QUESTION NO. 1

INTRODUCTION:

The word "Audit" has been taken from Latin word "Audire" which means, "to hear". In old days, audits were done by listening arguments of the parties, who maintained the books of accounts.

With the passage of time audit became necessary at the end of accounting cycle and declared a statutory requirement in case of Public Limited. companies. Proper rules and regulations were, framed up where by subject of auditing came into existence.

Dictionary Meaning:

The word audit means, "An examination of the accounting record."

Definition:

> *Such examination of books, accounts & voucher of a business as will enable the auditor to report whether the profit & Loss Account and Balance Sheet have been properly drawn up and they are showing a true & fair view of business affairs according to the best of his information and explanation given to him and as shown by the books of the business, and if not to report then in what respect he is not satisfied."*
>
> ***Spicer & Peglar (1963)***

OBJECTIVES OF AN AUDIT

A. Primary objective

B. Secondary objectives

C. Implied objective

(A) PRIMARY OBJECTIVE:

REPORTING:

The auditors are required to be appointed under the following provisions of Companies Ordinance 1984 for submitting the report about the accuracy of business accounts at different stages:

(a) Statutory Report: **[Section 157 (5)]**

It requires an audit report to be included in the statutory meeting about the shares allotment & receipts and payments statement.

(b) Prospectus Report: **[Section 53(1)]**

It requires an audit report, to be included in the prospectus of the company about the performance of the Company in the past five years.

(c) Annual Report: **[Section 255(3)]**

It requires a report of fairness about the profit & loss Account and the Balance sheet for the latest year to be presented at the Annual General Meeting.

(d) **Solvency Report:** **[Section 362(2)]**

It requires an audit report about the solvency position of the company to be represented for the purpose of passing liquidation resolution for voluntary liquidation by the members.

(B) SECONDARY OBJECTIVES:

(1) DETECTION & PREVENTION OF ERRORS:

What are Errors?

ISA Para 4 says

" Unintentional mistakes in financial statements are called errors."

KIND OF ERRORS

(a) **Clerical Errors:**

Those committed at the initial stage by the Clerical staff.

(i) ***Omissions:***

Where one or both parts of the transaction have been omitted to record.

(ii) ***Commission:***

Where different amount than actual has been recorded.

(iii) ***Compensatory:***

Where the second error has compensated the effect of first error.

(iv) ***Trail Balance:***

Where incorrect transfer or posting is made in the trail balance.

(b) **Principal Errors:**

Where accounting rules & regulations have not been followed normally by some senior persons.

(i) ***Incorrect allocation:***

Where a capital item is treated as revenue or revenue as capital.

(ii) No adjustment for accrued item or liabilities.

(iii) No adjustment for prepaid items & assets:

LOCATION OF ERRORS:

Following techniques can be helpful in detection and prevention of errors.

(a) **Vouching:**

Careful vouching of books & ledgers will highlight errors of omission.

(b) **Compression:**

An auditor may detect errors by comparing the data of previous period with current period.

(c) Inquiries:

Errors made by principals can only be traced by general inquiries and by independent checking.

(d) Trail checking & Verification:

Trail checking & verification are also helpful devices for the location of errors.

(2) DETECTION AND PREVENTION OF FRAUDS:

ISA Para 3 says

> *"An intentional act by one or more individuals among management, employees or third parties, which results in a misrepresentation of financial statements is called fraud."*

KINDS OF FRAUDS

(a) FRAUDS OF CASH:

(I) Understatement of Cash Receipts:

(i) No record of accounts receivables

(ii) Less record of accounts receivables

(iii) No record of casual sales e.g., scrap, bad debts recovered.

(iv) Discount recorded but not allowed

(iv) Teeming & Lading: Creating a deficiency in the account of a debtor and concealing it through another deficiency and so on for a short period i.e., Short Banking or Delayed Accounting.

(vi) Under casting the receipts of a particular page

(II) Overstatement of Cash Paid:

(i) Fictitious payments on forged bills.

(ii) Double record of the same voucher by change of date.

(iii) Personal expenditure paid out of business e.g. utility bills & entertainment bills.

(iv) Over casting the payment side.

(b) Frauds of Goods:

(i) Understatement of quantity received.

(ii) Overstatement of quantity issued.

(iii) Less balance of available stock.

(iv) No record of material returned back from the department.

(c) Fraud of Accounts (Manipulation of Accounts):

This type of fraud is comparatively more difficult to detect. The directors or the management usually carries out these frauds.

