock on 31.12.2009	
Raw materials	24000
Work in progress	35000
Finished goods	25000
Factory expenses	18000
Sales	420000

Selling and distribution costs amounted to 75 paise per unit sold. 25000 units were produced during the year. You are required to prepare cost sheet showing break –up of costs, total net profit and net profit per unit sold.

5. A factory produces a standard product. The following information is given to you from which you are required to prepare a cost sheet for January, 2009.

Direct materials consumed	Rs. 90,000
Direct Wages	Rs. 30,000
Other direct expenses	Rs. 10,000
Factory overheads – 80% of direct wages	
Office overheads – 10% of work cost	
Selling and distribution expenses Rs. 2 per unit sold.	

Units produced and sold during the month 10000. Find out the selling price per unit on the basis that Profit mark up is uniformly made to yield a profit of 20% of the selling price. There was no stock of work in progress at the beginning or at the end of the period.

6. A toy manufacturer earns an average net profit of Rs.3 per piece on a selling price of Rs.15 by producing and selling 60,000 pieces at 60 percent of the potential capacity. The composition of the cost of sales is :

Direct Materials	Rs. 4
Direct wages	Rs. 1
Work overhead	Rs. 6 (50 per cent fixed)
Sales Overhead	Rs. 1 (25 percent variable)

During the current year, he intends to produce the same number of pieces, but anticipates that-

- a) Fixed expenses will go up by 10 per cent.
- b) Direct labour will increase by 20 percent.
- c) Direct material cost will increase by 5 percent.
- d) Selling price will remain the same.

He obtains an order for a further 20 per cent of his capacity. What minimum price will you recommend for accepting an order to ensure the manufacturer an overall profit of Rs.183500?

7. The following particulars are extracted from the works and other relevant source in respect of a Ltd. Company?
- a) Estimated material cost of the job is Rs.25000 and the direct labour cost is likely to be Rs.5000
 - b) It will require machining by a German machine for 20 hours and a Japanese machine for 6 hours.

- c) The machine hour rates for the German and Japanese machines are Rs.100 and Rs.150 respectively.
- d) The direct wages in all other shops during the last year amounted to Rs.800000 as against Rs. 180000 of factory overhead.
- e) The factory cost of all other jobs amounted to Rs.375000 as against Rs.375000 of office expenses.

You are required to make a quotation with 20 per cent profit on selling price.



11

RECONCILIATION OF PROFIT AS PER COST AND FINANCIAL ACCOUNTS

STRUCTURE :

11.0 Objectives :

11.1 Introduction

11.2 Need For Reconciliation

11.0 OBJECTIVES :

Study of this unit will enable you to :

1. Ascertain the difference between Profit as shown by Financial Profit and Loss Account and Profit appearing in Costing Profit & Loss Account.
2. Identify and quantify the cost components, which contribute to the difference in profit figures.
4. Prepare a statement reconciling the two profit figures reported by financial and cost records.

11.1 INTRODUCTION

It is normally assumed that the profit of a business for a given period is given by the Profit & Loss account made out for that period.

Imagine your surprise, when Profit and Loss Account prepared by the financial accountant of X Ltd. shows a profit of Rs.4,56,000 for the year ended 31.03.2009. While the cost accountant has prepared a cost sheet for the same period and arrived at a profit of Rs.5,12,000. You feel that one of the figures reported should be wrong, otherwise how could there be a difference.

However, there is a logical explanation for the difference in the profit figures and both may be right.

This is because the fundamental assumptions made by the two accountants for preparing the profit and loss account vary. For example, Interest on loan will be debited in financial Profit & Loss Account but the cost accountant will ignore this item as he does not consider this interest expense as an item of cost. Naturally, in this case, the cost accountant will report a higher profit than the financial account.

In the following sections we shall see the types of differences and the items which give rise to these differences.

11.2 NEED FOR RECONCILIATION

The need for reconciliation arises due to the following reasons :

- a) To ensure that no income or expenditure item has been omitted and that there is no under or over recovery of overheads.

- b) To check the arithmetical accuracy, as well as for the determination of reason for disagreement between the two results.
- c) To know the reason for variation of profit or loss as internal control.
- d) To take administrative decisions such as depreciation, stock valuation and direct expenses.
- e) To test the reliability of cost accounts.

REASONS FOR DISAGREEMENT BETWEEN COST AND FINANCIAL RESULT:-

It is very essential to know the causes, which generally give rise to disagreement between Cost and Financial Accounts. These are briefly summarised below:-

Expenses that are not taken into account. The under mentioned expenses are usually not included in overheads or, for that matter in cost.

- (a) Expenses or income of purely financial nature like dividends received, rent received, cash discount allowed, etc.
- (b) Expenses or profits of capital nature like profit or loss on sale of investments, plant and equipment, etc.
- (c) Items not representing actual costs but dependent on arbitrary decisions of management e.g. an unreasonably high salary to the managing director, providing for depreciation at a rate exceeding the economic rate.
- (d) Appropriation of profits for dividends, payment of income tax and transfer to reserves.

I) Items recorded in financial books only and not in cost books:

- a) Interest received/ paid on Debentures,
- b) Interest received and paid on Investment and Bank loan or overdraft respectively.
- c) Interest charged/ paid to debtors /creditors
- d) Discount allowed/ received.
- e) Provision for discount on debtors/ creditors
- f) Bad Debts written off/ bad debts recovered.
- g) Discount on issue of shares and debentures.
- h) Income tax paid /refund
- i) Penalty and fines paid / received
- j) Rent received/ paid
- k) Loss by fire, natural calamities or theft /damage recovered.
- l) Loss/ profit on sale of fixed assets, investment
- m) Cost of share transfer /share transfer fees received.
- n) Donation given/received
- o) Deferred revenue expenses written off. Such as write off of :
 - i. Preliminary Expenses
 - ii. Discount on Shares/ Debentures

II) Items recorded in cost book only and not in financial books:-

- a) Notional rent charges of owned premises
- b) Salary of proprietor
- c) Interest on proprietors fund

III) Items recorded in both books with different amounts:-

In Cost book and Financial book some item of expenses and incomes which are treated differently such as -

a) Method of charging depreciation:

In Financial Books depreciation may have been provided, on Straight Line Method or Written down Value Method whereas in Costing Book depreciation may have been charged on the basis of Machine Hour Rate Method. Amounts of depreciation charge in both books are bound to be different.

b) Under and Over recovered expenses:

The expenses in costing books are recorded on the basis of pre-determined rates but in financial books they are recorded on actual basis hence the amount recorded in these two set of books differ.

c) Method of Valuing Stocks:-

It is well known that in Cost Book Stocks are only valued at cost. But in Financial Books stock are valued either at cost or market price, whichever is lower.

PROCEDURE FOR RECONCILIATION :-

When there is a difference between the profit/loss shown by cost accounts and financial accounts the procedure for reconciliation is similar to that of Bank Reconciliation Statement. For reconciliation following steps should be considered.

1. Prepare a cost sheet for a particular period and find out costing profit or loss if it is not given.
2. If financial profit or loss is not given then find out the same by preparing Trading and Profit and loss account for a period which corresponds to the cost sheet.
3. Ascertain items which are shown in financial account and not in cost account.
4. Ascertain items which are shown in cost account only.
5. Calculate difference between expenses recorded in financial books and the amount of expenses recorded in cost accounts.
6. Reconciliation Statement is to be prepared as on a particular date. Hence one can start with the figure of profit / loss as per cost account and arrive at the figure of profit/ loss as per financial accounts or vice –versa.

[Entries which are at variance with each other will appear in Reconciliation Statement and also entries appearing in only one set of book (non - common items)]

PROFORMA STATEMENT OF RECONCILIATION

1. Starting with financial profit Statement of Reconciliation

Between Financial Profit and Cost Profit For the Year ended

Particulars	Rs	Rs
Financial Profit (as per the financial books)		xxx
Add Expenses, losses and appropriation debited in financial books only	xxx	
Closing stock under valued in Financial Books		
Opening Stock over valued in Financial books	xxx	
Excess depreciation charged in Financial Books		
Expenses under recovered in Cost Books	xxx	
Income credited only in Cost Books	xxx	
Less		
Income credited only in Financial Books	xxx	
Closing stock over valued in Financial Books	xxx	xxx
Opening Stock under valued in Financial books		xxx
Short depreciation charged in Financial Books		
Expenses over recovered in Cost Books	xxx	

Costing Profit (as per Costing books)	xxx	
	xxx	
	xxx	
	xxx	xxx
		xxx

Statement of Reconciliation Between Financial Profit and Cost Profit For the Year ended.....

Particulars	Rs	Rs
Costing Profit (as per the Costing books)		xxx
Add Income credited only in Financial Books	xxx	
Closing stock over valued in Financial Books	xxx	
Opening Stock under valued in Financial Books	xxx	
Short depreciation charged in Financial Books	xxx	
Expenses over recovered in Cost Books	xxx	
Expenses debited only in Cost Books	xxx	xxx
Less		xxx
Expenses, losses and appropriation debited in financial books only	xxx	
Closing stock under valued in Financial Books	xxx	
Opening Stock over valued in Financial Books	xxx	
Excess depreciation charged in Financial Books	xxx	
Expenses under recovered in Cost Books	xxx	
Income credited only in Cost Books	xxx	xxx
Financial Profit (as per the financial books)		xxx

Illustration 1 : From the following particulars prepare a reconciliation statement:-

	Rs.
Net Profit as per financial records	154506
Net Profit as per costing records	206880
Works overheads under recovered in costing	3744
Administrative Overheads recovered in excess in costing	2040
Depreciation charged in financial accounts	13440
Depreciation recovered in Cost Accounts	15000
Interest received but not included in Cost Accounting	9600
Obsolescence loss charged in financial records	6840
Income tax provided in financial books	48360
Bank interest credited in financial books	900
Stores adjustment credited in financial books	570
Depreciation of stock charged in financial books	8100

Solution

RECONCILIATION STATEMENT	Rs.	Rs.
Net Profit as per costing records		206880
Add:		
1. Administrative Overheads over absorbed	2040	
2. Depreciation excess charged	1560	
3. Income not credited in costing -		
Interest received	15000	
Bank interest	900	
Stores adjustment	570	
	16470	20070
Total		226950
Less	3744	
1. Works overheads under recovered		
2. Expenses not charged in costing books	9600	
3. Income tax provided in Financial Book	48360	
4. Depreciation of Stock charged in Financial Book	8100	
	66060	69804
Net Profit as per financial books		157146

Illustration 2 : Following is the Trading and Profit and loss account of a factory producing a particular unit of a product of which the actual output is 100000 units.

Trading & Profit and Loss A/c for the year ended 31/12/09

	Rs		Rs.
To Material	200000	By Sales	400000
To Wages	100000		
To Works Exp.	60000		
To Office rent	18000		
To Selling & Dist. Exp.	12000		
To Net Profit	10000		
	400000		400000

The normal output of the factory is 1,50,000 units. Works expenses are fixed to the extent of Rs.36,000. Office expenses for all practical purposes are constant, Selling and distribution expenses are variable to the extent of Rs.6000/- Prepare a cost sheet and reconciliation statement.

Solution :

(a) COST SHEET

Actual output 1,00,000 units Normal output 1,50,000 units

	Per Unit (Rs.)	Total (Rs.)
Material	2.00	2,00,000

Wages	1.00	1,00,000
-------	------	----------

PRIME COST	3.00	3,00,000
------------	------	----------

Works expenses

Fixed (2/3 of 36000) = 24000

Variable	= 24000	0.48	48,000
----------	---------	------	--------

WORKS COST	3.48	348000
------------	------	--------

*Actual output/ Normal output = 2/3

Proportionate fixed cost are considered

Office Expenses (2/3 * 36000)	0.12	12,000
-------------------------------	------	--------

COST OF PRODUCTION	3.60	3,60,000
--------------------	------	----------

Selling and Distribution Expenses

Fixed (2/3) = 4000

Variable	= 6000	0.1	10,000
----------	--------	-----	--------

COST OF SALES	3.7	3,70,000
---------------	-----	----------

Profit	0.3	30,000
--------	-----	--------

Sales	4.00	4,00,000
-------	------	----------

b) Reconciliation Statement

Profit shown by Cost Accounts		30,000
Less : 1. Under recovery of Work Expenses	12000	
2. Under recovery of Office Expenses	6000	
3. Under recovery of Selling Expenses	2000	20000

Profits shown by Financial Accounts		10,000

Illustration 3 : The Trading & Profit & Loss account of "A" Ltd. is as follows:-

Trading & Profit & Loss Account

To Purchases	25120	By Sales (50000 units @ of Rs Rs.1.50 each)	75000
Less : Closing Stock	4050		
To Gross Profit	53870		-----
	-----		75000
To Net Profit	75000		
			43870
To Direct Wages	10500	By Gross Profit	260

To Works Expenses	12130	By Discount received	2340
To Selling Expenses	7100	By Profit on sale of land	
To Administrative Expenses	5340		
To Depreciation	1100		-----
To Net Profit	20300		56470

	56470		

The profit as per cost accounts was only Rs.19,770. Reconcile the financial and costing profits using the following information :

- Cost accounts valued closing stock at Rs. 4280
- The work expenses in the cost accounts were taken at 100% of direct wages.
- Selling & administration expenses were charged in the cost accounts at 10% of sales and 0.10 per unit respectively.
- Depreciation in the cost accounts was Rs.800

Solution :

RECONCILIATION STATEMENT	Rs.	Rs.
Profit as per Cost Accounts		19770
Add: 1. Over absorption of selling expenses	400	
2. Discount received	260	
3. Profit on sale of land	2340	3000
	-----	-----
		22770
Less 1. Difference in valuation of closing	200	

2. Under absorption of Administrative Exp.	340	
3. Under absorption of Works Exps.	1630	
4. Depreciation under changed	300	2470
Profit as per Financial Accounts	-----	-----
		20300

Illustration 4 : From the following Profit & loss account draw up a Memorandum Reconciliation account showing the Profit as per Cost Accounts:-

To Office Salaries	11282	By Gross Profit	54648
To Office Expenses	6514	By Dividend received	400
To Salary to Salesmen	4922	By Interest on Bank FD	150
To Sales Expenses	9304		
To Distribution Exp.	2990		
To Loss on Sale of Machinery	1950		
To Fines	200		
To Discount	100		
To Net Profit c/d	17936		
To Income Tax	55198		55198
To Transfer to Reserves	8000	By Net Profit b/d	17936
To Dividend	1000		
To Balance c/d	4800		
	4136		
	17936		17936

The cost accountant has ascertained a Profit of Rs.19636 as per his books.

Solution :**Memorandum Reconciliation Account :**

Dr

Cr.

	Rs		Rs.
To Expenses not debited to Cost accounts:		By Profit as per cost account	19636
Fines	200	By Income not credited in Cost accounts:	400
Discount	100	Dividend Received	150
Loss on sale of Care	1950	Interest on Bank FD	
Income Tax	8000		
Tr. to Reserves	1000		
Dividend	4800		
To Net Profit c/d	4136		
	20186		20186

Illustration : 5

M/s ESVEE Ltd. has furnished you the following information from the financial books for the year ended 31st December, 2009.

Particulars	Rs.
Materials consumed	260000
Wages	150000
Factory overheads	94750
Administration Overheads	106000
Selling and Distribution overheads	55000
Bad Debts	4000
Preliminary expenses	5000
Opening Stock (500 units at Rs.35/- each)	17500
Closing stock (250 units at Rs.50/- each)	12500
Sales (10250 units)	717500
Interest Received	250
Rent Received	10000

The cost sheet shows the following :

Cost of materials	Rs. 26 per unit.
Labour cost	Rs. 15 per unit
Factory overheads	60% of Labour cost
Administration overheads	20% of Factory cost
Selling expenses	Rs, 6 per unit
Opening Stock	Rs. 45 per unit

You are required to prepare :

1. Financial Profit & Loss Account
2. Costing Profit & Loss Account
3. Statement of Reconciliation

Solution

A) Financial Books

Profit and Loss Account for the year ended 31-12-2009

	Rs		Rs.
To Opening Stock (500 Units at Rs.35 each)	17,500	By Sales (10250 units)	7,17,500
To Materials consumed (10000 units)	2,60,000	By Closing stock (250 units	
To Wages	1,50,000	at Rs.50 each)	12,500
To Gross Profit c/d	3,02,500		
	-----		-----
	7,30,000		7,30,000
To Factory overheads	94,750	By Gross Profit b/d	3,02,500
To Administration c/d	1,06,000	By Interest received	250
To Selling Expenses	55,000	By Rent Provided	10,000
To Bad Debts	4,000		

To Preliminary Expenses	5,000		
To Net Profit	48,000		
	-----		-----
	3,12,750		3,12,750

B) COST SHEET FOR THE YEAR ENDED 31.12.2009

Prod. 10000 units

Particulars	Total Cost Rs.	Cost per Unit Rs.
Material Consumed	260000	26
Labour	150000	15
	-----	-----
PRIME COST	410000	41
Factory Overheads (60% of Labour cost)	90000	9
	-----	-----
WORKS COST	500000	50
Administration overheads (20% of work cost)	100000	10
COST OF PRODUCTION	600000	60.
Add : Opening Stock of finished goods (500 units at (Rs.45/- each)	22500	

	622500	
Less : Closing stock of finished goods (250 units)	15000	
	-----	-----
Selling Expenses	607500	
	61500	6

	-----	-----
COST OF SALES	669000	66
PROFIT	48500	4
	-----	-----
SALES	717500	70

C) STATEMENT OF RECONCILIATION AS ON 31.12.2002

Starting Point (Cost Accountant)	Rs.	Rs.
Profit as per Cost Accounts		48500
Add: 1. Over recovery of overheads :		
Selling expenses	6500	
2. Over valuation of stock :		
Opening stock	5000	
3. Purely financial income:		
Interest	250	
Rent	10000	31750
	-----	-----
		70250
Less : Under recovery of overheads-		
4. Factory overheads	4750	
5. Administrative overheads	6000	
6. Over valuation of stock :	2500	
Closing Stock		
7. Purely financial expenses:	4000	
Bad Debts		
Preliminary expenses	5000	22250
	-----	-----

Project as be Financial Accounts		48000
----------------------------------	--	-------

Books Recommended

1. Principles & Practice of Cost Accounting – N.K. Prasad
2. Cost Accounting - Jawaharlal

EXERCISES:

1. What is the need for reconciliation of cost and financial accounts?
2. Discuss the main sources of difference between Profit shown by cost accounts and that as per financial accounts.
3. The following transaction have been extracted from the financial books of a company.

	Rs.	Units
Sales	250000.00	20000.00
Materials	100000.00	
Wages	50000.00	
Factory overheads	45000.00	
Office & Administrative overheads	26000.00	
Selling & Distribution overheads	18000.00	

Closing stock:

Finished goods	15000.00	
Work in progress	1230.00	
Materials	3000.00	
Wages	2000.00	
Factory overheads	2000.00	
	7000.00	
Goodwill written off	20000.00	
Interest on capital	2000.00	

In costing books factory overheads were charged at 100% of wages, administration over heads were charged at 10% of factory cost and selling and distribution overheads at the rate of Re.1 per unit sold. Prepare a statement reconciling the Profit as per cost and financial accounts.

4. The financial Profit and loss Account of a manufacturing company for the year ended 31st March, 2009 is as follows:-

	Rs		Rs.
To Materials consumed	50000.00	By Sales	124000.00
To Carriage inwards	1000.00		
To Direct wages	34000.00		
To Works Expenses	12000.00		
To Administration Expenses.	4500.00		
To Selling an Distribution Expenses	6500.00		
To Debenture Interest	1000.00		
To Net Profit d	15000.00		
	124000.00		124000.00

The net profit shown by the cost accounts for the year is Rs.16,270 Upon a detailed comparison of the two sets of accounts it is found that (a) The amounts charged in the cost account in respect of overheads charges are as follows:- Works overhead charges Rs.11,500; Office overhead charges Rs.4590, Selling and Distribution Expenses Rs.6,640 (b) No charge has been made in the cost account in respect of debenture interest. You are requested to reconcile the profits shown by the two sets of accounts.

5. During the year a company's profit have been estimated from the costing system to be Rs.23,063 whereas the financial accounts prepared by the auditors disclose a profit of Rs.16,624. Given the following information you are required to prepare a Reconciliation statement showing clearly the reason for the difference.

Profit and Loss Account for the year ended March 3, 2009

	Rs.	Rs.		Rs.
Opening			Sales	3,46,500
Stock	2,47,179			
Purchases	82,154			

	3,29,333			
Closing stock	75,121	2,54,212		

Direct wages		23,133		
Factory overheads		20,826		
Gross Profit		48,329		
		-----		-----
		3,46,500		3,46,500
Administration expenses		9,845	Gross profit	
			b/d	48,329
Selling expenses		22,176	Sundry Income	316
Net Profit		16,624		
		-----		-----
		48,645		48,645

The costing record shows:

- a. a stock ledger closing balance of Rs.78,197
- b. a direct wages absorption account of Rs.24,867
- c. a factory overhead absorption account of Rs.19,714
- d. administration expenses calculated at 3% of the selling price
- e. selling expenses are five percent on selling price
- f. no mention of sundry income.

Question 6 :

A company's Trading and Profit and Loss Account was as follows:-

	Rs.	Rs.		Rs.
Opening			Sales	175000.00
Stock	100000.00			
Purchases	80000.00			

	180000.00			
Less:				
	80000.00			
Closing stock	-----			
		100000.00		
To Direct wages		20000.00		
To Factory Wages		15000.00		
To Gross Profit C/f.		40000.00		

Total Rs.		----- 175000.00	Total Rs.	----- 175000.00
To Administration expenses		----- 10000.00	By Gross profit	----- 40000.00
To Selling expenses		15000.00		
To Net Profit		15000.00		
		----- 40000.00		----- 40000.00

Costing records show the following :-

- a. Stock Ledger closing balance Rs.89,000
- b. Direct labour Rs.23,000
- c. Factory overheads Rs.13,000
- d. Administrative overheads and selling expenses each are calculated at 8 per cent of the selling price.

Prepare costing profit and loss account and the statement of reconciliation between the profit or loss as per the two accounts.

Question 7:

From the following information you are required to prepare a statement reconciling the result of Cost Book with Financial Books

	Rs.
Net profit as per Financial Books	51,052
Works overhead under recovered in Cost Book	1,001

Depreciation charged in Financial Book	13,000
Depreciation charged in Cost Book	14,326
Obsolescence loss charged in Financial Books only	2,021
Income tax provided in Financial Books only	2,626
Interest received but not recorded in Cost Book	3,031
Bank interest debited in Financial Book only	292

Question 8 ;

The following is the Financial Profit and Loss Account of a company for the year ending 31st March, 2009.

Profit and Loss Account

	Rs		Rs.
To Purchases	2,53,000	By Sales (50000 (units at Rs. 16 each)	8,00,000
“ Wages	1,03,000	By Closing stock	43,000
“ Works Expenses	1,16,000	By Interest on Investments	3,000
“ Administration Expenses	55,000	By Profit on Sale of building	24,000
“ Selling Expenses	68,000		-----
“ Depreciation	12,000		8,70,000
“ Net Profit	2,63,000		

	8,70,000		

The cost accounts disclosed the following information :-

1. Value of closing stock was Rs.45,000/-
2. Works expenses in cost accounts have been taken at 100% of wages
3. Selling Expenses in cost accounts have been charged at 10% on sales.
4. Administration Expenses in cost accounts have been taken at Rs.1 per unit sold.
5. Depreciation shown in cost accounts was Rs.10,000

Prepare a reconciliation statement to reconcile the profit shown as per cost accounts with the profit shown as per financial accounts.



12

MATERIAL, LABOUR AND OVERHEADS

STRUCTURE :

- 12.0 Objective
- 12.1 Introduction to Material
- 12.2 Storage of Materials
- 12.3 Issue of Materials
- 12.4 Inventory Control
- 12.5 Material Losses
- 12.6 Storage Records
- 12.7 Introduction to Labour Control & Documents
- 12.8 Time Keeping
- 12.9 Payment of wages
- 12.10 Idle time
- 12.11 Introduction to Overtime
- 12.12 Overheads and classification
- 12.13 Collection and codification of overheads
- 12.14 Allocation of overheads
- 12.15 Books Recommended
- 12.16 Self Test

12.0 OBJECTIVES

This unit will help you to

- Identify the characteristics of Material Labour and Overheads.
- Prepare and maintain documents needed for control of these costs.
- define and distinguish between direct and indirect materials, purchase, storage and issue of materials.
- Define material control, procedure and documents
- Explain direct and indirect labour, time keeping
- Discuss methods of payments, idle time, overtime
- Define and classify overheads
- Discuss methods of allocation and apportionment of overheads.

12.1 INTRODUCTION

Materials and labour are the two major elements of costs. Hence, the ascertainment and control of these costs are important aspects. Proper accounting and control over material purchase, consumption and inventories are important aspects of effective management. Labour is also an essential factor of production. Therefore, it is necessary to use different methods of time keeping, time booking, wage payments and pay roll accounting and treatment of idle time and overtime in cost accounts. Factory overheads are opening costs of a business enterprise which cannot be traced directly to a particular unit of output. It is the aggregate of indirect materials. Labour and expenses.

12.2 STORAGE MATERIALS

Materials refer to raw materials used for production, sub-assemblies and fabricated parts. The term materials and stores are used in the same sense. However, stores is a wider term and comprises many other items besides raw materials. It includes tools, equipment's maintenance and repairs items, factory supplies, components, jigs, fixtures etc.

DIRECT AND INDIRECT MATERIALS

Materials can be classified as direct and indirect materials. The materials which can be easily identified and attributed to the individual units are known as direct materials.

For example, leather used in manufacture of shoes. These materials form part of the finished goods. All costs, which are incurred to obtain direct materials are also known as direct materials for example carriage inward, octroi etc.

Indirect materials on the other hand, do not form part of the finished product and cannot be conveniently and accurately allocated to a particular unit of product. For example, consumable stores, cotton waste, lubricating oil etc. Cost associated with indirect materials are also included in the cost of indirect materials. The grouping of materials into direct and indirect sometimes, become a matter of convenience.

PURCHASE OF MATERIALS

There is a purchase department which carries out the function of purchases of materials. The purchase manager is responsible for ensuring the items ordered are of the standard quality, lower cost and received in time. The purchase procedure vary with different business firms. The purchase procedure is given below:

a) Purchase Requisition:

Purchase requisition is the formal request made by the storekeeper to the purchase department for giving order of raw materials or stores. It serves the dual purpose of authorizing the purchase department to make purchases and provides a record of the description and quantity of materials required. It also fixes the responsibility of the department or personnel making purchase requisition.

b) Purchase order:-

After receiving the duly approved requisition, the purchase department has to place an order with a supplier. It is an offer to buy certain materials at stated price and terms. For routine purchases, the order is placed through established supplies. In other cases, the purchase department may ask for bids or send out request for quotation before placing an order. The purchase order is a formal contract for the supply of materials. Copies of the purchase order are sent to the departments concerned.

c) Receiving and Inspection of materials:

The stores department is responsible for taking delivery of packages and to get a physical verification of the contents. When the materials are received, the stores official gets the packages, open them and make a detailed verification of the contents. After the contents of the packages are checked, the details are entered into a Goods Received Note. Copies of the G.R.Note are issued to the supplier, purchase and accounts department, where the factory has to test the materials received for quality and specifications. It has to ensure that the quality of materials is as per purchase order.

d) Approval of Invoices and Payment

Invoice received by the purchase department is forwarded to the Accounts department for payment with their recommendation. Accounts department has to check the authenticity, arithmetical accuracy and G. R. Note in order to make sure that the goods are as per purchase order.

When it is found that everything is in order, it is passed for payment by the Accountant. Then the cashier will draw the cheque as per terms and conditions of the purchase order and invoice and finally payment is made to the supplier.

12.3 STORAGE OF MATERIALS

After purchase, receipt and inspection of materials, the next important step is storage of materials. It is known as storekeeping. It is physical storage of materials. The storekeeper is appointed to look after this work in the stores department. The storekeeper should have the technical knowledge and experience in stores routine and storekeeping. He has to ensure regular supply event overstocking and under stocking and minimize the cost of materials. The storekeeper has to perform the following functions:

- i) Receipts of materials.
- ii) Issue purchase requisitions.
- iii) Maintain proper record of receipt, issue and balance stock of materials.
- iv) Placing and arranging materials at proper place.
- v) Issue of materials against proper authorization.
- vi) Minimizing storage handling and maintaining costs.
- vii) Ensure that the stock neither exceed maximum level or go below the minimum level.

12.4 ISSUE OF MATERIALS

All materials in the stores are meant for issue to various departments. The procedure for the issue is normally laid down by the management. The storekeeper issues materials to various department against material requisition note, the specimen of which is given below:-

Specimen of Materials Requisition

MATERIAL REQUISITION							
Department				Serial No.....			
Job No.				Date			
Code No.	Description	Quantity	Weight	Bin Card No.	Stores Ledger Folio	Rate	Amount
							Rs.
Authorised by				Received by.....			
Storekeeper's Signature				Checked by			

On receipt of material requisition, the storekeeper issues the necessary materials after obtaining the signature of the person receiving the materials. Materials requisitioned from the storekeeper and not needed or found to be defective are returned to the storeroom and a returned materials report is prepared by the concerned person upon receipt of the materials. Sometimes, it is necessary to return any rejected, excess or damaged materials to the supplier after making correct entries in the stores ledger.

Materials are issued from stores on properly prepared and approved materials requisition. It is a written order to the storekeeper to deliver materials to the place and the department. The materials requisition note includes date, requisition number, department charged, name of the stores, ledger account to be credited, description of materials, quantity, unit price, total value, delivery point and the signature of the person requisitioning the material and signature of the departments executive approving the requisition or comparatively fixed list of materials generally use a special form of material requisition which is called as 'bill of materials'. Materials requisitioned from the stores and not required or found to be defective are returned to the stores, where a returned material report is prepared by the concerned person. The amount and value of materials returned to the stores are deducted from total value of materials issued. Similarly, the amount shown by materials returned is deducted from the total amount charged to each department. It may be necessary

to return any rejected, excess or damage materials to the supplier. This also requires some correction entries in the stores ledger.

PRICING OF MATERIALS ISSUED:

When materials are purchased they are recorded at price at which they are purchased after asking necessary adjustments for discounts, transportation charges, cost of containers etc. But, when it comes to the issue of materials, the problem arises with regard to the price at which each issue should be recorded because the different quantities of materials are purchased at different prices. For this purpose, a number of methods of pricing the issue of materials are used which are as follows:-

a) FIFO Method :- The first in first out method is used when the materials received but are to be issued first. The price of the earliest lot/ quantity is taken first and then for the next lot. The value of closing stock confirms more or less, to the current market price. This method is suitable for falling price.

b) LIFO Method : - The last in first out method, is used when materials received last are issued first. The storekeeper will charge the cost price of the latest lot purchased. This is suitable in the times of rising prices.

d) Average Rate Method:- Under this method the materials are issued at a price which is an average price of materials purchased. The simple average is an average of prices without having regard to the quantities involved. Weighted average price is used in order to avoid fluctuation in price and reduce the number of calculations. Weighted average of the total cost and total quantities of materials purchased. is calculated each time a purchase is made.

12.5 INVENTORY CONTROL

In manufacturing organizations inventories include raw materials, work in progress and finished goods. In trading concerns, inventories consist of merchandise held for sale and packing and other supplies. Inventory control is the technique of maintaining inventory items at desired levels. It is a system which ensures the required quantity of inventories of the required quality, at the required time and with the minimum price. The function of inventory turnover is to obtain maximum inventory turnover with the sufficient stock to meet all requirements. Inventory control is of great importance in almost all types of business organizations. If inventories are kept at high levels due to over production or slow demand, capital is tied up which cannot be used for other productive purposes. Alternatively, production is likely to suffer due to inadequate inventory on hand.

12.6 MATERIAL LOSSES

Some material losses are bound to occur during manufacturing operations due to the nature of materials. These losses may be in the form of scrap, spoilage, defectives or wastage. Scrap is residue for manufacturing operations that has measurable but relatively minor recovery value. It is saleable material resulting from the primary manufacturing operations. Scrap should be accounted for in some manner not only from the point of view of efficiency but because scrap is often a tempting source of theft. If the value of scrap is very insignificant, it is not considered in the cost accounts, on the other hand, if the value of scrap is significant it deducted from the material cost.

Spoilage can be defined as the materials which in the process of manufacture are badly damaged or have developed some imperfection which cannot be economically correct and thus the goods should be sold as seconds. The loss due to spoilage may be charged to a specific product or job on which the spoilage occurred, if it is clearly traceable to the work done on that order. The normal spoilage loss may be charged to factory overhead and thus spread over the cost of all jobs or products. The cost of abnormal spoilage is transferred to the costing profit and loss account. Abnormal loss is unexpected and should have been avoided by the management.