Manipulation of Accounts is defined as:

> *"The presentation or record of accounts in a manner slightly different than the original way"*

(i) **Inflation of Sales:**

By way of arranging sales order through another company in the closing period.

(ii) **Deflation of Sales:**

By delaying the record of normal sales especially few a large orders.

(iii) **Inflation of Purchases:**

By arranging purchase order with another company.

(iv) **Deflation of Purchases:**

By delaying the record of normal purchases.

(v) **Use of Secret Reserve:**

The management may resort to adopt the method of secret reserve, its creation and use instead of the above steps in any of the following manners:

(a) Increase or decrease in the rate of depreciation.

(b) Increase or decrease in the rate of bad debts reserve.

(c) By changing the method of diminishing balance or into the reverse practice.

(d) By charging a capital expenditure to revenue or in the reverse practice.

Location of Frauds:

A careful examination of vouchers, invoices, wage sheets and other evidences of transactions can discover many frauds. But only a good system of internal check can provide adequate protection against embezzlement of cash and pilferage of stores.

(c) IMPLIED OBJECTIVE:

Related guideline in this respect, contained in ISA 1, is explained below:

Moral Check:

The system of audit if adopted regularly in the business will put a check on the business employees and they will not commit irregularities, as they know that these will be discovered and reported later on through audit. Thus it is claimed that audit prevents the occurrence of errors and frauds before it starts.

> *"the objective of an audit of financial statement, prepared within a framework of recognized accounting policies, is to enable an auditor to express an opinion on such financial statements."*

QUESTION NO. 2

INTRODUCTION:

Internal control system is a complete system of control, organized by management, financial or otherwise, for the smooth conduct of business. According to International Standards on Auditing (ISA), it means all the policies and procedures adopted by the management of an entity to assist in achieving management's objective of ensuring as far as practicable.

PRINCIPLES OF INTERNAL CONTROL

INTERNET CONTROL SYSTEM:

For an ideal and non-fraudulent internal control system, the following principles can be taken.

(A) ADMINISTRATIVE CONTROLS:

(1) Clear Cut Duties:

Division of duties is a part of internal control. The duties should be assigned according to the capacity. One person should perform only one duty, which should be clear-cut, e.g. one person records sales while other keeps cash books.

(2) No Complete Reliance:

The business rules of regulations should be equal for all employees. No exemptions should by given to any individual. The business authorities should not rely on any person completely.

(3) Sufficient Staff:

The staff should be sufficient according to the requirements of business.

(4) Rotation of Duties:

The duties of clerks should be changed from time to time and from departments to departments or branch wise, after a fixed period.

(5) Safety Measures:

According to the business requirements different safety measures should be undertaken.

(6) Cash and Personal Security:

A reasonable cash security and personal guarantee should be taken at the start of the employment.

(7) Correspondence Received:

All daily correspondence received should be recorded by a junior person and taken to the officer's room where opened and presented for making.

(8) Physical Check of Stock:

The stock should be confirmed by the purchase manager surprisingly.

(9) Quotation System:

Open choice quotation system through print media should be followed.

(10) **Attendance Procedure:**

The attendance procedure should applied equally on juniors and seniors

(B) **FINANCIAL CONTROLS:**

(11) **Double Entry System:**

Real double entry system of recording, debit by one person and credit effect by another should be followed.

(12) **Use of Accounting Calculator:**

If the business resources allow then calculators, computers & printers should be used for computations.

(13) **Internal Audit:**

There should be a separate department according to business needs for overall checking.

(14) **Remittance & Deposit:**

All the remittance received should be deposited in the bank account the same day or next day if received after the close of banking hours.

(15) **Payment Authorization:**

Every payment bill should be first approved by the chief accountant.

(16) **Wages & Salaries:**

Salaries should be paid through crossed cheques as there are no chance of fraud in it but wages in indirect manner through token slips avoiding direct payment by the job incharge.

(17) **Records of Goods:**

Detailed records should be maintained for all goods received and sent out.

(18) **Receipt Books:**

The receipts books used should be

(i) Printed

(ii) Numbered consecutively

(iii) Having a carbon copy

(19) **Petty Cash Fund:**

A separate fund for various minor expenditures should be established on imprest system.

(20) **Review of Work Done:**

A system should be maintained under which work done by the individuals may be seen by the senior officers.

(21) **No Access to Books / Accounts:**

The cashier should not be allowed to record or inspect customer's account.

(22) **Separation of Records:**

Financial and accounting operations must be separated.

(23) Statement of Accounts:

All customers should be informed about the summary of their dealing after the end of every quarter.

(24) Internal Appliance Computer and other Machine:

Modern mechanical appliance such as cash, registers, receipt books, accounting machines should be used in the business.

QUESTION NO. 3

AUDIT PROGRAMME

INTRODUCTION:

International Standards of Auditing: (AS-4 Para-10)

"The Auditor should develop and document an audit program setting out the nature, timing and extent of planned audit procedures required to implement the overall audit plan. The audit program serves as a set of instruction to assistants involved in the audit."

DEFINITION:

"It is a written scheme of various details of an audit work to be carried out by each member of an audit team in respect of a particular audit."

COMPOSITION/MANAGEMENT OF AUDIT FIRM/TEAM

(A) MANAGEMENT:

The management of audit firm includes:

(1) Partners (Owners):

The owners of the audit firm are called partners who must be Chartered Accountants.

(2) Audit Manager:

Audit manager are the person with five years experiences and are called the principals of audit team.

(B) AUDIT TEAM:

(3) Seniors:

Seniors have the experience of 3 to 4 years.

(4) Semi-Seniors:

These persons have the experience of about 2 years and are called semi-seniors.

(5) Juniors:

Persons having 1 year experience are called juniors.

(6) Semi-Juniors:

Those who have less than 1 year experience are called semi-juniors.

So

Audit Management = Partners + Managers

Audit Team = Seniors + Semi-seniors + Juniors + Semi-juniors

[FEATURES]

Following are the main features of an audit programme:

(1) It is prepared by top management i.e. partners & managers

(2) Audit team follows it strictly.

(3) It is prepared for every business separately.

(4) It is prepared after taking guidance form previous audit results and internal control system.

(5) It contains the techniques of test checking to be followed during audit.

PURPOSE OF AUDIT PROGRAMME:

(1) To ensure that point of the routine has not been ommitted.

(2) To issue clear instructions to the audit team.

(3) It is prepared to control the work of audit.

(4) To fix the responsibilities of staff regarding audit work.

(5) To prepare timetable for the whole audit work.

(6) To serve as an evidence of the work carried out and duties performed.

(a) Audit Program:

MIS & Co. Chartered Accountants

Tests of Control over Fixed Assets

Client: ____________________

Reviewed by:

Audit Manager: __________

Senior Assistant: __________

Period Covered: __________________________

Voucher No.	Voucher Data	Purchase Requisition No.	Approval Yes/No	Purchase Order No.	Delivery Note	Gate Pass No.	Inspection Note No.	Invoice Compared with			Depreciation
								Purchase Order	Delivery Note	Gate Pass	

Budget Hours: __________ Actual Hours: __________ Variance: ____________________

Work Done By: __________ Date: __________________ Conclusion: ____________________

[MERITS OF AUDIT PROGRAMME]

(1) Distribution of Work:

Exact line of action in written form is very helpful in dividing the audit work between audit staff according to their abilities. So goals can easily be achieved.

(2) Fixation of Responsibilities:

Audit program is a guideline for workers assigning every one's task so no one can avoid his part of duty.

(3) Audit Evidence:

It acts as solid evidence to prove that auditor has taken due cares and practiced professional skill. So if he is litigated of any reason it is the only legal evidence of work done.

(4) Review of Work:

If any step is missing, that can easily be identified with the help of scheduled audit program.

(5) Check on Progress of Work:

At ever time auditor can estimate that how much work has already been completed from the target with the help of this program.

(6) No Chance of Overlooking:

Verbal actions cannot be implemented and enforced as decided. Sketching out a procedure can only ensure that no step is passed without performance.

(7) Sequence in Work:

Audit program draws a sequential flow of work. Sequence is as necessary as conduct of audit itself.

(8) Short Time:

Planned activities in the form of audit program make auditor efficient. So he is able to complete task in short time.

(9) Source of Learning:

Principal auditor cannot be at audit practically to guide juniors so audit program is a theoretical source of learning for junior clerks.

(10) Useful for Future:

In subsequent years, when auditor will be reappointed in the same organization, there will be no need to draw audit program again. Only few modifications will be sufficient to implement it

(11) Audit Staff Needed:

It is helpful to determine the number of persons needed to do the work. The exact number of senior and junior audit clerks can be determined.

(12) Easy Claim for Higher Payment of Audit Fee:

Due to audit programme auditor can Claim fee with prove because work is supported by the detail of time spent.

[DEMERITS OF AUDIT PROGRAMME]

(1) Mechanical Nature:

The audit work may become mechanical as every time the same procedures are carried out in the same way.