Defectives are such semi-finished or finished products which in the process of manufacture have developed some imperfection, but which unlike spoiled materials can be made into imperfect finished articles with additional labour and materials. The accounting treatment for defectives is similar to that relating to spoiled goods.

Wastage generally, refers to that portion of raw materials which are lost in storing, handling and in manufacturing process. It does not possess any recovery of realizable value. Waste can be classified as normal and abnormal waste. Normal waste is expected and uncontrollable. It is valued like good output. Its cost is transferred to the costing profit and loss account.

12.7 STORES RECORDS

The important function of the storekeeper is to maintain records of receipts, issues and balances of various items of materials. Bin Card and store ledger are two important stores records that are kept for making a record of the various items at stores,

I) **BIN CARD :**

A bin is a place where the materials are stored. It may be a shelf, an aluvarch, open space etc. depending upon the nature of the commodity. A bin card provides a quantitative record of the receipts, issues and balance of materials. The bin cards are usually attached to or placed near to the bin so that receipts and issues may be entered therein as soon as they take place. Separate bin cards are prepared for each item of stores. Thus, bin card provides a continuous record of the stock in each bin and assist the storekeeper to control the stock. For each materials, the maximum stock to be held are noted on the card. An ordering level is also indicated therein so that fresh supplies may be ordered before the minimum is reached. A specimen of the bin card is given below:

BIN CARD

Name	Maximum level
Description	Minimum level
Bin No.	Ordering level ,.....
Location Code	Re-ordering quantity
Stores Ledger Folio	Unit

Date	Receipts	Issues	Balance	Audit		
	G.R. No.	Qty.	Date	Req. No.	Qty	Qty
Date	Initials					

ii) Stores Ledger

Stores ledger is a continuous record of stores received and issued and discloses the balance in hand at any time both in quantity and value. It includes an account of each class of materials and facilitates ascertainment of all details relating to the material in minimum time. It provides management with a perpetual inventory. A specimen of the stores ledger is given below:

STORES LEDGER

Name Maximum level

Description Minimum level

Bin No. Ordering level ,.....

Re-ordering quantity

Unit

Date	RECEIPTS		ISSUES			BALANCE		Remarks
G.R. No.	Qty.	Rate	Req. No.	Qty	Amt.	Qty.	Rate Amt.	

12.8 INTRODUCTION TO LABOUR CONTROL AND DOCUMENTS:

Labour is an essential factor of production. It is a human resource and participates in the process of production. Wages paid to labour is a significant item of cost. The labour cost should be distinguished between direct and indirect labour. Direct labour cost can be identified with and charged directly to the product or a job whereas, indirect labour cost is not so identifiable and, therefore, it is included in overheads which may be allocated to different products or department on some suitable basis. Cost accounting for labour has three primary objectives :-

- Determining labour costs in the cost of product or service
- Reporting labour costs for planning and control and
- Reporting labour costs for decision-making.

LABOUR CONTROL :

Labour cost is an important part of total cost of production. Therefore, there is a need for effective control over labour and labour-related costs. Various departments contribute to the efficient utilisation of labour and adequate control over costs. Personnel department has to provide an efficient labour force. The engineering department maintains control over working conditions and production methods for each job and department or process by preparing plans and specifications. Time-keeping department maintains an accurate record of the time spent by each employee. Preparation of the pay roll from the clock cards, job or time tickers or time sheets is done by the pay roll department. The Cost Accounting department is responsible for the accumulation and classification of all data of which labour costs are one of the most important items.

12.9 TIME KEEPING

As the labour costs constitute a significant portion of the total cost of a product, proper recording of time and collection of cost data are pre-requisites of any system of labour cost control. Time keeping is a system of recording the time of arrival and departure of workers. It provides a record of total time spent by the workers in the factory. In addition to recording of time of arrival and departure of workers it is also necessary to record time spent by workers on each job, order or process which is known as time booking. The system of time booking may be maintained either manually or mechanically. Time recording clocks may be used to enter the time of starting and finishing each job separately on the job cards. Time booking can be made with daily time sheets, weekly time sheets or job cards. The specimen of time card is as follows:-

TIME CARD

Name of the worker

Department

Token No.

Week ending,.....

Day	Regular	Overtime	Total time			
	In	Out	In	Out	Normal time	Overtime

Total Wages

Time keeper

Foreman

Job card is issued to each worker for job at the beginning of each day or week depending upon the number of job he has to work on. It gives complete record of the time spent by each worker on different jobs during a particular period. The specimen job card is given below :

JOB CARD

Name of the worker

Department

Token No.

Week ending

Day	Job No.	Description	Time	Hours	Rate	Amount Rs
				On	Off	

Checked – verified

Total Hours

Worker

Normal

Foreman

Overtime.....

12.10 PAYMENT OF WAGES

Every organization has to maintain a system of payroll accounting for the purpose of computing wages payable to workers. The work involves the calculation of wages, deductions, net wages payable to employees etc. The gross wages payable to each worker are computed with the help of time card, job card or piece work card. Certain statutory deductions are also made from the gross wages. The wage sheet is prepared showing the gross wages, deductions and net wages payable to workers. It is prepared at periodical intervals according to the time of wage payment. Normally, wage sheet are prepared separately for department. But this wage sheet should be checked properly to minimize the possibilities of wrong payments either deliberately or inadvertently. Detection and prevention of both errors and frauds, including the checking for dummy workers in wage sheet, need attention to ensure accuracy in wage payments.

12.11 IDLE TIME

Idle time is a period or duration for which workers are paid but they have not worked for production in the factory. When workers are paid on time basis, some difference between the time for which they actually spend upon production is bound to arise. Idle time does not include holidays, leave etc. It may be normal in nature or abnormal. Normal idle time is that idle time which is unavoidable; it is of normal nature and is inherent in a production or work environment. Normal idle time is caused due to the movement of workers. Abnormal idle time is that time which is not caused by the usual routine of production. The time wasted by the workers may represent abnormal idle time. The loss incurred by abnormal conditions cannot be considered as part of the cost of the product and should be transferred to the Costing Profit and Loss A/c. For example time lost due to break down of machinery, lack of materials, strikes, lock out etc.

12.12 OVERTIME

Overtime is the time put in by the workers and work done by them beyond normal hours of work. It is an extra time over and above the schedule hours of work.

Factories Act, 1948, provides that every worker is to be paid overtime at a higher rate, normally at double the normal wage rate, if he is called overtime to work more than 8 hours a day. The excess over normal wage rate is called overtime premium. Overtime may be considered useful when there is an urgency, company needs extra production or when the workers are less than the required number.

In cost accounting, overtime premium should be separated from regular earning and charged as follows;-

Nature of Overtime Charged to

a. Customers request to complete the job early	Job directly
b. General pressure of work	General Overhead
c. Delayed Schedule	Department
d. Unavoidable Reasons	Costing P & L A/c
e. Seasonal rush and peak load	Prime cost

Overtime payments made to workers engaged in direct labour are treated as direct cost and overtime payments made to indirect labour are treated as part of factory overheads.

12.13 INTRODUCTION TO OVERHEADS

All indirect costs are collectively termed as overheads. It is total of all indirect material, indirect labour and indirect expenses. They constitute an important component of total cost of a product, a job or a process. Overhead costs have to be incurred for production although they are not directly measurable, observed related to specific activity or unit of production. For example, depreciation of factory building and machinery, rent, taxes, insurance, maintenance etc.

CLASSIFICATION OF OVERHEADS

The process of grouping the overheads according to their common characteristics is known as classification of overheads. It provides the manager with information that enable them to manage the business effectively. The overheads can be classified according to:

- a) Element : Indirect materials, Labour Expenses;
 - b) Functions : Production, Administration, Selling and Distribution overheads;
 - c) Behaviour : Fixed ,Variable, and Semi-variable overheads
-
- i) Fixed overheads remain fixed and are unaffected by the changes in the level of production. For example, rent, rates, salaries, legal expenses etc.
 - ii) Variable overheads vary in direct proportion to changes in the volume of production, such as indirect materials, fuel, power, stationery, salesmen's commission etc.
 - iii) Semi- variable overheads are the expenses which are partly fixed and partly variable.

They remain fixed up to a volume of production and vary when the production is made beyond the particular volume. For example, telephone charges depreciation of machinery, repairs and maintenance, cost of supervision etc.

12.14 COLLECTION AND CODIFICATION OF OVERHEADS

Overheads are collected and codified under proper heads. Similar overhead cost items should be grouped together. The grouping of overheads is done through a technique called 'Codification'. It is a method of identification and describing various overhead expenses in numbers or letter or in combination of both, so that cost data can be easily collected. Codification of the entire items is done through a proper coding system. Overheads are collected through the sources of stores requisitions, financial accounts, wage sheets, registers and reports.

12.15 ALLOCATION OF OVERHEADS

Allocation of overheads is the 'allotment' of all items of cost of cost centres or cost to units. It refers to charging overheads to the cost centres. It means that overheads have been incurred because of the existence of that cost centre. When the company provides more than one product, factory overheads are allocated to various production departments or cost centres. Proper overheads allocation is of great importance as wrong allocation can distort income determination, asset valuation and performance evaluation. The overhead allocation process is as follows:-

- i) Accumulating overheads on the basis of departments or products.
- ii) Identifying the cost objectives of the allocated costs
- iii) Selecting the method of relating costs so accumulated to the cost objectives.

12.16. APPORTIONMENT OF OVERHEADS:

Apportionment of Overheads refers to the distribution of common items of cost to two or more cost centres on some appropriate basis. When overheads are incurred for the factory as a whole and benefit two or more cost centres, it is necessary to apportion them to different departments that receive benefits from such overhead costs. For example, factory rent benefits all the departments, hence it should be apportioned to all the departments on the basis of the floor area occupied by each department in factory. Thus, common factory overheads have to be apportioned to various production and service departments in the factory on some appropriate basis.

A production department is one that engages in the actual manufacture of product. On the other hand, service department is one that renders a service which contributes indirectly in the manufacture of the product. It renders services to the production as well as other service departments.

The common factory overheads are to be apportioned to various production and service departments on some equitable basis which are called principles of apportionment. Accordingly, overheads are distributed over various departments on the basis of actual benefit received or potential benefits to be received by the respective departments. Overheads can also be apportioned on the specific criteria or given ratio which may be determined after careful survey for different service functions. Apportionment of overheads can also be made on the basis of ability to pay (Revenue) of the departments.

The usual basis of apportionment of common items of factory overheads can be stated as follows:-

Items of Overheads	Basis of Apportionment
a. Rents rates, taxes and Insurance	- Floor space/ area occupied depreciation & repairs of buildings
b. Canteen, welfare expenses	- No. of employees Time keeping & Personnel office

- | | | | |
|----|-------------------------------------|---|---|
| c. | Depreciation, repairs & maintenance | - | Capital cost of machinery
& Insurance of machinery |
| d. | Power, steam, lighting | - | Technical estimates
(HP hours) |
| e. | Compensation | - | Direct wages |
| f. | Advertising, Packing, Warehousing | - | Sales value/ volume |

12.17 SELF TEST.

1. What do you mean by materials control?
2. Distinguish between direct and indirect material cost?
3. How will you ensure effective inventory control?
4. What is the importance of control of labour cost?
5. Explain various methods of recording time of the workers?
6. What are the reasons for booking workers on idle time in a factory?
7. What are the overheads ? How are they classified?
8. Distinguish between fixed, semi-fixed and variable overheads costs giving examples of each overhead.
9. What are the causes of under/ over absorption of factory overheads? How will you deal with them in cost accounts?
10. Write short notes on

a) Bin Cards	c) Over time
b) Stores ledger	d) Idle time
	e) Basis of overhead apportionment.
6. Given below are the summarized balance sheet of XYZ Ltd. As on 31st December, 1974 and 31st December, 1975.

Balance Sheets

	1974	1975		1974	1975
	Rs.	Rs.		Rs.	Rs.
Issued Share Capital	120000	150000	Freehold Properties		
Share Premium a/c	--	10000	At cost	66000	48000
Capital Reserve (Profit on sale of freehold property)			Plant & Machinery		
Profit & Loss A/c	--	34000	At cost, less Depreciation		
Trade Creditors	43000	42400	Preliminary Expenses	41600	120600
Proposed Dividend	54400	65200	Stock-in-trade	2400	1200
	12000	17000	Debtors	60700	65700
	-----	-----	Balance at Bank	40200	49500
	229400	318600		18500	33600
				-----	-----
				229400	318600

The Following is a summary of the Profit and Loss A/c for the year 1975.

Profit and Loss Account

	Rs.		Rs.
Proposed Dividends	17000	Net profit for the year	16400
Balance c/f		Balance from 1974	
	42400		43000
	-----		-----
	59400		59400

No plant and machinery was sold during 1975. The net profit Rs.16400 is the amount after charging Rs.15000 for depreciation of Plant and Machinery and after writing off preliminary expenses Rs.1200.

Prepare a statement showing ;

- i) The net increase in Working Capital during the year 1975 and
- ii The Sources S and Applications of working Capital during that year

(Adapted – Chartered Institute of Secretaries Eng.)

Ans. Increase in Working Capital Rs.18600, Funds from Operations Rs.32600 Total of Sources & Applications Rs. 124600 and Rs. 106000 respectively)

7. The Balance Sheets of XYZ Ltd. As on 31st March, 1974 and 31st March, 1975 are given below

Balance Sheet

	1974	1975		1974	1975
	Rs.	Rs.		Rs.	Rs.
Issued Share Capital (Shares of Re.1 each)	300000	350000	Freehold Properties	20000	16000
Capital Reserves			At cost		
Share Premium		10000	Plant & Machinery		
Profit on sale		2900	At cost, less	286000	308000
Of freeholds			Depreciation		
Profit & Loss A/c	32000	10000	Preliminary Expenses		
5% Debentures		5000	Current Assets	1600	800
Current Liabilities	64000	68000		138400	166100
	-----	-----		-----	-----
	446000	490900		44600	490900

The whole Share capital of the company was issued for cash
 Depreciation on Plant and machinery written. Off during the year to 31st
 March 1975 amounted to Rs.28000 During the same year company paid
 a Dividend of Rs.15000

Prepare a statement showing:-

- the net increase in the Working Capital during the year ended 31st March, 1975 and
- the sources and applications of funds during the year

(Adapted – Chartered Institute of Secretaries Eng.)

(Ans Increase in Working Capital Rs.23700; Funds from Operations Rs.71800, Total of Sources & Applications rs.138700 and Rs.115000 respectively)

- The comparative Balance Sheets of ABC Industries Ltd. For 1974 and 1975 are given below:-

Balance Sheets

	1974 Rs.	1975 Rs.		1974 Rs.	1975 Rs.
Paid up Capital	300000	340000	Bank	45600	48800
Reserves & Surplus			Debtors	9800	16000
Mortgage Loan	120600	143600	Stock	42000	65200
Sundry Creditors	20000	19000	Marketable securities	32200	10000
Liabilities for Expenses	42400	45200	Trade Investments		
Provision for Depreciation	2600	1000	Plant & Machinery	42300	35100
Provision for Taxation	25600	34000	Land and Buildings		
			Intangible Assets	183400	268000
	11000	12400		150000	140000
				16900	12100
	-----	-----		-----	-----
	522500	595200		522200	595200

The following transactions took place during 1975

Land which had cost Rs.10000 was sold for Rs.25000. Some of the marketable securities were sold at a loss of Rs.3000. difference between the figures to trade investments represents amount written off in respect of worthless investments. A dividend of Rs. 25000 was paid. An old machinery which had cost Rs.10000 (accumulated depreciation thereon Rs.8000) was sold for Rs.6000

Prepare a Funds Flow Statement.

(Ans. Increase in W.C Rs. 9200; Funds from operations Rs.58800, Total of Sources & Applications Rs.129800 and Rs.120600 respectively)

12. Below are given the Balance Sheets as on December, 31, 1969 and December, 31 1970 for Ashoka Co. Sales for the year 1969 were Rs.2,10,000. Net income after taxes was Rs.7000. In arriving at the Net Profit, items deducted from sales included among others. Cost of goods sold Rs.165000; depreciation Rs.5000 wages and salaries Rs.20000. There was a gain of Rs.1000 on the sale of a truck. The truck had cost Rs.600, depreciation of Rs.4000 had been accumulated for it and it was sold for Rs.3000. This was the only asset written off during the year. The company declared and paid Rs.6000 in dividends during the year.

Balance Sheets

	Dec 31, 1969		Dec 31, 1970	
	Rs.	Rs.	Rs.	Rs.
Assets				
Cash		5000		6000
Accounts Receivable		14000		14000
Inventory		22000		8000
Prepaid Insurance		200		250
Prepaid Rent		150		100
Prepaid Property Taxes		300		400
Land		4000		8000
Building & Equipment	30000		48000	
Less: Accumulated depreciation	10000	20000		37000
			11000	
Total Assets		65650		73750
Liabilities				
Account Payable		20000		18000
Accrued Expenses		2000		4000
Income tax Payable		1000		1100
Capital Stock		30000		37000
Retained Earnings		12650		13650

		-----		-----
Total liabilities		65650		73750

Prepare a fund flow statement and described the most significant development revealed by his statement.



METHODS OF COSTING

STRUCTURE :

- 13.0 Objectives
- 13.1 Introduction
- 13.2 Unit or Batch Costing
- 13.3 Job costing
- 13.4 Contract Costing
- 13.5 Process costing
- 13.6 Operating costing
- 13.7 Books Recommended
- 13.8 Exercises

13.0 OBJECTIVES

The objectives of this study are :-

- (a) Define unit or batch costing and determine the cost of production of each batch or unit.
- (b) Define job costing and prepare a job cost sheet.
- (c) Define process costing and prepare process cost accounts.
- (d) Define operating costing and determine a statement of operating cost of services

31.1 INTRODUCTION

There are various products manufactured in business organizations. They use different costing systems to meet their needs. Basically, there are two methods or systems of assigning costs of manufacture to individual products :- (a) Job order costing and (b) Process costing. These are the important methods of Product costing. These methods are used for determining the unit cost of production and keeping detailed records supporting the work in Process inventory. There are variety of methods of costing which are merely variations or adaptations of the two basic methods of costing Important methods can be enumerated as follows :-

- (i) Unit or Batch costing
- (ii) Job costing
- (iii) Contract costing
- (iv) Process costing
- (v) Operating costing

13.2 UNIT OR BATCH COSTING

Unit costing is a method of costing under which the cost of a unit is ascertained by dividing the total cost by the number of units produced. It is used in the industries which are engaged in manufacturing exclusively one homogeneous product or a few grades of the same product. It is also called as single or output costing. Unit is also called as single or output costing. Unit cost is the average cost of production. The examples of industries are Cement, Paper, Sugar, Steel etc. The computation of cost is done in the form of cost sheet.

Batch costing is concerned with producing a large quantity of products which could be stocked and sold later on. A batch is a cost unit consisting of a group of identical items which maintain their identity through one or more stages of production. A lot is the quantity of product which can be conveniently and economically produced and costed. The companies which produce shoes, medicines, drugs and nuts & bolts use

this method of costing. In batch costing the cost unit is a batch of specific quantity of identical products.

In batch costing each batch is given a definite order number. All the costs relating to the batch are accumulated. After completion of batch or order the cost sheet is totaled and the total cost is divided by the total quantity produced in order to determine the cost per article.

Illustration – 1 :

SMP Ltd. manufactures papers. The following details are given for the current year

Direct materials - Paper Pulp – 500 tonnes @ Rs. 500 each

Other materials – 100 tonnes @ Rs. 300 each

Direct labour - 80 Skilled men @ Rs. 30 per day for 25 days

- 40 unskilled men @ Rs. 20 per day for 25 days

Direct expenses – Special equipment & Dyes Rs. 40,000 Factory overheads are variable @ 100 % of direct wages and Fixed @ 60% of direct wages. Administrative overheads are @ 10 Percent of Factory cost and Selling & Distribution overheads are @ 15 % on Work cost. 400 Tonnes of Paper was manufactured during the year and Rs. 8000 realized by selling waste materials. Calculate unit cost of production per tone of paper manufactured.

Solution :**Cost sheet for the year ended**

Production 400 Tonnes	Total cost (Rs.)	Cost Per Tonne (Rs.)
Direct materials –		
Paper Pulp	250000	625
Other materials	30,000	75
Direct Labour		
Skilled	60,000	150
Unskilled	20,000	50
Direct Expenses	40,000	100
PRIME COST	4,00,000	1000
Factory overheads :		
Variable	80,000	200
Fixed	48,000	120
Sale of waste	-8000	-20
WORKS COST	520,000	1300
Administrative overheads	52,000	130
COST OF PRODUCTION	572,000	1430
Selling & Distn Expenses	78,000	195
COST OF SALES	650,000	1625

Illustration – 2 :

PGG Ltd. undertakes to supply 1000 units of a component per month for Jan. Feb. & March. Every month a batch order is opened

against which materials and labour cost are booked at actuals. Overheads are levied at a rate per labour hour. The selling price is fixed at Rs. 15 per unit. From the following data, determine the cost and profit per unit of each batch order and overall position of the order for 3000 units.

Month	Batch output (Numbers)	Materials cost Rs.	Labour cost Rs.
January	1250	6250	2500
February	1500	9000	3000
March	1000	5000	2000
Labour is paid at the rate of Rs.2 per hour. The other details are :-			
Month			
January	Overhead		Total labour hour
February	Rs.12000		4000
March	Rs.9000		4500
	Rs,15000		5000

PGG Ltd.

Statement of cost & Profit per unit of each Batch

	January	February	March	Total
Batch output (Nos)	1250	1500	1000	3750
Sale value (Rs.)	18750	22500	15000	56,250
Cost	-	-	-	-
Materials	6250	9000	5000	20,250
Wages	2500	3000	2000	7500
Overheads	3750	3000	3000	97500
Total	12500	15000	10000	37500
Profit per batch	6250	7500	5000	18750
Cost per unit	10	10	10	
Profit per unit	5	5	5	

Overall position of order for 3000 units –

Sales value – 3000 x 15 Rs.45,000

Total cost - 3000 x 10 Rs.30,000

Profit Rs.15,000

Workding :-

	Jan.	Feb.	March
Cost	2500	3000	2000
(a) Labour Hours =	-----	= -----	-----

	Rate	2	2	2
	=	1250	1500	100
	Overheads =	12000	9000	15000
(b) Overhead per hour	=-----	-----	-----	-----
	Hours	4000	4500	5000
	Rs. =	3	2	3
(c) Overheads for batch	=	1250 x 3	1500 x 2	1000 x 3
		3750	3000	3000

13.3 JOB COSTING

Job costing is a method of costing which is applied to determine the cost of specific job of production generally manufactured according to customers specification. All the jobs are not similar. They do not pass through the same manufacturing process. Each job requires different amount of materials and labour and different levels of skills. Therefore, the cost of each job differs from other. The cost is recorded separately for each job. Each job or batch is regarded as a cost unit from the view point of accumulation. For example, Printing jobs, Automobile repairs, Hospitals, Ship-univers have to follow job costing.

A job cost sheet is prepared on receipt of an order. A specific number is allotted to each job put into production. General information in respect of the job is recorded at the top of the job-sheet. Appropriate inputs are recorded in the job cost sheet regarding direct materials, labour and overheads. Additional information such as labour-hours, machine hours, quantity and quality of materials used are also recorded for the purpose of planning controlling cost and evaluating performance. Finally the profit or loss on the job can be easily determined. The job cost sheet also provides for the comparison of the actual cost with the estimated costs.

Illustration – 3 :

The following information is taken from the records of Automotive Engineering Works in respect of Job. No. 101.

Materials	Rs. 4020
-----------	----------

Wages :-

Dept. A – 60 Hours @ Rs. 3 per hour

Dept. B – 40 Hours @ Rs. 2 per hour

Dept. C – 20 Hours @ Rs. 5 per hour

The overhead expenses are as follows :

Variable :-

Dept. A – Rs. 5000 for 5000 Labour Hours

Dept. B – Rs. 3000 for 1500 Labour Hours

Dept. C – Rs. 2000 for 1000 Labour Hours

Fixed :- Rs. 20,000 for 10,000 working Hours. Determine the cost of Job No. 101 and price for the job to give a profit of 25 per cent on the Selling Price.

Solution :

Job Cost Sheet – Job No. 101

	Amount Rs.

Materials	4020
Wages Dept. A – 60 x 3 =	180
Dept. B – 40 x 2 =	80
Dept. C – 20 x 5 =	<u>100</u> 360

Overhead expenses :- Variable

Dept A – 60 x 1	Rs. 60	
Dept B – 40 x 2	Rs. 80	
Dept C – 20 x 2	Rs. <u>40</u>	180

Overhead expenses – Fixed

120 hours @ Rs. 2 each	240
Total cost	4800
Profit (33 1/3% on cost)	1600

Selling Price	6400

Workding :-

1) Variable overhead Rate =

Dept. A – Rs. 5000 for 5000 Hours = Rs. 1 per hour

Dept. B – Rs. 3000 for 1500 Hours = Rs. 2 per hour

Dept. C – Rs. 2000 for 1000 Hours = Rs. 2 per hour

2) Fixed overhead Rate = Rs. 20000 for 10000 hours = Rs. 2 per hour

Illustration – 4 :

The normal expenses attributable to Machine No. 303 and the normal hours for which the machine is expected to be utilized in the current year are given below :-

Fixed		Rs. 2000
Variable – Power	Rs. 15000	
– Repairs	Rs. 900	
– Lubricants	Rs. 600	3000

	Total	5000

Predetermined normal hours of working :-

To make ready	-	200
To run the jobs	-	800

Total		1000 Hours

From the following information, compute the cost of Job No. 123

Materials consumed – 10 units @ Rs. 5 each

Direct labour cost :-

To make ready – 2 machine Hours @ Rs. 1 each

To run the job – 8 machine Hours @ Rs. 1 each

Solution :

Job cost sheet (Job No. 123)

	Amount Rs.
	50
Materials (10 units @ Rs. 5 each)	
Direct Labour :-	
To make ready – 2 Hours @ Re. 1 each	02
To run the job – 8 Hours @ Re. 1 each	08
Prime cost	60
Factory overheads :-	
To make ready :- 2 hours @ Rs. 2 each	04
To run the job – 8 Hours @ Rs. 5.75 each	46
Cost of Production	110

Working :

Determination of Factory overheads :

$$\text{Fixed overhead rate to make ready} = \frac{2000}{1000} = \text{Rs.2}$$

13.4 CONTRACT COSTING :

Introduction : Contract Costing is the form of specific order costing which applies where work is undertaken to customer's special requirements and each order is of long duration. It is a special type of job costing where the unit of cost is a single contract. Contract itself is the cost centre and it is executed under the specifications of a customer. Contract Costing is mainly used by Civil Engineers who undertake long term projects such as construction of road, bridge, building etc. it is similar to job costing. It has following features.

- (i) The work is done at a site which is generally away from the contractor's premises.
- (ii) The contract takes more than a single accounting period.
- (iii) Most of the expenses are chargeable directly to the contracts.
- (iv) Each contract is distinct and dissimilar from other contracts.

13.4.1 Important Terms used in Contract Costing :

The following terms are generally used in Contract Costing.

- (a) **Contract** : A contract is a legally enforceable agreement. It is an agreement between contractor and contractee which contains the terms and conditions in relation to a job.
- (b) **Contractor** : The person who undertakes to do the job is a contractor.

- (c) **Contractee** : The person for whom the job is being done is the contractee.
- (d) **Contract Price** : It is the amount agreed to be paid by the contractor as consideration for the job to be done.
- (e) **Work certified** : It is the quantum of work done by the contractor and certified by the technical assessor (surveyor or architect) appointed by the Contractee in terms of the contract.
- (f) **Work uncertified** : It is the value of work completed by the contractor but not certified by the Architect or Surveyor at the end of the accounting period.
- (g) **Reteintion Money** : It is the amount in respect of the portion of work certified and retained by the contract with firm as security deposit on account of any loss that may arise due to defects in the work noticed in future.

13.4.2 Recording costs on contract :

Under Contract Costing, a contract is basically the cost unit and it is regarded as a cost centre for the purpose of control. A separate contract account is opened for individual contract for the purpose of determination of profit or loss on each contract. The following costs are recorded in the contract account.

(1) **Materials :-**

Materials are normally purchased and delivery obtained at the site. Excess materials, if any, may either be sold at site or returned to the store. Sometimes, materials are sent from one site to another. All the materials purchased or sent from the stores or another site are debited to contract account and materials sold or returned to stores are credited to the contract. Materials on hand at the end of the accounting period are credited to contract account.

(2) Labour :

It is easy to allocate major part of the labour to contract account. A muster is maintained at the site for the contract. Labour cost is accumulated and debited to each contract. Some workers are deputed from one site to another for some time which is debited to the respective contract on the basis of the time spent on each contract. At the end of the accounting period, the amount of outstanding labour charges is determined and also debited to the contract account.

(3) Plant & Tools :

The contract account is debited to the extent of the depreciation of the plant or tools used for the period on each contract.

(4) Sub-Contracting :

A part of the work may be given to another contract or which is called sub-contracting. The entire amount paid to the sub-contractor is debited to the particular contract account.

(5) Work in Progress :

At the end of the accounting period an incomplete contract will appear as an asset in the balance sheet. The work in progress includes the following :

Cost of work Certified	xxx
Cost of work uncertified	xxx
Profit taken credit for	<u>xxx</u>

Total

Less : Account received from the Contractee xxx

Work in Progress xxx

The value of work in progress is the balance on the contract account which is carried down to the following accounting period.

13.4.3 Profit on Incomplete Contracts :

The difference on the two sides of contract account naturally indicates the profit or loss on the contract and is transferred to costing profit and loss account. When the contract is incomplete at the end of the costing period, several adjustments are usually necessary to close the books.

It is the general rule that profit cannot be anticipated and taken credit for. Therefore, profit earned on a contract must be recognized only on the completion of the contract. However, large contracts are hardly completed in the year of commencement. They extend over a number of accounting periods. Therefore, it is advisable to take credit for profit where it is anticipated. In such a case it is always good that profit is conservatively calculated and only a percentage of total estimated profit on the complete contract equivalent is transferred to the general profit and loss account.

The following principles must be borne in mind in determining the amount of profit to be taken credit for :

- (i) The stage of completion of the contract is determining as follows :

$$\text{Work Certified} = \text{Contract Price} \times 100$$

- (ii) It is conventional to classify incomplete contracts on the basis of the stage of completion as under :

- (a) If the work completed is less than 25%, then no profit is

- taken credit for during that accounting period.
- (b) If the work completed is 25% to 50%, one third of profit is taken credit for during that period.
 - (c) If the work completed is more than 50% but less than 75%, half of the profit is taken credit for during that period.
 - (d) If the work completed is more than 75 % but less than 90 % two third of the profit is taken credit for during that period and
 - (e) If the work is almost completed and very insignificant portion is remained, estimated cost of expanses for the outstanding work is charged, to the cost and the entire profit is taken credit for during the period.

Even here, it is considered improper to take the entire estimated profit to the profit and loss account when cash for the work done is not received. The portion of profit for which credit can be taken is determined by using the following formula :

$$\text{Profit} = \text{Estimated Profit} \times \frac{\text{Cash received}}{\text{Work Certified}}$$

Since the cash received from the contractee is normally less than work certified, this method is suitable for conservatism principles.

Illustration – 5 :

National Co. Ltd. undertook a contract at a price of Rs. 10,00,000. The work started 1st on April 2008. Prepare a Contract Account for the year ended 31st March 2009, from the following particulars.

	Rs.
Materials issued to site	85,000

Labour on site	75,000
Plant installed at site	15,000
Sundry Direct Expenses	3,000
Establishment charges allotted to contract	4,000
Materials returned to stores	500
Work certified by architect	2,00,000
Cost of work not certified	5,000
Materials on hand on 31-3-2009	2,000
Wages due on 31-3-2009	10,000
Value of plant on 31-3-2009	12,000
Cash received	1,80,000

Solution :**Contract Account**

		Rs.		Rs.
To Materials		85,000	By Contractee A/c	2,00,000
To wages	75,000		(Work Certified)	
+ Outstanding	10,000		By Materials returned to	
		85,000	Stores	500
To Depreciation on Plant		3,000		
To Sundry Expenses		3,000	By Work in Progress	

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To Establishment charges	4,000	Work uncertified	5,000
To Balance c/d	32,000	Materials on hand	<u>2,000</u>
(work in Progress)			7,000
	2,12,000		2,12,000

Note :- Since the contract has been completed less than 25% no profit will be taken to Profit & Loss Account. Hence, the balance of contract account will be taken as work in progress.

Illustration – 6 :

SM Construction Ltd. have obtained a contract for construction of a bridge. The contract price is Rs. 12,00,000 and the work commenced on 1st November 2008. The following details are shown in their books for the year ended 30th September 2009.