(2) For Large Concerns Only:

Audit program can save time of auditor in large concerns where as in small businesses where economic events are few audit program is an extra and tiring work.

(3) Death of Creativity:

At many occasions clerks of audit firm have to take random decisions according to type of errors; but they are instructed to follow audit program, as it is whereby suggestions would not be recognized.

(4) Known to Accounting Staff:

Most often Client's Staff knows about the plan of audit before hand. This allows them to manipulate books accordingly.

(5) Spoon Feeder:

When audit programme has already been provided for implication, learning will be no more. Every time staff members will expect readymade procedure.

(6) Not Comprehensive:

Auditor tries to cover all the aspects of audit nearly of every organization but many steps in the audit of bank are entirely different from audit of manufacturing houses.

(7) To Rigid:

An audit program is generally not elastic and is too rigid i.e. it is usually not revised or Changed according to the changed conditions in the relevant organization.

(8) New Matters:

Due to the fixed nature of audit program, any new matters may be overlooked by the auditor.

QUESTION NO. 4

VOUCHING:

Vouching is the essence of auditing. The auditor can inspect the documents that support and prove a transaction these documents are called "Voucher" there is a need to test the fairness of items recorded in the books of accounts.

Vouching means to prove a transaction in the records with its documentary evidence as well as to check the transaction has been properly authorized and recorded in the books of accounts.

DEFINITION:

As the examination of the evidence offered in substantiation of entries in the books including in such examination the proof, so far as possible, that no entries have been omitted from the books.

TECHNIQUES OF VOUCHING

At the time of vouching the auditor must keep in mind the following points.

(1) Dates and Period:

The dates appearing on different papers attached with the vouchers should support and correspond with the date as recorded on the transaction.

(2) Correct Allocation:

Correctness in allocation of certain amounts can be achieved by thorough examination and scrunching of documentary evidence attached with the main vouchers.

(3) Arrangement of Vouchors:

The auditor must very carefully check the vouchers in the company under audit are arrange in the same order as the entries are made in the books of accounts.

(4) Proper Authorization:

All the voucher must be properly authorized by the competent and responsible authority of the company the signature of the authorized officers must appear on the voucher and related documents.

(5) Agreement of Accounts:

This technique states the fact that the amount stated on the vouchers must be written in both words and figures.

(6) Checking of Accounting Heads:

This technique of vouching can be materialize by extensive and detailed checked of the documentary evidence attached with the main voucher.

(7) Arithmetical Accuracy:

Correct costing of the vouchers is to be ensured by the auditor.

(8) Revenue Stamp:

The vouchers established in the company must bear a revenue stamp of proper value according to the requirements of the voucher.

(9) Alteration and Duplication:

Alteration or any kind of duplication must be very carefully checked in the vouchers. The auditor in this context must thoroughly examine that all vouchers are approved by an authorized and responsible staff member of the company.

(10) Entry in Business Books:

The auditor once completely satisfied in respect of the above steps, the auditor then reconciles the vouchers with the transactions recorded in the books of the company under audit.

(11) Stamping:

Being totally satisfied in respect of the reconciliation procedure, the auditor will put a tick (✓) mark against the transactions and simultaneously affix a stamp on the relevant vouchers.

(12) **Observations:**

Comprehensive and complete notes should be taken in context of such items which require further clarification or evidence such as partnership deeds lease agreements memorandum and articles of association minute book and various contracts etc.

QUESTION NO. 5

(a) **INVESTMENTS:**

If there are a large number of investments as in the care of banks and Insurance companies, the auditor should ask for a schedule of investment held by his client securities may be checked securities include share certificates. Government loans bonds etc. If the securities are with the bank, the auditor must obtain relevant certificate to verify such securities. It they are inverted with many parties a list should be made available to the auditor on the date of balance sheet by the management of the company. This should show names, cost, market value on the date book value, rate of interest, dates of payments of interest etc.

This list should be checked by the auditor through certain tests like market rates are checked through financial journals, securities through broker notes. IN addition to this the auditors must also see that all income from investments is properly collected and recorded.

(b) **PLANT AND MACHINERY:**

While verifying plants and machinery the auditor must have the following point in mind.

(i) The auditor should see some of the main plants and machinery by visiting the factory plants and machinery account must agree with the balance sheet. Amounts of the commencement and end of period. A plants register should be maintained with particulars in detail must by certified by the engineer.