	Rs.
Materials issued to site	3,25,000
Wages paid	3,00,000
Plant purchased	50,000
General overheads apportioned	30,000
Direct Expenses	10,000
Wages accrued on 30-9-2009	3,000
Materials at site on 30-9-2009	4,000
Direct expenses accrued as on 30-9-2009	1,000
Work not yet certified	14,000

Cash received being 80% of work certified 6,00,000

Life of the plant purchased is 5 years and the scrap value is nil.
Prepare Contract account, and show the amount of profit which would be taken on contract on a conservative basis.

Solution :

Contract Account

		Rs.		Rs.
To Materials		3,25,000	By Work in progress	
To Wages	3,00,000		cost of work	
+ Accured	3,000	3,03,000	Uncertified	14,000
			Materials at site	4,000
To Direct Exp.	10,000		By Contractee A/c	7,50,000
+ Accured	1,000	11,000		
To Depreciation on Plant		10,000		
To General Overheads		30,000		
To P & L A/c	35,600			
To Balance C/d	53,400			
		89,000		
		7,68,000		7,68,000

Note : Profit to be taken to P & L Account is as follows :

$$(i) \quad \text{Contract completed} = \frac{7,50,000}{12,00,000} \times 100 = 62.5\%$$

- (ii) Since contract is complete more than 50% but less than 75% half of the estimated profit should be taken to Profit and Loss Account which will further be reduced to the proportion of cash received to work certified.

Cash received

$$\begin{aligned} \text{Profit} &= \text{Estimated Profit} \times \frac{1}{2} \times \frac{\text{Cash received}}{\text{Work certified}} \\ &= 89,000 \times \frac{1 \times 6,00,000}{2 \times 7,50,000} = 35,600 \end{aligned}$$

$$\begin{aligned} \text{(iii) Work certified} &= \frac{100}{80} \times 6,00,000 = 7,50,000 \end{aligned}$$

13.5 PROCESS COSTING :

Introduction : Process costing is a method of costing in which the cost of each process is ascertained and the same is absorbed by the output of that process. It is a product costing system which is applied to manufacturing concerns in producing large volume of similar products with continuous flow or process. In a process costing system the type of production is such that a continuous flow of output of identical products is produced.

There is no unit with an individual identity because each unit is part of a process. This method is used in industries like chemicals, textiles, rubber, cement, sugar, coal etc. It can also be used in the assembly type industries which manufacture items like typewriters, automobiles, radios and TV's etc. Therefore, process costing is usefully applied when products are manufactured under conditions of continuous processing or under mass production method.

13.5.1 Features of Process Costing :

A Process cost system has the following features :

- (i) The factory is divided into departments or process which are limited to a certain operation.
- (ii) Manufacturing costs are accumulated for each production department or process.
- (iii) The manufacturing cost are accumulated by department or process for specific period.
- (iv) Process costing is an averaging process.
- (v) Each process or department has its own account for recording the processing costs.
- (vi) The production is continuous and emphasis is uniform or standardized product.
- (vii) The unit completed in one process are transferred to the next process together with costs associated with them. Completed unit are transferred to finished goods.
- (viii) Wastages or cost of spoiled units is added to the cost of good units produced which increases the average cost per unit.

13.5.2 Costing Procedure :

Specific accounting procedure is followed in order to accumulate production costs by process and to compute unit costs. A separate account is maintained for each process to which all costs of material, labour, direct expenses and overheads are debited.

Materials :

Normally, all materials required for production are issued to the first process. However, extra or new materials may be added to the next process. The cost of materials consumed is debited to the respective process account.

Labour :

Wages and salaries paid to workmen and supervisory staff

engaged in a particular process are debited to the concerned process account. When workers are engaged in more than one process, the gross wages are distributed to each process on the basis of time spent on each process.

Direct Expenses :

Direct expenses, which can be attributed directly to a process, are debited to the respective process account. For example, electricity, depreciation, hire charges of equipments etc.

Manufacturing Overheads :

Overheads are generally high in the process costing. The overheads have to be analysed and apportioned on some equitable basis over the different processes involved. Overheads may be apportioned on a predetermined rate based on direct wages or prime cost.

13.5.3 Treatment of Process Loss :

In many processes, a loss of weight may arise in the course of manufacture. In process industries, production losses are inevitable and output is always less than the input. Thus, when the output is less than the input the difference is known as process loss. Even though the loss is inevitable, it is still essential that accurate records are maintained and suitable steps are taken to minimize the process loss. Since it affects the production costs, it should be pointed out to the foremen and supervisors for ensuring efficiency in the use of material in future. They may have keen inspection at each stage of production and losses can be reduced in future. Process loss can be divided into two categories (i) Normal loss and (ii) Abnormal loss.

- (i) **Normal loss :-** Certain losses can be anticipated and an estimate of such loss can be made depending upon the material used, production operation involved, equipment used, technology employed and other factors. These losses are inherent in the production operation and are known as normal losses. For example, in the Sugar or Oil Industry the output cannot be equal to

the input of sugarcane or oil seed. Normal loss is unavoidable, uncontrollable and expected in normal conditions. It may be inherent in the manufacturing process. When normal loss occurs, the cost of such loss is absorbed in the cost of production of good products i.e. output. Thus, normal losses are absorbed by good production and its cost shown as nil in the process cost account. However, if the normal loss is in the form of scrap and has some realizable value, the process cost account is credited with the value of scrap.

- (ii) **Abnormal Loss :** Losses which are in excess of normal losses are called Abnormal Losses. These losses are incurred due to abnormal or unexpected conditions like accidents, inferior quality of materials, carelessness of workers and defective plant maintenance. Abnormal process loss is controllable and avoidable. All losses of this type must be recorded and thoroughly investigated and possible steps should be taken to prevent such losses in future.

Abnormal losses are not included in the cost of normal output. The average cost of the lost units is charged to an abnormal loss account which is credited with the scrap and transferred to profit and loss account. The value of abnormal loss is determined as under :

$$\text{Abnormal loss per unit} = \frac{\text{Cost of Production} - \text{Scrap Value}}{\text{Output (no of units)}}$$

The value of abnormal loss is debited to Abnormal Loss Account and credited the process Account. The scrap value of abnormal loss is credited to Abnormal Loss Account. The balance so Abnormal loss account is transferred to the Profit and Loss Account

Abnormal Gain :

Abnormal gain arises when the actual loss is less than the normal loss expected. When the loss is less than expected, the result is abnormal gain. The value of abnormal gain is calculated in a similar manner to an abnormal loss and such value is debited to the concerned Process Account and Credited to a separate account called Abnormal Gain Account. The amount of scrap which would otherwise have been realized had there been normal loss and no abnormal gain is debited to the abnormal gain account. The balance of abnormal gain account is finally transferred to the Profit and Loss Account.

12.5.4 Joint Product and By Products :

Most of the industries carry out multiple production in their factories. Two or more

products can be produced simultaneously from the use of a single raw material. There are many industries which produce Joint Product and By Products. Some examples of industries where Joint Products and By Product are produced are as under :

Industry	Joint Products and By products
Oil	Oil Oil Cakes
Dairy	Butter, Cream, Ice-cream
Steel	Iron, Steel
Sugar	Sugar, Paper, Country Liquor.

Joint Products :

When two or more products are separated in the course of processing, each having a sufficiently high saleable Value, these are called joint products. Thus a joint product is any output of a manufacturing process producing multiple products that add significantly to the total market value of all output. Joint products require simultaneous common processing. They have a physical relationship and processing of one of

the joint products simultaneously results in the processing of the other joint products. Joint products are the primary objectives of manufacturing process.

By Products :

By products is a product which is recovered incidentally from the material used in the manufacture of main product. The value of By product is generally less than the values of main products. Thus a product which is secondary to the main product and obtained during the course of manufacture of main product is a By product. By-product is generally subject to further processing after separation from the main product.

When income from By product is negligible, it is treated as miscellaneous income. However, when the income from By product is considerable, the market value of the By product after deducting costs and expenses incurred from the point of separation to the actual sales should be credited to the main product process account. If the By product is sold after further processing the main product process cost account must be credited with the market value of the By product after deducting the further processing charges from the point of separation.

Illustration – 7 :

The manufacture of Product X requires three distinct process. On completion, the product is passed from PROCESS III to finished stock. During June 2009 the following information was obtained in respect of the product.

Element of cost	Total		Process	
		I	II	III
	Rs.	Rs.	Rs.	Rs.
Direct Material	7,600	5,600	1,250	750
Direct Labour	3,360	620	860	1,880
Direct Expenses	1,000	800	200	-

Production Overhead 5,040 - - -

There was no stock of raw material or work in progress either at the beginning or at the end of the period. Production overhead is absorbed by processes on the basis of 150% of direct wages. Production during the month of June 2009 was 100 units.

Prepare Process Account and Finished Stock Account.

Solution :

Process I Account

	Rs.	Per Unit Rs.		Rs.	Per Unit Rs.
To Direct Material	5,600	56.00	By Output transferred to Process II	7,950	79.50
To Direct Labour	620	6.20			
To Direct Expenses	800	8.00			
To Production Overhead	930	9.30			
Total	7,950	79.50	Total	7,950	79.50
Process II Account					
	Rs.	Per Unit Rs.		Rs.	Per Unit Rs.

To Output transferred from Process I	7,950	79.50	By Output transferred to Process III		
To Direct Materials	1,250	12.50		11,550	115.50
To Direct Labour	860	8.60			
To Direct Expenses	200	2.00			
To Production Over head	1,290	12.90			
Total	11,550	115.50	Total	11,550	115.50

Process III Account

Output	Rs.	Per Unit Rs.		Rs.	Per Unit Rs.
To Transferred From Process II	11,550	115.50	By Output transferred to Finished stock Account		
To Direct Materials	750	7.50		17,000	170.00
To Direct Labour	1,880	18.80			
To Direct Expenses					
To Production Overhead Head	2,820	28.20			
Total	17,000	170.00	Total	17,000	170.00

Finished Stock A/c

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	Rs.	Rs.
To Output transferred from		
Process III	17,000	-
	-----	-----
	-	-
	-----	-----

Illustration – 8 :

Product Z is obtained after it is processed through three distinct processes. The following cost information is available for the operation.

Element of Cost	Total	Process		
		I	II	III
	Rs.	Rs.	Rs.	Rs.
Direct Materials	56,250	26,000	20,000	10,250
Direct Wages	73,300	22,500	36,800	14,000
Production Overhead	Rs. 73,300			

5000 Units @ Rs. 4 Per Unit were introduced in Process I. Production overheads be distributed as 100% on direct wages.

The actual output and normal loss of the respective process were.

	Output	Normal	Value of
	Units	Loss	scrap per
		On input	Unit Rs.
Process I	4,500	10%	2
Process II	3,400	20%	3
Process III	2,70	25%	4

There was no stock in progress in any processes. You are required to prepare -

- (a) Process Accounts.
- (b) Normal Loss Account.
- (c) Abnormal Loss and Abnormal Gain Account.

Solution :

Process I Account

	Units	Cost Rs.		Units	Cost Rs.
To Materials Introduced	5,000	20,000	By Normal Loss	500	1,000
To Materials		26,000	By Transfer to Process II	4,500	90,000
To Direct Wages		22,500			
To Production Overhead		22,500			
	5,000	91,000		5,000	91,000
Process II Accounts					
	Units	Cost Rs.		Units	Cost Rs.
To Transfer from Process I	4,500	90,000	By Normal Loss	900	2,700
To Materials		20,000	By Abnormal Loss	200	10,050
To Direct Wages		36,800	By Transfer to Process III	3,400	1,70,850
To Production Overhead		36,800			
	4,500	1,83,600		4,500	1,83,600

Working :**(1) Calculation of Abnormal Loss**

$$\text{Input} - \text{Normal Loss} = \text{Normal Output}$$

$$\text{Abnormal Loss} = \text{Normal Output} - \text{Actual Output.}$$

$$\begin{aligned} \text{Normal output} &= 4,500 \text{ Units} - 900 \text{ Units} \\ &= 3,600 \text{ Units} \end{aligned}$$

However Actual Output is 3,400 units.

$$\text{Abnormal Loss} = 3,600 - 3,400 = 200 \text{ units}$$

(2) Valuation of Abnormal Loss

$$\begin{aligned} \text{Abnormal Loss Per Unit} &= \frac{\text{Total Cost} - \text{Scrap Value}}{\text{Normal Out put}} \\ &= \frac{1,83,600 - 2700}{3,600} = \text{Rs. } \frac{1,80,900}{3,600} \\ &= \text{Rs. 50.25} \end{aligned}$$

$$\begin{aligned} \text{Total Abnormal Loss} &= 200 \text{ units @ Rs. 50.25} \\ &= \text{Rs. 10,050} \end{aligned}$$

Process III Account

Per	Rs.	Per Unit Cost	Rs.	Per Unit Cost	
To Trans from Process II	3,400	1,70,850	By Normal Loss	850	3,400
To Materials		10,250	By Transfer to Finished Stock A/c	2,700	2,17,801
To Direct Wages		14,000			
To Production Overhead					
To Abnormal Gain		14,000			
	450	12,101			
	3,550	2,21,201		3,550	2,21,201

Working :

(1) Calculation of Abnormal Gain.

$$\begin{aligned}
 \text{Normal Output} &= \text{Input} - \text{Normal Loss.} \\
 &= 3,400 - 25\% \text{ of } 3,400 \\
 &= 3,400 - 850 \\
 &= 2,550 \text{ Units}
 \end{aligned}$$

Actual Output was 2,700 units. Hence there is abnormal gain of 150 units as under : Actual Output – Normal Output =

$$2,700 - 2,550 = 150 \text{ Units.}$$

(2) Valuation of Abnormal Gain -

$$\begin{aligned}
 & \text{Abnormal Gain Per Unit} = \frac{\text{Total Cost} - \text{Scrap Value}}{\text{Normal Out put}} \\
 & = \frac{2,09,100 - 3,400}{2,05,700} \\
 & = \frac{2,05,700}{2,550} \text{ Rs.} \\
 & = \text{Rs. } 80.67
 \end{aligned}$$

Total Value of abnormal gain = 80.67 x 150 units = Rs. 12,101

Normal Loss Account

	Units	Rs.		Units	Rs.
To Process I	500	1,000	By Cash – Process I	500	1,000
To Process II	900	2,700			
To Process III	850	3,400	By Cash – Process II	900	2,700
			By Cash – Process III	700	2,800
			By Abnormal Gain	150	600
	2,250	7,100		2,250	7,100

Abnormal Loss Account

	Units	Rs.		Units	Rs.
To Process II A/c	200	10,050	By Cash	200	600
			By Profit & Loss A/c		9,450
	200	10,050		200	10,050

Abnormal Gain A/c

	Units	Rs.		Units	Rs.
To Normal Loss A/c	150	600	By Process III A/c	150	12,101
To Profit & Loss A/c		11,501			
	150	12,101		150	12,101

13.6 OPERATING COSTING :

Operating costing is that form of costing which applies where standardized services are provided either by an undertaking or by a service cost centre within an undertaking. It is also known as service costing. It is suitable for the business such as transport, electricity, hospital, canteens and hotels, banking etc. Operating costing is designed to determine the cost of services rendered by an organization. It is a form of unit costing which is applied to costing of services.

Operating costs are period costs. Expenses accumulated for a period are related to the quantum of services rendered during the period. The method of collection and analysis of cost is similar to single cost system. Direct materials and their costs are obtained from voucher or material requisitions. Information about direct labour is collected from wage records. Overhead costs are allocated on the basis of cost units. The following cost units are generally applied in different service organizations.

Nature of organization	Cost Unit
Transport	Per tonne or Per K.M
Electricity	Per Kilowatt hour
Hospitals	Per Patient, Per Bed
Hotels	Per Room
Canteen	Per Plate, Per Thali

Operating cost are generally collected under the following heads.

- (i) **Fixed or standing charges :-** These charges are incurred whether the organization is operating or not. For example, Depreciation. Interest on capital, Insurance Premium. License fees. Rent etc.
- (ii) **Semi fixed or Maintenance Charges :-** These expenses are incurred on repairs and maintenance of equipments, vehicles, and machines, in order to keep them in working condition. They are semi-fixed or semi-variable nature. For example, Repairs and maintenance, Garage Charges, Painting, Hire charges for vehicles etc.
- (iii) **Variable or Running charges :-** These expenses are incurred on the actual running of equipments, machines or vehicles. They vary from day to day. They are variable in nature. For example, Petrol, Oil, Electricity and Power, Driver's wages etc.

The computation of costs is recorded in a cost sheet or operating cost statement. The various elements of costs are arranged in such a way so as to calculate the operating cost per unit. The cost per unit is based on average cost.

Illustration – 9 :

ABC Transport Company is running four buses between two towns 50 kms apart. Seating capacity of each bus is 40 Passengers. The following particulars were obtained from the records of the company

	Rupes
Wages of Drivers, Conductors & Cleaners	24,000
Salaries of office staff	10,000
Diesel Oil etc.	40,000
Repair & maintenance	8,000
Taxes, Insurance etc.	16,000
Depreciation	26,000
Interest & other charges	20,000

Actual Passengers carried were 75 percent of the full capacity. All the four buses run on all days of the month. Find out operating cost per Passenger- KM.

Solution :**Operating cost Statement**

	Total Cost	Cost Per
		Passenger KM
	Rs.	Rs.
(a) Standing charges :-		
Wages of Drivers, Conductors		
& Cleaners	24,000	0.067
Salaries of Office Staff	10,000	0.027
Taxation & Insurance	16,000	0.045
Interest & other charges	20,000	0.055

	-----	-----
Total	70,000	0.194
(b) Running Charges :		
Diesel, Oil etc	40,000	0.111
Reparis & maintenance	8000	0.023
Depreciation	26,000	0.072
	-----	-----
Total	74,000	0.206
	-----	-----
Grand Total	1,44,000	0.400
	-----	-----

Operating cost per Passenger KM = Rs. 0.40 or 40 paise.

$$\begin{aligned}
 & \quad \quad \quad 75 \\
 \text{(c) Passenger KMs} &= \frac{\quad}{100} \text{ (Buses x capacity x Distance x day x 2)} \\
 & \quad \quad \quad 75 \\
 &= \frac{\quad}{100} (4 \times 40 \times 50 \times 2 \times 30) \\
 &= 100 \\
 &= 0.75 (480000) \\
 &= 3,60,000
 \end{aligned}$$

Illustraction – 10 :

From the following information relating to a hotel, calculate room rent to be charged to give a profit of 25% on cost excluding interest :-

- Salaries to staff Rs. 1,80,00 p.a.

- Wages of the room attendant Rs. 20 per day There is a room attendant for each room and wages are paid only when the room is occupied.
- Lighting, Heating & Power-Normal Lighting expenses for a room. For the whole month is Rs. 50/- when occupied.

Power is used only in winter and the charges are Rs. 20/- for a room, when occupied.
- Repair to Building Rs. 40,000 p.a.
- Linen Rs. 6000 p.a.
- Sundries Rs. 16000 p.a.
- Interior decoration & Furnishing Rs. 20,000 p.a.
- Depreciation @ 5% is to be Charged on buildings of Rs. 10,00,000
- Interest to be charged @ 15% on Investment of Rs. 15,00,000.
- There are 100 rooms in the hotel out of which 80% of the rooms are generally occupied in summer and 30% in winter. The period of summer and winter may be considered to be of 6 months in each case. A month may be assumed of 30 days.

Solution

Operating cost statement

	Rs.
	(Per Annum)
(a) Standing charges	
Staff Salaries	1,80,000
Repairs to Building	40,000
Linen	6,000
Sundries	16,000
Interior decoration etc.	20,000
Depreciation of Building	50,000
Interest on Investment	2,25,000

Total	5,37,000
(b) Running Charges	
Room attendant's wages :	288000
- summer (20 x 30 x 6 x 80)	108000
- winter (20 x 30 x 6 x 30)	36600

Lighting, Heating & Power	432600

Total Rent	969600
Profit @ 25% on cost excluding interest	186150

Total Rent	1155750

1155750

$$\text{Room Rent per day} = \frac{\text{-----}}{19800} = \text{Rs. 58.37}$$

Working :

(1) Calculation of room days =

- Summer 100 rooms x 6 months x 30 days x 80%	=	14400
- winter 100 rooms x 6 months x 30 days x 30%	=	5400
Total		19800

(2) Calculation of Lighting, Heating & Power =

Lighting

$$\text{Summer} = 50 \times 6 \times 100 \times 80\% = 24000$$

$$\text{Winter} = 50 \times 6 \times 100 \times 30\% = 9000$$

Power

$$\text{Winter} = \text{Rs. } 20 \times 6 \times 100 \times 30\% = 3600$$

$$\text{Total} \quad \quad \quad \text{36600}$$

13.7 BOOKS RECOMMENDED

1. Cost Accounting & Costing Methods – H. J. Wheldon
 2. Cost Accounting – Jawaharlal.
-

13.8 EXERCISES

1. What is unit costing? What are its advantages?
2. What is job order costing? What is the nature of job costing?
3. What is contract costing? What are the principles to be followed in respect of computing and taking credit of profits on incomplete contracts?
4. What are the general features of process costing? What is the difference between normal and abnormal loss?
5. Why operating costing used.
6. Lion Industries Ltd. undertakes to supply 1000 units of a component pre month for January, February and March. Every month a batch order is opened against which materials and labour cost are booked at actual. Overheads are levied at a rate per labour hour. The selling price is contracted at Rs. 15 per unit. From the following data, present the profit per unit of each batch order and the overall position of the order for 6000 units :

Month	Batch output	Material cost	Labour cost
	(Nos.)	Rs.	Rs.

January	2500	12,500	5,000
February	3,000	18,000	6,000
March	2,000	10,000	4,000

Labour is paid at the rate of Rs. 20 per hour. The other details are :-

Month	Overheads Rs.	Total labour Hours
January	24000	8000
February	180000	9000
March	30000	10000

7. A work order for 5000 units of a commodity has to pass through four different machines of which the machine hour rates are :-

No. 1	Rs. 12.50
No.2	Rs. 30.00
No.3	Rs.40.00
No.4	Rs. 25.00

The following expenses have been incurred on the work order
Materials Rs. 40,000 and Wages Rs. 15000 :-

Machine No.	1. worked for 200 hours
	2. worked for 300 hours
	3. worked for 240 hours
	4. worked for 100 hours

After the work order had been executed, Materials worth Rs. 4,000 were returned to stores. Office overheads are to be estimated @ 60% of the

works cost. 10% of the production is going to be discarded, being unsatisfactory for which $\frac{1}{2}$ the amount can be realized from sale in the junk market. Find out the rate of Selling Price per unit if 20% Profit on Selling Price is desired.

8. Job No. X-10 has incurred the following costs by ABC Co. Ltd.

Materials – 15 kg @ 2.5 per kg.

Wages – Dept A-18 Hours @ Rs. 4 per hour

B-32 Hours @ Rs. 3 per hour.

Budgeted overhead for the year, based on normal capacity, is as follows :-

Variable overhead –

Dept A – Rs. 60000 for 9000 Direct labour hours

Dept B – Rs. 8000 for 10,000 Direct labour hours.

Fixed overheads –

Total budgeted direct labour hours –	Rs. 22000
--------------------------------------	-----------

Total budgeted expenditure	Rs. 16,500.
----------------------------	-------------

You are required to calculate the cost of job No. X-10 and estimate the percentage of profit obtained if the Price quoted to the customer was Rs. 372.

9. The General Foundries undertakes to deliver 100 machines to be manufactured out of mild steel at Rs. 7.50 per casting. The expenses pertaining to the job are given below :-

Materials 150 kg mild steel @ Rs. 1.50 per kg.

- Moulding – 80 hours @ Rs. 1 per hour
- Coremaking – 40 hours @ Rs. 0.8 per hour
- Finishing – 50 hour @ Rs. 1.25 per hour

Overhead expenses –

- Moulding – 150 Percent of labour cost
- Core making – 200 per cent of labour cost
- Finishing – 100 percent at labour cost.

Casting cost come to Rs. 250 per operation and the input of mild steel in this case was 1000 kgs. 30 kg. of the metal is tested out and the value creditable is Rs.1 per kg. Also 2 kgs were lost in the process of melting and moulding. Actually 105 castings are made out of which 3 were defective and were rejected on inspection.

The excess casting in good condition were also delivered to the customer at a concessional rate of Rs. 6 per casting. Prepare the job – cost sheet suitably showing all the details.

10. ABC Contractor were engaged on one contract during the year 2009. The contract price was Rs. 2,00,000. The trial balance extracted from the books on 31st December 2009 stood as follows :

	Rs.	Rs.
Share Capital		50,000
Sundry Creditors		14,000
Buildings	27,000	
Cash at Bank	5,000	
Contract Account		

Materials	37,000	
Plant	20,000	
Wages	50,000	
Other Expenses	5,000	
Cash received (80% of work certified)		80,000
	-----	-----
	1,44,000	1,44,000
	-----	-----

Of the plant and materials charged to the contract, plant costing Rs.2,000 and materials costing Rs. 1,000 were destroyed by an accident. On 31st December 2009 plant costing Rs. 2,000 was returned to stores and materials at site was valued at Rs. 1,400, cost of uncertified work was Rs. 2,000.

Charge 10% depreciation on plant. Prepare Contract Account for the year, transferring two-third of profits on the basis of cash received to the profit and loss account and show the relevant items in the Balance Sheet as at 31st December 2009.

11. Farewell Limited commenced a contract on 1st January 2008. The total contract was for Rs. 20,00,000. It was decided to estimate the total profit and to take to the credit of profit

& loss account the estimated profit on the basis of cash received.

Actual expenditure for the year 2008 and 2009 was as follows :

	Rs.	Rs.
Materials	3,00,000	5,20,000
Labour paid	2,00,000	2,40,000
Labour accrued	20,000	-
Plant purchased	1,80,00	-
Expenses paid	80,000	1,42,000

Plant returned to store at the end of the year	20,000	50,000
Materials on site	20,000	-
Work certified	8,00,000	Full
Work uncertified	30,000	Nil
Cash received	6,00,000	Full

The Plant is subject to annual depreciation @ 20% on cost.

Prepare Contract account and Contractee account for both the years.

12. XYZ Ltd. manufactures three grades of products. The following details are available for a particular month .

Particulars	Process I	Process II	Process III
Materials used (tonnes)	20,000	15,000	10,000
Cost per tonne (Rs.)	20	10	5
Wages (Rs.)	80,00	40,000	30,000
Manufacturing expenses (Rs.)	40,000	30,000	10,000
Sent to warehouse	20%	40%	100%
Transferred to next process	80%	60%	-
Sale of scrap per tonne (Rs.)	10	12	15

In each process 5% of the total weight put in is lost and 4% is scrapped.

Prepare Process Cost accounts.

13. A Chemical product passes through Processes A and B before completion. In Process B, By – product is produced which after further processing in Process C is sold at a profit of 20% of cost.

You are required to prepare the following :

- (a) Process A, B and C Account
- (b) Abnormal Loss Account
- (c) Abnormal Gain Account

Particulars	Process		
	A	B	C
Output in units	4,200	3,800	100
Normal loss in process	20	5	-
(% of input)			
Scrap Value of any loss in			
Process per unit	Rs. 2	Rs. 5	-
Cost	Rs.	Rs.	Rs.
Direct Materials introduced	30,000	-	-
(5000 units)			
Direct Materials added	10,000	3,100	100
Direct Wages paid	12,000	14,700	300
Direct Expenses	6,000	1,200	-

Production overhead for the month were Rs. 12,000. These overheads are to be absorbed on the basis of Direct Labour.

14. A Transport company has been given a 40 k.m. long route to run a bus. The bus costs Rs. 500,000 and has been insured @ 4 per cent per annum. Annual taxes payable amount to Rs. 3000. Garage Rent is Rs. 200 p.m. Annual Repairs will be Rs. 4000 and the bus will be used for 5 years.

The drivers salary will be Rs. 300 p.m. and conductors salary will be Rs. 2400 p.m. Cost of Printing tickets will be Rs. 1000 p.m, Manager's salary will be Rs. 4000 per month.

Fuel cost will be Rs. 60 per 100 k.m. The bus will make 3 round trips carrying an average of 30 passengers on each trip. Assuming 25% profit on taking, calculate the bus fare to be charged from each passenger. The bus runs on an average 25 days in a month.

15. The following cost data pertaining to the year 2009 has been collected from the books of BEES Ltd. Prepare a cost sheet showing the cost of generation of Power per unit of KWTS.

Total units generated	15,00,000 kwts.
	Rs.
Operating labour	16,500
Plant supervision	5250
Lubricant & supplies	10,500
Repairs & Maintenance	21,000
Administration overheads	9000
Capital cost	1,50,000

Coal consumed per Kwts is 1.5 and cost of coal delivered to the power station is Rs. 33.06 per metric tonne. Depreciation rate chargeable is 4% p.a. and interest on capital is to be taken at 7%.



ELEMENTARY PRINCIPLES AND TECHNIQUES OF MARGINAL AND STANDARD COSTING

STRUCTURE :

- 14.0 Objectives
- 14.1 Introduction
- 14.2 Marginal costing
- 14.3 Introduction to Standard costing
- 14.4 Standard costing
- 14.5 Establishing cost standards
- 14.6 Steps for introducing standard costing
- 14.7 Limitation of standard
- 14.8 Variance Analysis
- 14.9 Types of Variances
- 14.10 Labour Variances
- 14.11 Overhead Variance
- 14.12 Books Recommended
- 14.13 Exercise

14.0 OBJECTIVES :

This units covers two techniques viz : (1) Marginal Costing and (2) Standard Costing

- Classify various costs into the three groups : Fixed, Variable and Semi-Variable
- Divide the Semi-Variable costs into (a) Fixed Costs and (b) Variable Costs.

- Ascertain the Break Even level of activity.
- Quantify the effect of pricing decisions on the Break Even Point and Profitability.
- Identify standard cost of the cost elements.
- Compare standard costs with actual / budgeted costs.
- Analyze the reasons for the difference between the standard cost and actual / budgeted costs.

14.1 INTRODUCTION

Consider the cost break up of a product as under :

	Cost per Unit Rs.	Cost for 1000 Units Rs.
Material	50	50000
Wages	30	30000
Supervisor's Salary		5000
Rent		3000
Other Administrative, Selling and Distribution expenses		12000
Total		100000

In the above chart you will notice that Material and Wages increase or decrease directly in proportion to the level of production i.e. if 1500 units are manufactured raw material cost will be Rs. $50 \times 1500 = \text{Rs. } 75000$ and wages will be Rs. $30 \times 1500 = \text{Rs. } 45000$. However, the other components of cost viz Supervisors Salary, Rent and Expenses will remain the same. Take, for instance, Rent-whether you manufacture 1 unit or 1500 units, in the same space taken on rent, the rental expenses will not change. If the Rent is Rs. 5000 per month, even if you manufacture only one unit of the product, the Landlord is not going to reduce the rent. Marginal cost refers to the portion of cost of a product which increases or decreases in proportion to the increase or decrease in quantity produced. Marginal cost is also referred to as variable cost. In the following sections we will see how to use this idea to analyze the cost of a product and ascertain the profit at various level of production.

Introduction to Standard Costing

Assume that you are a manufacturer and you just receive a big enquiry for 40000 meters of tape. You decide to submit your most attractive quotation and started to work out the probable cost of 400000 meters of tape. You will base your calculation on what the cost ought to be under given conditions of output, facilities and efficiency. The basis used by you can be referred to as Standard costs.

In the ensuing sections you will learn to identify the standard cost components, relate them to the material cost, labour cost or overheads as the case may be, derive the standard total cost of the product and arrive at the difference between standard cost and actual cost and also analyse and quantify the costs contributing to the difference.

14.2 MARGINAL COSTING :

Marginal costing is a technique of costing in which only variable manufacturing costs are considered and used while valuing inventories and determining cost of goods sold. Only variable manufacturing costs are considered as product costs including direct materials direct labour and variable factory overheads. Fixed factory overheads are not considered as product costs and are not used for determination of value of inventories and cost of goods sold. Fixed costs are excluded from the cost of the products. Fixed manufacturing costs are treated as period costs. Fixed manufacturing overheads are written off to the Profit and Loss account in the period they are incurred.

Marginal cost means variable production cost. These costs tend to vary in direct proportion to the changes in the production level. Marginal cost is the amount at any given volume of output by which aggregate costs are changed if the volume of output is increased or decreased by one unit. Thus, marginal cost is equal to prime cost plus variable overheads. This technique of marginal costing differentiate between fixed and variable costs for finding out the effect of changes in the volume of

output on profit. The usefulness of Marginal costing depends upon the accuracy of differentiation between fixed and variable costs. Product cost and Work in Progress are computed on the basis of variable cost only. Fixed cost is charged during the same period out of Contribution which is equal to Sales less variable Cost. Prices are fixed on the basis of variable costs and profitability of the product is determined on the basis of Contribution.