(ii) Yearly addition of sales or purchase of machinery should be verified with invoices contracts or receipts. If the client manufacture machinery for his own use, verification. About material labour and overheads should be included in machinery account. The expense must go under capital expenses

(iii) The profit and loss due to sale of machinery should be made in the relevant accounts of the company. If deductions are made it should be verified very carefully.

(iv) Small tools are of short time durability so they should be checked and detected to avoid any such purchases.

(c) **LOANS:**

The auditor must take the following points into consideration while verifying loans.

(i) The auditor should examine the agreements entered into or correspondence with the lenders

(ii) If loans or the overdrafts have been taken from a bank, the agreement with the bank and a certificate to that effect should be obtained and examined.

(iii) The auditor must check the interests due on loans. He must also check whether the interest due has been paid or not

(iv) The auditor must also check the register of mortgages maintained by the company.

(d) GOODWILL:

The auditor should consider the following points while verifying goodwill of the company:

(i) The auditor should examine the purchase agreement or partnership deed to assess the cost of good will. In addition to this he must also see that the goodwill has been entered in the books of accounts of a proper figure.

(ii) The auditor must see that no improper items have been added to goodwill.

(iii) The auditor must see that the deferred goodwill must be clearly shown in the balance sheet difference from purchased good will must be written off within a reasonable period of time.

QUESTION NO. 6

APPOINTMENT OF AUDITOR:

In the light of section 252 of companies ordinance 1984, auditor / auditors may be appointed by four ways to fulfill statutory requirement:

(1) First Auditor:

[U/S 252(3)]

The First auditor or auditors of a company shall be appointed by the directors within sixty days (60 days) of the date of incorporation of the company, and the auditor or auditors so appointed shal' hold office until the conclusion of the first annual general meeting.

If the directors fail to exercise their powers and within 60 days incorporation of company no auditor is appointed. The company (shareholders) in general meeting may appoint the first auditor or auditors in next 60 days.

(2) Subsequent Appointment:

[U/S 252(1)]

Every company shall at each annual general meeting appoint an auditor or auditors to hold office from the conclusion of that meeting until the Conclusion of the next annual general meeting.

(3) Casual Vacancy:

[U/S 252(4)]

The directors may fill any casual vacancy in the office of an auditor but, while any such vacancy Continues, the surviving or continuing auditor or auditors, if any may act.

U/S 252(5):

The auditor appointed to fill in any casual vacancy shall hold office until the conclusion of the next annual general meeting.

(4) Appointment By Authorities:

[U/S 252(6)]

Where the first auditors are not appointed under clause (b) of the provision sub section (3) within one hundred and twenty days (129 days) of the date of incorporation of the company, or,

→ Where at an annual general meeting no auditors are appointed or,

→ Where auditors appointed are unwilling to act as auditors of the company, or.

→ Where a casual vacancy in the office of an auditor is not filled within 30 days after the occurrence of the vacancy

The authority may appoint a person to fill the vacancy.

QUALIFICATION OF AUDITOR: **[U/S 254(1)]**

A person shall not be qualified for appointment as auditor of a public company, or a private company which is a subsidiary of a public company unless he is a Chartered accountant within the meaning of the chartered Accountant Ordinance 1961.

Provided that for a private company having paid up capital of three million rupees or more, in addition to a chartered accountant, a cost and management accountant within the meaning of the cost and management Accountant Act 1966, shall also be a person qualified for appointment as an auditor.

U/S 254(2):

A firm where of all the partners practicing in Pakistan is Chartered Accountant may be appointed by its firm name as auditors of a company referred to in sub section (1) and may act in its firm name.

DISQUALIFICATION OF AUDITOR:

U/S 253(3):

None of the following persons shall be appointed as auditor of a Company, namely:

- A person who is, or at any time during the preceding three years was a director, other officer or employee of the company.
- A person who is a partner of, or in the employment of, a director, officer or employee of the company.
- The Spouse of a director,
- A person who is indebted to the Company.
- A body Corporate.

REMOVAL OF AUDITORS: **[U/S 253]**

First Auditor: **[U/S 252(3)]**

The company in general meeting may remove any such auditor or auditors and appoint in his or their place any other person or persons who have been nominated for appointment by any member of the company not less than fourteen days (14 days) before the date of the meeting.

Subsequent Auditor: **[U/S 253(1)]**

A notice shall be required for a resolution at a company's Annual general meeting appointing as auditor a person other than a retiring auditor.