14.2.1 INCOME STATEMENT UNDER MARGINAL COSTING :

Under marginal costing, only variable costs of production are subtracted from sales revenue to determine Contribution or margin of profit. All fixed costs are deducted from Contribution in order to arrive at net profit. Fixed Manufacturing costs are excluded from marginal cost, hence inventories are valued at lower of cost or market price. The specimen of income statement which is prepared under marginal costing technique is given below :-

INCOME STATEMENT		Amount (RS)	
Sales			
Less :	Variable costs		
	Direct materials		
	Direct Labour		
	Variable Manufacturing overheads		
		_____	_____
COST OF GOODS MANUFACTURED			
Add :-	Opening stock of inventory		_____
Less :	Closing stock of inventory		

Marginal Contribution			

Less :	a) Fixed manufacturing overheads	
	b) Variable Administrative & selling overheads	
	Net Profit	_____

Illustration 1.

ABC Co. Ltd. has its plant capacity of 20000 units per month. The variable cost per unit is as follows :-

	Rs.
Direct Materials	3.00
Direct Labour	2.25
Variable factory overheads	<u>0.75</u>
Total	6.00

Fixed overheads are Rs. 25000 per month or Rs. 1.25 per unit at normal capacity Fixed selling and distribution overheads are Rs. 5000 per month. Actual Production, Sales and Inventory units were as follows :-

Opening stock of inventory
Units Produced
Units sold
Closing Stock of inventory
Sales Price Per unit

Prepare income statement under marginal costing and determine the Profit.

Solution**INCOME STATEMENT**

	Rs	Rs.
Sales		210000

Less : Variable costs		
Direct materials	57000	
Direct Labour	42750	
Variable Manufacturing overheads	14250	

COST OF GOODS MANUFACTURED		114000
Add :- Opening stock of inventory	18000	
132000		
Less : Closing stock of inventory	6000	

(100*6)		
Cost of Goods sold		
Marginal Contribution	126000	
Less : Fixed Expenses	84000	
Factory	25000	
Selling& Overheads Distribution	<u>5000</u>	
30000		
Net Profit		54000

Working The value of closing stock =

Cost of goods Manufactured	114000	Rs. 6 Per unit
No of units Produced	19000	

Total Value $1000 \times 6 = \text{Rs } 6000$

14.2.2 Applications of Marginal costing Technique

Marginal costing has great potentialities for management in different managerial task and decision making process. It assist management in selection of product mix, capacity utilization, make or buy decision, Classification of costs into fixed and variable enables fixation of responsibility for cost because variable costs are controllable. It also helps in evaluation of performance of different products or departments. Marginal costing helps planning for making maximum profit by suggesting suitable products mix. It also provides more useful information to management for pricing the goods. Marginal costing also enables to meet the situation most satisfactorily when business is slack or when the firm is facing acute competition.

14.2.3 BREAK EVEN POINT

The break – even point can be defined as the point of sales levels at which profits are Zero and there is no loss. In other words, Break – Even Point is that point at which total costs are equal to total sales revenue. At break even point profit being zero, contribution is equal to fixed costs. If the actual volume of sales is higher than break even volume there will be a profit. Beyond the break even point, all the marginal contribution represents profit.

Break even point establishes the output level which evenly breaks the costs and revenues.

The BEP is determined by using the following formula :-

$$\text{BEP} = \frac{\text{Fixed Costs}}{\text{Contribution per unit}} \quad \text{Or} \quad \frac{\text{Fixed Costs}}{\text{Sales price per unit} - \text{Variable cost per unit}}$$

Contribution Per unit

Profit Volume Ratio

Contribution is equal to Sales less Variable costs or Fixed cost plus Profit.

$$\text{Profit Volume Ratio} = \frac{\text{Contribution Per unit}}{\text{Sales Price Per unit}}$$

$$\text{OR} = \frac{\text{Fixed cost} + \text{Profit}}{\text{Sales}}$$

$$\text{OR} = \frac{\text{Sales} - \text{Variable cost}}{\text{Sales}}$$

Illustration 2

From the following particulars calculate break even point for a) unit and b) Sales value.

Total Variables costs

Total fixed costs

Total Sales

Selling Price Per unit

Output

Variable cost Per unit

Solution :-

$$\begin{aligned}
 \text{a) BEP (unit) } &= \frac{\text{Fixed Costs}}{\text{Selling Price} - \text{Variable cost}} \\
 &= \frac{2000}{10-2} = \frac{2000}{8} = 2500 \text{ units}
 \end{aligned}$$

$$\begin{aligned}
 \text{b) BEP (Sales) } &= \frac{\text{Fixed Cost}}{\text{P.V.Ratio}} \\
 \text{P V Ratio} &= \frac{\text{Sales} - \text{Variable cost}}{\text{Sales}} = \frac{50000-10000}{50000} = 0.8
 \end{aligned}$$

$$20000 = \text{Rs. } 25000$$

$$\text{BEP} = 0.8$$

14.2.5 Limitations of Marginal Costing

The limitations of Marginal costing are given below :-

- (a) The marginal costing method requires that all costs should be divided into fixed and variable components. It is not easy to divide all Semi-variable costs into fixed and variable costs.
- (b) Marginal cost is not full cost. Hence, it cannot be used for fixation of price in normal course of time. It is useful for short-term management decisions only.

- (c) Closing inventories are undervalued under marginal costing. It does not contain the element of fixed costs.
- (d) Fixed costs are increasing from time to time. Therefore, it is not proper to ignore it while fixing the price of a product.
- (e) Management has to consider many other factors before deciding to expand the business or to drop a product on the basis of marginal cost.

Illustration 3

The Golden Snow company manufactures and sells 10000 jars direct to consumer under the brand name 'Golden' per month @ Rs. 12.50 Per Jar. The company's normal production capacity is 20000 Jars per month. An analysis of cost for 10000 jars show the following :-

Direct materials	Rs.	10000
Direct Labour	Rs.	24750
Power	Rs.	1400
Misc – Supplies	Rs.	4300
Jars	Rs.	6000

		46450
Fixed expenses (mfg.)		
Selling		79550

Total		126000

The Company has received an offer for the export under a different brand name of 120000 jars of snow at 10000 jars per month at Rs. 7.50 per. jar State whether the order should be accepted or not?

Solution :-

Cost Analysis for Current & Proposed Production

	Current Position	Proposed offer
Capacity	50%	100%
Sales (Units)	10000	20000
Selling Price (Rs.)	12.50	12.50*7.50
Sales value	125000	200000
Direct materials	10000	20000
Direct Labour	24750	49500
Power	1400	2800
Misc. – Supplies	4300	8600
Jars	6000	12000
Total	46450	92900
Contribution	78550	107100
Fixed Costs	79550	79550
	-1000	27550

Marginal Cost

$$\frac{92900}{20000} = \text{Rs. 4.645}$$

Thus, it would be clear from the above cost analysis that the marginal cost per Jar is Rs. 4.645 as against the export Price of Rs. 7.50. There is a net loss of Rs. 1000 at 50% capacity. The export order would bring additional contribution of Rs. 28550 which would result in net profit of Rs. 27550. Hence, it is advisable to accept the export order.

Illustration 4

Bombay plastics make plastic buckets. An analysis of their accounting reveals the following :

Variable cost per buckets Rs. 20

Fixed cost	Rs. 50000 for the year
Capacity	2000 buckets per year
Selling price per bucket	Rs.60

You are required to find out (a) Break even point (b) The number of buckets to be sold to get a Profit of Rs. 14000 and (c) If the Company can manufacture 600 buckets more per year with an additional fixed cost of Rs. 2000, what should be the Selling Price to maintain the profit per bucket as stated above?

Solution :

$$\begin{array}{lcl} \text{Fixed Cost} & & 50000 \\ \text{(a) BEP} & \frac{\text{-----}}{\text{Contribution Per unit}} = & \frac{\text{-----}}{40} = 1250 \text{ buckets} \end{array}$$

$$\begin{array}{lcl} \text{Sales for desired profit} & & \\ \text{(b)} & \frac{\text{-----}}{\text{Contribution Per unit}} = & \text{Fixed cost} + \text{desired profit} \end{array}$$

$$\begin{array}{lcl} & \frac{50000 + 14000}{40} = & \frac{64000}{40} = 1600 \text{ buckets} \end{array}$$

(c) Computation of new Selling Price =

$$\begin{array}{lcl} & & 14000 \\ \text{Profit Per bucket on of the sale of 1600 buckets} = & \frac{\text{-----}}{1600} & \text{Rs. 8.75} \end{array}$$

Total Profit desired $2200 \times 8.75 = \text{Rs. } 19250$

Fixed Cost = $50000 + 2000 = \text{Rs. } 52000$

$$\begin{aligned}
 \text{Sales Value} &= \text{Variable cost} + \text{fixed cost} + \text{Profit} \\
 &= 2200 \times 20 + 52000 + 19250 \\
 &= 44000 + 52000 + 19250 \\
 &= 115250
 \end{aligned}$$

$$\begin{aligned}
 &115250 \\
 \text{Selling Price per Bucket} &= \frac{\text{-----}}{2200} = \text{Rs. } 52.39
 \end{aligned}$$

Illustration 5 :-

X Ltd. has a production capacity of 200000 units per year. Normal capacity utilization is reckoned as 90% and standard variable production costs are Rs. 11 per unit. The fixed costs are Rs. 360000 per year. Variable selling costs are Rs. 3 per unit and fixed selling costs are Rs. 270000 per year. The selling price per unit is Rs. 20. During the year ended on 31st March 2009, the production was 160000 units and sales were 150000 units, the closing inventory on 31-3-2009 was 20000 units. The actual variable production costs for the year were Rs. 35000 higher than the standard. Calculate the Profit for the year by using marginal costing method.

Solution :

INCOME STATEMENT (MARGINAL COSTING)

For the year ended 31-3-2009

	Amount (Rs.)
Sales (150000 units (Rs. 20 each)	30,00,000
Variable Production costs	1760000

(160000*11)

Additional Variable Production Costs	35000	
Add Cost of opening stock	1795000	
(10000 unit @ Rs. 11 each)	110000	
1905000		
Less : Cost of Closing Stock	224118	1680882
	-----	-----
Marginal contribution		13919118
Less : Fixed costs :-		
Factory	360000	
Selling	270000	

	630000	
Variable Cost selling	450000	1080000

Net Profit		239118

20000*1905000

Working 1) Cost of closing stock = ----- = Rs. 224118

170000

14.3 STANDARD COST

Standard cost is a predetermined cost which is calculated from management's standards of efficient operation and the relevant necessary expenditure. It is used as a basis for Price fixation as well as for cost control through variance analysis. A standard may be a norm or a measure of comparison in terms of specific items, such as kilograms of materials, labour hours required, plant capacity etc. Standard costs are pre-determined realistically and much more scientifically through the use of time and motion studies, engineering estimates and specifications, selected measures of plant capacity and cost behavior patterns. It

involves more sophistication, operation analysis and evaluation and comprehensive review of internal and external factor which provide reliable measure for product costing, pricing, planning, co-ordination and controlling of costs. However, Standard costs are not estimated costs.

14.4 STANDARD COSTING

Standard costing is the process of preparation and use of standard costs, their comparison with actual costs and the analysis of variances to their causes and points incidence. It is in other words, setting of predetermined cost estimates in order to provide a basis for comparison with actual costs. In the standard costing, the emphasis is on standard costs i.e. cost of materials, labour and overhead which are incurred if the factory is operated as a highly efficient unit with Manager, Foreman, Worker or a machine functioning as an efficient part of Production Process. Standard costing is one of the most recent developed refinement of cost accounting. It has been universally accepted as an effective instrument for cost control in different industries. It serves as a suitable yard stick to measure the efficiency of actual performances.

14.5 ESTABLISHING COST STANDARDS

Standards should be established for the purpose of cost control. All factors should be considered for establishment of Standards. Standards are established for a definite period of time. Standards are developed for Materials, Labour and Overheads. The two standards developed for Materials are Material quantity Standards and Material price standards. The standard used for labour cost standard requires the determination of standard capacity and standard overhead costs can be computed using normal capacity. The normal or expected actual capacity aims at a production level according to an existing set of conditions. Standard costs require continuous review and revision. A Company should establish a programme to raise standards whenever required so that standards can be set at a currently attainable level.

14.6 STEPS FOR INTRODUCING STANDARD COSTING

- (a) Predetermination of technical details regarding materials, labour operations, capacity utilization etc.
- (b) Fixation of Standard costs in respect of Material, Labour and Overhead
- (c) Ascertaining the actual cost of Materials, Labour and Overhead.
- (d) Working out variations between the Standard and actual costs and ascertaining reasons thereof.
- (e) Presentation of suitable report to the appropriate level of management for taking remedial measures, whenever required.

14.7 LIMITATIONS OF STANDARD COSTING

- (I) It is difficult to establish suitable standards
- (II) If the standard set is very high the staff will not be able to reach the target in spite of working hard.
- (III) Standard Costing may not be suitable for small organizations. Where conditions of production vary widely at short intervals, variances will fluctuate considerably.
- (IV) Where products are of non standard nature varying widely from time to time, standard costing may not be useful.

14.8 VARIANCE ANALYSIS

Variance represents the difference between Actual cost and Standard cost. The function of standards in cost accounting is to indicate variances between standard costs which are allowed and actual costs which have been recorded. Variance analysis can be defined as the process of computing the amount of and isolating the cause of variance between actual costs and standard costs. Variance analysis involves two steps :-

- (a) Computation of Individual Variances.
- (b) Determination of the causes of each variance.

Variances may be Favorable or Unfavorable.

If the actual cost is less than standard cost. It is a sign of efficiency and the difference is termed as Favorable or positive variance. On the other hand, Actual Cost is more than the standard cost it is a sign of inefficiency and the difference is termed Unfavorable or negative Variance. The words favorable or unfavorable are indicative of the direction of variance from the standard costs. They need not in essence be good or bad from the point of view of the firm, such a quantitative indication can be made only after the underlying cause of the variance has been determined. If the standards are properly set, variances would serve as useful tool in the implementation of the concept of management by exception in that variance keep the management informed about the erratic and out of line behavior of the business.

14.9 TYPE OF VARIANCES

Variances relate to costs of manufacturing. The three elements of costs of manufacturing are Materials. Labour and Overheads. Thus the three important variances are Material variances. Labour variances and Overhead Variances.

14.9.1 MATERIAL VARIANCES :-

The following variances constitute Material variances :-

- a) Material cost variance
- b) Material price variance
- c) Material usage variance

14.9.2 a) Material cost Variance

Material Cost Variance is the difference between the actual cost of direct materials used and standard cost of direct materials specified for the output achieved. This can be computed as follows -

Material cost variance (Actual Quantity Actual Price)

(Standard Quantity * Standard Price)

It is favorable when actual cost is less than standard cost

14.9.3 b) Material Price Variance

Material Price Variance occurs when raw materials are purchased at a Price different from Standard Price.

Material Price Variance = (Actual Price – Standard Price) * Actual Quantity

It is favorable when Actual Price paid is less than the Standard Price.

14.9.4 c) Material usage variance

Material Usage Variance results when actual quantities of raw materials used in production differ from standard quantities that should have been used to Produce the output achieved Material Usage Variance = (Actual Qty – Standard Qty) Standard Price

It is favorable when total actual quantity of materials used is less than the total standard quantity.

Illustration 6 :

From the following particulars compute a) Material cost variance b) Material Price variance and c) Material usage variance.

Quantity of Materials purchased	- 3000 units
Value of Materials purchased	- 8250
Standard Quantity of Materials	
Required per tone of output	- 30 units
Standard rate of Materials	- Rs. 2.50 per unit
Opening stock of Materials.	- Nil
Closing stock of Materials	- 500 units
Output during the Period	– 80 Tonnes

Solution :-

Materials consumed = 3000 – 500 = 2500 units

$$\begin{aligned} & \frac{8250}{\text{Actual rate of Materials purchased} = \text{-----}} \\ & \quad \quad \quad 2.75 \\ & = \quad \quad 300 \end{aligned}$$

Standard Quantity of actual output = 30*80 = 2400 units.

$$\begin{aligned} \text{a) Material Cost Variance} &= \text{Actual Cost} - \text{Standard Cost} \\ &= (\text{AP} \times \text{AQ}) - (\text{SP} \times \text{SQ}) \\ &= (2.75 \times 2500) - (2.50 \times 2400) \\ &= \text{Rs. } 6875 - 6000 \\ &= \text{Rs. } 875 \text{ (adverse)} \end{aligned}$$

$$\begin{aligned} \text{b) Material Price variance} &= \text{Actual Qty (AP-SP)} \\ &= 2500 (2.75 - 2.50) \end{aligned}$$

= Rs. 625 (adverse)

c) Material Usage Variance = Std. Price (AQ – SQ)

= Rs. 2.50 (2500 – 2400)

= Rs. 2.50 * 100

= Rs. 250 (Adverse)

14.11 LABOUR VARIANCE

The following variances constitute labour variances

- (a) Labour Cost variance
- (b) Labour Rate variance
- (c) Labour Efficiency variance

14.10.1 (a) Labour Cost Variance :-

Labour cost variance is the difference between the actual direct labour cost and the standard direct labour cost specified for the output achieved. It is calculated as follows :

Labour cost variance = (Actual Hours * Actual Rate) – (Standard Hours * Standard Rate)

= (AH * AR – SH * SR)

It is favorable when actual is less than standard labour cost.