Notice of Removal: **[U/S 253(2)]**

The notice referred to in sub section (1) shall be given by a name member of the company to the company not less than fourteen days (14 days) before the annual general meeting and the company shall forth with send a copy of such notice to the retiring auditor and shall also give notice there of to its members not less than seven (7) days before the fixed for AGM and, if the company is a listed company, shall also publish it at least in one issue each of daily newspaper in English language and a daily newspaper is Urdu language having circulation in the province in which stock exchange on which the company is listed is situate.

QUESTION NO. 7

LIABILITY FOR NEGLIGENCE

INTRODUCTION:

As the auditor is appointed by the shareholders, so in the light of law of agency, auditor is an agent for shareholders and liability for negligence arises when auditor doesn't take reasonable care or exercise skill in the performance of his duties and in owing to this company sustains losses.

NEGLIGENCE (Meaning):

"Negligence means carelessness or breach of duty. It is an act of commission or omission on the part of an auditor. He may omit to do certain work under the terms of contract. He may perform his work without reasonable care."

LEGAL PROVISION:

Legal provisions supported with case laws in this regard are following:

No Suffering of Loss:

Where the auditor is proved to be negligent but no loss is sustained by this client due to his negligence, he is not liable. **(Liver Pool & Wigan Supply Association Ltd. 1907)**

Suffering of Loss:

If the auditor is proved negligence in discharging of his professional duties, he is liable to make good any loss caused by his negligence to others.

No Restriction:

No clause in an agreement into by the auditor & Co. can restrict the liability of auditors against those defined in the Co. Ordinance. Any such clause even if it is included, is against the law and is void. **(Newton vs. Birmingham Small Arms. Co. Ltd. 1906)**

Relief from Liability:

No clause in the articles of association of the company can relieve the auditor, of his liability. Section 194 of the Companies Ordinance declares any such clause to be void. If the auditor has performed his duty with reasonable sill and care he can be released from the liability.

Action against the Auditor:

The company can sue auditor at any time during its lifetime for negligence.

CASE LAWS

(1) LONDON OIL STORAGE CO. LTD. VS SEEAR HASLUCK & CO. (1904)

Facts of Case:

The balance, as shown by the petty cash book in this case amounted to 796£, while actual cash in hand amounted to 30£ only.

Plaintiff's Plea:

Auditor ignored physical counting of petty cash balance in hand. He authorized wrong figures shown in balance sheet.

Defendant's Plea:

He argued that actual negligence is on part of directors who kept large sum of money with cashier that caused misappropriation.

Verdict of Court:

The main party to negligence is not auditors but directors. So loss was to be compensated by directors and auditors were relieved with nominal damages only.

(2) ARTHUR E. GREEN & CO. VS THE CENTRAL ADVANCE & DISCOUNT CORPORATION LTD. 1920):

Facts of Case:

Auditors were claiming party for their fees due from company. A counter suit was filed by money lending company and grounds were less provision of bad debts was made then required and auditor could not detect it. He relied on lists supplied by managing director. It resulted in overstatement of profit. Purpose was to give benefit to manager. Time barred debts were not disclosed.

Plaintiff's Plea:

Shareholders held the auditor liable for negligence and claimed the damages for loss sustained due to misstatement of transactions.

Verdict of Court:

Auditors could not justify all the points raised by shareholders & they wee held liable.

(3) ARMITAGE VS. BREWER & KNOTT (1932):

Facts of Case:

Miss. Harwood was the bookkeeper for business. In absence of internal check, she had an access to all books, vouchers and wages sheet. She embezzled huge amount by misstating figures in wage sheet.

Plaintiff's Plea:

It was pleaded in court of law that auditor did not vouch wage sheet.

Defendant's Plea:

Such fraud cannot be discovered by ordinary way of scrutiny but I was diligent in the performance of my duty.

Verdict of Court:

The auditor was held liable to pay 1259£.

LIABILITY FOR MISFEASANCE

Black's law dictionary defines the term as:

"The improper performance of some act which a person may lawfully do."

LEGAL PROVISIONS:

At Liquidation:

Section 412 of the Companies Ordinance provides that the court may order the auditors of a company under liquidations to repay any loss caused to the company by the misfeasance of auditors.

Action can be taken by:

For this purpose action must be taken by any one of the following during the prescribed time:

(i) The liquidator

(ii) The creditor

(iii) A contributory of the company

LIMITATION TO SUE FOR MISFEASANCE:

Proceeding against auditor or employee of company for misfeasance can be initiated within 5 years from the date of winding up or appointment of liquidator.

CASE LAWS

(1) THE KINGSTON COTTON MILLS COMPANY LTD. (1896):

Facts of Case:

Manager falsified the accounts of company by over valuation of stock in trade and resulting profits were inflated to declare more dividend. Actually dividends were paid out of capital.

Plaintiff's Plea:

Auditor was sued for misfeasance because he accepted certificate regarding stock from manager & stated in accounts a note "As per manager's certificate". He didn't conduct detailed checking.

Defendant's Plea:

Auditor relied on the stock sheets prepared by the responsible officers o the client under circumstances that did not arise suspicion.

Verdict of Court:

Auditor was not held liable. It was observed by court:

- He was not a valuer
- It was not his part of duty to take stock.
- He may rely on officials of company after taking due care and skill.

(2) LONDON & GENERAL BANK LIMITED (1895):

Facts of Case:

The bank had advanced loans which were not recoverable but these were treated as good and interest was credited to profit & loss A/C. The auditor fails to bring to the notice of shareholders the fact that there was an overvaluation of assets shown in balance sheet and dividends were paid out of capital for years 1890-1891.

Client's Plea:

The auditor was fully aware that securities were insufficient and provisions for doubtful debts were not booked.

Auditor's Plea:

The auditor plead that in his report to shareholders, the auditor stated:

"The value of the assets as shown by the balance sheet is dependent upon realization".

Verdict of Court:

The court held auditor guilty of misfeasance if he knows that in the balance sheet proper disclosures is not made regarding assets. He should simply state this fact in his report so he has to pay the dividend of two years.

(3) **WEST MINISTER ROAD CONSTRUCTION CO. LTD. (1932):**

Facts of Case:

As a matter of fact two defaults were committed by auditor first was over statement o work in progress in balance sheet and second understatement of liabilities by under casting credit purchases and automatically profit inflated to £3458 where actual profits were £297. Due to this, dividend was paid out of capital

Plaintiff's Plea:

It was pointed by shareholders that auditor left many invoices unchecked which were of concerned period.

Verdict of Court:

Auditors were held responsible and directed to return to company the amount of dividend wrongly paid plus interest for the period.

QUESTION NO. 8

COMMON POINTS FOR ALL SPECIAL AUDITS

Auditor has to probe into different facts when he conduct audit in different classes of businesses. There are many steps important to be considered for one industry but not advantageous for another industry. For example, audit in manufacturing business requires financial information, which would have no importance in banking business. However some general points can be summed up which are nearly applicable in every type of business:

(1) **Efficiency of Internal Control:**

First of all, Auditor see the efficiency of internal control before starting an exhaustive audit work in the organization. Auditor is not merely a machine of checking vouchers and records. He is not a detective but a watch-dog so test system, internal audit and other environmental controls of organization. Sample size in test checking always depends on level of reliance on internal control system.

(2) **Verification of Cash in Hand:**

The liquid position of organization is very important for decision makers so auditor utilizes his professional skills to discover embezzlements of cash. It is the only item, which at no cost can be test checked. Detailed scrutiny of cash takes place by comparing Cash Book items with cash receipt and cash payment vouchers and also confirmations are made from third party. For example cash received from debtors can be verified with his records and auditors can demand statement of accounts from debtors to confirm the amount received. To find any difference in book balance and physical balance, cash should be counted physically on the date of balance sheet.

(3) Verification of Bank Balance:

Often bank balance does not appear in cash book as it is shown in bank statement due to unpresented cheques, uncredited cheques, receipt from customer directly in bank and bank charges directly deducated. Bank reconciliation statement should be checked in this context so that undue discrepancy is found out. He should also check serial numbering of bank vouchers and missing vouchers must be queried with bank and company officials.

(4) Legal Documents of Business:

Auditor should read legal documents of the company in detail. Careful reading of memorandum, articles, prospectus and manuals of company will highlight the remunerations of directors, policies of company, credit limit, rights and duties of directors and managers etc. auditor can posses copies of these legal documents as working papers helpful not only for reporting but also for next audit in the same company.

(5) Comparative Study of Previous Years Balance Sheets:

Overall trend of business and abnormalities in different assets can only be scanned by comprehensive study of previous years audited balance sheets in contrast of this year financial results. Comparison of previous year and current year statement will highlight all the abnormal differences. Usually horizontal and vertical analyses are practiced to watch the trends of financial figures.

(6) Proper Allocation of Capital and Revenue Items:

Accountants wrongly charge capital and revenue items to understate or overstate the business profits, so auditors should check proper allocation of capital and revenue items. Dislocation is an error of principle and very important to detect for opinion on financial statements. Expenses on purchase of assets, initiation of business, extension of business, giving long term benefit and increasing the earning capacity of business are capital in nature so should not be treated as revenue. Similarly receipts from sale of assets, from surrender of right, from substituting source of income are capital receipt so auditor should confirm their existence in balance sheet only.