14.10.2 (b) Labour Rate Variance :-

Labour rate variance is the difference between the wages at actual rate and wages at Standard Rate for actual labour hours worked, It ignores the question whether the actual labour hours worked during the

period were more or less than the standard labour hour required to complete the work. It is calculated as follows.

$$\begin{aligned}\text{Labour Rate Variance} &= (\text{Actual Rate} - \text{Standard Rate}) * \text{Actual Hours} \\ &= (\text{AR} - \text{SR}) * \text{AH}\end{aligned}$$

It is favorable when actual wage rates are fllower than the standard wage rates.

14.10.3 (c) Labour Efficiency Variance :-

Labour efficiency variance is the difference between the wages at standard hours the worker should have consumed in actual production and the wages for actual hours worked. The time required for labour work is an index of its efficiency. Thus, this variance seeks to isolate the impact of working greater or lesser number of hours than the standard hours in production. The labour efficiency variance is calculated as follows :-

$$\text{Labour Efficiency Variance} = (\text{Actual Hours} - \text{Standard hours for actual output}) * \text{SR}$$

Illustration 7 :

The standard time rate for unit component “X” are given below :-

Standard hours per unit	15
Standard Rate	Rs. 4 per hour

The Actual data and related infoformation are as follows :-

Actual Production	1000 units
Actual hours	15500 hours
Actual Rate	Rs. 3.80 per hour.

Calculate :-

- (a) Labour Cost variance
- (b) Labour Rate Variance and
- (c) Labour Efficiency variance.

Solution :-

				(AH * AR – SH * SR)
(a)	Labour cost Variance =	-----		
			-1100	
		=	Rs. 58,900-60,000	
		=	Rs. 1100	(F)
			(AR – SR) * AH	
(b)	Labour Rate Variance	=	-----	
			-3100	
		=	Rs. 3100	(F)
(c)	Labour Efficiency Variance	=	(AH – SH)*SR	
		=	Rs. (15500-15000)*4	
		=	Rs. 2000	(A)

14.11 OVERHEAD VARIANCES

Overhead variance is the difference between the actual overhead cost incurred and standard overhead cost charged to production. The manufacturing overhead is not entirely variable with level of Production. Therefore, Standard Costs for factory overheads are based upon budgets and not on standards. There should be a distinction between variable and fixed manufacturing overhead cost. The following are the overhead variances :-

- (a) Overhead Cost Variance
- (b) Overhead Expenditure Variance
- (c) Overhead Volume Variance.

14.11.1 (a) Overhead Cost Variance

This overall overhead variance is the difference between the actual overhead cost incurred and the standard difference between the actual overhead cost incurred and the standard cost of overhead for the output achieved. It can be computed as follows :-

Overhead Cost Variance = Actual Overhead incurred – Standard hours for actual output *

Standard overhead Rate or Actual OH-Actual output *Standard Rate

It is favorable when actual overhead is less than – the Standard Overhead.

14.11.2 (b) Overhead Expenditure Variance :-

Overhead Expenditure variance is the difference between actual overhead and budgeted overhead based on actual hours worked. Actual overhead costs may not be same as budgeted overhead costs due to changes in tax rates, insurance premiums, depreciation etc. The expenditure variance provides management with information, which helps in controlling costs. It is determined as follows :-

Overhead Expenditure Variance = Actual Overhead – Budgeted Overhead Cost.

It is favorable when actual overhead cost is less than the standard overhead cost.

14.11.3 (c) Overhead Volume Variance :-

Volume Variance is applicable for fixed overheads. It is the difference between the standard fixed overhead cost allowed for the actual output and the budgeted fixed overhead based on standard hours allowed for actual output achieved during the period. It is calculated. As follows :-

Fixed Overhead Volume

Variance :- (Budgeted overhead applied to actual output – Budgeted fixed overhead based of standard hour allowed for actual output) OR

(Actual Production – Budgeted Production) * Std. – fixed overhead rate Per unit.

Illustration : 8

From the following information calculate

Overhead Variances	Budgeted	Actual
Output	15000 units	16000 units No. of Working Days 2527
Fixed Overheads	Rs. 30,000	Rs. 30,500
Variable overheads	Rs. 45,000	Rs. 47,000

Solution :

(a) Overhead cost Variance = (Actual OH – Actual units * Std. Rate)

Std. Rate		Std. OH	
-----	=	-----	= 75000 = Rs.5 per unit
Std. Output		15000	

$$\begin{aligned}\text{OH Cost Variance} &= (30,500 + 47000 - 16000 *) \\ &= \text{Rs. } 77,500 - 80,000 \\ &= \text{Rs. } 2500 \quad \quad \quad (\text{F})\end{aligned}$$

(b) Overhead volume Variance = Actual units * SR-Budgeted OH

$$\begin{aligned}&= \text{Rs. } 16000 * 2 - 30000 \\ &= \text{Rs. } 32000 - 30000 \\ &= \text{Rs. } 2000 (\text{F})\end{aligned}$$

(c) Overhead Expenditure Variance =

(i) Variable OH Expenditure Variance = (AOH-AO*Sr)

$$\begin{aligned}&= 47000 - 16000 * 3 \\ &= 47000 - 48000 \\ &= \text{Rs. } 1000 \quad (\text{F})\end{aligned}$$

(ii) Fixed OH Expenditure Variance = 30500-30000

$$= \text{Rs. } 500(\text{A})$$

Illustration 9

CSV Ltd. Has furnished you with the following data :-

No. of working days

Production units

Fixed overheads

Budgeted fixed overhead rate is Re. 1 per hour. In June 2002, the actual hours worked were 31500.

Calculate the following variances :-

- (a) Overhead Cost Variance
- (b) Overhead Expenditure Variance
- (c) Overhead Volume Variance

Solution

Workings

Budgeted Overhead	3000	Actual Overhead	Rs.31000
Budgeted Output (units)	20000	Actual Output (units)	22000
Budgeted Days	25	Actual Days	27
Budgeted hours	30000	Actual hours	31500

Budgeted OH Rate per hour	Re. 1
Std. Time per unit of output	1.5 hrs.
Std. Rate per unit	Rs. 1.50
Budgeted hours worked per day	1200 hours
Standard hours for actual output	$= 22000 \times 1.5 = 33000$

(a) Overhead Cost Variance	$= \text{Actual OH cost} - (\text{SH} \times \text{Sr})$
	$= 31000 - (33000 \times 1)$

388

$$= 31000 - 30000$$

= Rs. 2000 (F)

(b) Overhead Expenditure Variance

= Actual overheads – Budgeted of redheads

$$= 31000 - 3000$$

$$= 1000 \quad (\text{A})$$

(c) Overhead Volume Variance

= Std. Rate Per Unit (Actual output-Budgeted output)

= Rs.1.50 (22000-20000)

$$= \text{Rs. } 1.50 \times 2000$$

= Rs. 3000 (F)

Illustration 10

A manufacturing Company, which has adopted standard costing, furnishes you the following data :-

Standards :-

Materials for 70 g Finished Products 100 Kg

Price of Materials Rs.1 per kg.

Actuals :-

Output	210000
--------	--------

Materials used	280000
----------------	--------

Cost of materials	Rs. 252000
-------------------	------------

Calculate :-

- (a) Materials Cost Variance
- (b) Materials Price Variance
- (c) Materials Usage Variance

Solution :-

$$\begin{aligned}
 \text{(a) Materials Cost Variance} &= (AQ \times AP - SQ \times SP) \\
 &= (280000 \times 0.9 - 300000 \times 1) \\
 &= \text{Rs. } 252000 - 300000 \\
 &= \text{Rs. } 48000 \quad (\text{F})
 \end{aligned}$$

$$\begin{aligned}
 \text{(b) Material Price Variance} &= AQ(AP - SP) \\
 &= 280000(0.9 - 1.00) \\
 &= 280000 \times 0.10 \\
 &= \text{Rs. } 28000 \quad (\text{F})
 \end{aligned}$$

$$\begin{aligned}
 \text{(c) Material usage Variance} &= SP(AQ - SQ) \\
 &= 1(280000 - 300000) \\
 &= \text{Rs. } 20000 \quad (\text{F})
 \end{aligned}$$

Working

$$\begin{array}{rcl}
 & 252000 & \\
 \text{1. Actual Price of Materials} &= \text{-----} &= \text{Rs. } 0.90. \\
 & 280000 &
 \end{array}$$

Illustration 11.

The standard cost card for a product is given below :-

$$\text{Materials} = 2 \text{ kg @ Rs. } 2.50 \text{ each} = \text{Rs. } 5 \text{ per unit}$$

Wages = 2 hours @ 50 paise each = Rs. 1 per unit

The actual which were emerged from business operations were as follows.

Production 5000 units

Materials consumed 16500 Kgs. @ 2.40 each Rs. 39600.

Wages paid for 18000 hours @ Rs. 0.40 each = Rs. 7200

Calculate

- (a) Material cost Variance
- (b) Labour Variances

$$\begin{aligned}
 \text{(a) Material cost Variance} &= \text{Actual Cost} - \text{Standard cost} \\
 &= \text{Rs. } (16500 \times 2.40 - 16000 \times 2.50) \\
 &= \text{Rs. } 39600 - 40000 \\
 &= \text{Rs. } 400 \quad (\text{F})
 \end{aligned}$$

$$\begin{aligned}
 \text{(b) Material Price Variance} &= \text{AQ (AP} - \text{SP)} \\
 &= 16500 (2.40 - 2.50) \\
 &= \text{Rs. } 1650 \quad (\text{F})
 \end{aligned}$$

$$\begin{aligned}
 \text{(c) Material Wage Variance} &= \text{SP (AQ} - \text{SQ)} \\
 &= 2.50 (16500 - 16000) \\
 &= \text{Rs. } 2.50 \times 500 \\
 &= \text{Rs. } 1250 \quad (\text{A})
 \end{aligned}$$

$$\text{(d) Labour cost Variance} = \text{Actual Labour cost} - \text{Std. Labour}$$

cost

$$= \text{Rs. } 7200 - 8000$$

$$= \text{Rs. } 800 \quad (\text{F})$$

$$\begin{aligned} \text{(e) Labour Rate Variance} &= \text{Actual Hour (AR-SR)} \\ &= 18000 (0.40 - 0.50) \\ &= \text{Rs. } 1800 \quad (\text{F}) \end{aligned}$$

$$\begin{aligned} \text{(f) Labour efficiency variance} &= (\text{Actual Hour} - \text{Std. Hours for Actual Production}) \\ &\quad * \text{SR} \\ &= (18000 - 16000) * 0.50 \\ &= 2000 * 0.50 \\ &= \text{Rs. } 1000 \quad (\text{A}) \end{aligned}$$

Illustration 12.

The direct labour strength of a section of Vijay Engineering Co. is 100 workers all paid at the rate of Rs. 600 per day of 8 hours each. The normal production is 1000 pieces for a week of 48 hours. During a week in September 2009, an order for 1500 pieces was completed spending 7650 hours made up 6300 hours at normal wages and 1350 hours at overtime wages at double the rate. The total wages come to Rs. 6300. Calculate the labour cost variances for the week.

Solution :

Working

- (a) Standard Labour cost per piece :-
- weekly normal time $100 * 48 = 4800$ hours
 - weekly normal wages = $600 * 6 = \text{Rs. } 3600$

$$\begin{array}{rcl}
 & & 3600 \\
 \text{- Normal wage rate per hour} & = & \frac{4800}{3600} = \text{Rs.0.75 per hour} \\
 & & 4800 \\
 & & 4800 \\
 \text{- Normal time per piece} & = & \frac{1000}{4800} = 4.8 \text{ hours} \\
 & & 1000 \\
 & & 3600 \\
 \text{- Normal Labour Cost (STd.)} & = & \frac{3600}{1000} = \text{Rs. 3.60 per Piece} \\
 & & 1000
 \end{array}$$

(b) Actual Labour cost per piece :-

$$\begin{array}{rcl}
 \text{- actual hours worked in the week} & = & 7650 \text{ hours} \\
 \text{- pieces completed} & = & 1500 \\
 \text{-} & & 7650 \\
 \text{- Actual time taken Per Piece} & = & \frac{7650}{1500} = 5.1 \text{ hrs.} \\
 & & 1500 \\
 \text{- Normal actual hours taken} & = & 6300 \text{ hours} \\
 \text{- Overtime worked} & = & 135 \text{ hours} \\
 \text{- Total Hours of normal wages} & = & 6300 + (2 \times 135) = 9000 \\
 \text{- Actual Wages Paid} & = & \text{Rs.6300} \\
 \text{-} & & 6300 \\
 \text{- Average normal wage rate} & = & \frac{6300}{9000} = \text{Rs. 0.70 per hour} \\
 & & 9000 \\
 & & 6300 \\
 \text{- Actual Labour cost Per piece} & = & \frac{6300}{1500} = \text{Rs. 4.20} \\
 & & 1500
 \end{array}$$

(c) Labour cost variance = Actual cost – Std. Cost

$$= \text{Rs. } 6300 - 1500 \times 3.6$$

$$= 6300 - 5400$$

$$= \text{Rs. } 900 \quad (\text{A})$$

(d) Labour Rate Variance = Actual Time *(AR-SR)

$$= 7650(0.70 - 0.75)$$

$$= 7650 \times 0.05$$

$$= \text{Rs. } 382.50 \quad (\text{F})$$

(e) Labour Efficiency Variance = Std. Rate (Actual time – Standard time for actual Production)

$$= 0.75 (7650 - 4.8 \times 1500)$$

$$= 0.75(7650 - 7200)$$

$$= \text{Rs. } 0.75(450)$$

$$= \text{Rs. } 337.50 \quad (\text{A})$$

14.12 BOOKS RECOMMENDED

1. Cost Accounting : Jawahar Lal
2. Principles & Practice of Cost Accounting : N.K.Prasad

14.13 EXERCISES

1. What do you mean by Marginal costing? What are its advantages and limitation?
2. What is Break-even Point? What is its usefulness?
3. What are the most important areas of management decisions opened up by the application of marginal costing?
4. What is Standard Costing? What are its uses?
5. What is the difference between Standard cost and Estimated cost?

6. "Variance analysis is an integral part of Standard Costing" Explain this statement.
7. The following information has been taken from the records of ABC Co. Ltd. You are required to find out net profits using the technique of Marginal Costing:

Sales		Rs. 75000
Variable Cost :		
Direct Materials	22500	
Direct Wages	12500	
Factory Overheads	5250	
Adm. Selling & Distribution overheads	8000	48250

Fixed Costs		
Factory Overhead	2000	
Admin. & Other OH	3350	5350

Total Cost		53600

Profit		21400

Q.8 The following data are obtained form the records of a Factory

Sales – 4000 units @ of Rs. 25 each		Rs. 1,00,000
Materials consumed	40000	
Variable overheads	10000	
Direct labour	20000	
Fixed overheads	18000	88000
	-----	-----
Net Profit		12000

Calculate :

- (a) Break – Even point
- (b) Sales needed to earn a profit of 20% on sales.
- (c) Extra units which should be produced to obtain the present profit if it is proposed to reduce the selling price by 20%.
- (d) Selling Price to be fixed to bring down its B.E.P. to 500 units under present conditions.

Q.9 The Standard quantity and Standard price of raw material required for one unit of Product A are given below :-

Material	Quantity	Selling Price
X	2 Kg.	3 per Kg.
Y	4 Kg.	2 per kg.

The actual production and relevant data are given below.

Output 500 unit.

Material	Quantity	Selling Price
(For 500 units)		
X	1100 kg.	3 per kg.
Y	1800 kg.	2 per kg.

You are required to calculate

- (a) Material Cost Variance
- (b) Material Price Variance
- (c) Material Usage Variance

9. From the following data calculate

- (a) Labour Cost
- (b) Labour Rate and
- (c) Labour Efficiency Variances for the two department.

	Dept. A	Dept. B
Actual	Rs. 2000	Rs. 1800
Standard hours produced	Rs. 8000	Rs. 6000
Standard rate per hour	Rs. 0.30	Rs. 0.35
Actual hours worked	8200	5800