(7) Adequate Depreciation:

Sometimes profits are under stated to avoid tax or overstated to show more profits and accountants do it by charging more or less depreciation inconsistently without considering the usage of asset. Auditor should see that depreciation is charged on consistent basis. Physical value of asset can help in estimating the amount of depreciation chargeable in profit and loss account.

(8) Apportioning of Mixed Accounts:

It is a generally accepted accounting principle the expense or income should be recorded for a current accounting year even when cash is paid or received for more years. So auditor should check that advance payment or receipt of cash is recorded in balance sheet and no effect in profit and loss account. Outstanding expenses and unearned incomes must be on liability side whereas prepaid expenses and accrued incomes must be placed on asset side. Auditor's duty is to see that outstanding and prepaid items are shown with correct amounts.

(9) Graphs:

Shareholders are interested in profits so auditor is appointed to check overall financial position of the business. Auditors in modern times, draw graphs to see the fluctuations in profits with respect to time. On graph, months of fiscal period should be on X-Axis and profits or turnover on Y-Axis. This measure will show the consistency or deviation in profits for a particular period. Occurrence of fraud is likely to be in a period where there is an unexpected lies or fall in trend line. Such visual displays are very helpful for auditor when he has to apply test checking. Only abnormal periods will be checked in detail and smooth period can be test checked.

(10) Inspection of Wages Sheet:

Wages and salaries would carry many errors and frauds so wages should be carefully checked. After cashbook, wages sheet requires more concentration because frauds often exist in these two subsidiary records. Auditor can point out salary of dummy workers by proper vouching of Cash Book with wages sheet, leave register and appointment letters of employees.

(11) No Access to Ledgers:

Cashiers should not have an access towards ledger. If cashier is all in all in receiving, vouching and posting cash transactions then frauds of same family like teeming, and lading, kitting and short banking will be common. Auditor should see that separate persons are appointed for ledger maintenance and for cash receipt.

(12) Existing of Secret Reserves:

Audit of special organization is an obvious agency work for shareholders so he is responsible to discover any secret reserves maintained by management. Accountants record secret reserves under wrong head like under the head provision of taxation so auditor should be very careful regarding any abnormal figure of balance sheet.

(13) Schedules of Debtors and Creditors:

Amount of debtors and creditor shown in balance sheet often disturb the short-term solvency position of business. Auditor should verify amount of debtors and creditors with schedules or with subsidiary ledgers. Aging report is also helpful in determining bad debts and in finding age of each debt. Concerned debtor or creditor may also be visited to confirm the figures shown in schedule.

(14) Adequate Supporting Evidences:

Entry without substance (supporting evidence) has no recognition in financial terms so auditor is responsible to check that every expense recorded in books has its supporting evidence. List of missing vouchers should be prepared because fraudulent entries often have a link with such missing vouchers.

(15) Schedule of Loans and Overdraft:

Overdraft from bank is the regular practice of every business to keep the cash cycle active. All the working capital loans, overdrafts and guarantees from bank must be confirmed from bank officials. A systematic way is to prepare a list of borrowings with reference to time period and their utilization should be analyzed in concerned accounts. Credit limit should also be confirmed so that borrowing powers are checked with legal documents of the company. Auditor should also take of securities under charge and accounts on which lien in marked.

(16) Valuation of Current Year Balance Sheet:

Balance sheet is a last resort of financial position and it carries effect of all other financial statements so every item requires scrutiny. Balance sheet is a statement containing assets on one side and owner's equity and liabilities on other side. Shareholders' equity should be in accordance of legal documents (capital clause of memorandum). Outsider' funds are placed in balance sheet under the contracts and agreements with banks and other parties. Fixed assets must be shown at depreciated value and current assets are to be recorded under the rule of cost or market price whichever is less.

(17) Careful Reading of Minute Book:

The proceeding of directors' meeting carry answers of many queries of auditor. So minute book, containing all the important decision and suggestions of directors and shareholders should carefully be read. Powers of directors, financial policies of organization and other information always come from minute book.

(18) Inspection of Marketable Securities and Investments:

Fluctuations in securities are inherent so day-to-day price fluctuation in market should be compared with face value and lesser value should be considered. If abnormal fluctuations are frequent in securities then auditor should see that whether proper provision is made out of profit for investment fluctuation fund.