6th Semester B.com Cooperation
University Calicut

Auditing and Corporate Governance

Prepared by

Safeer parayil
Assistant Professor
PG Department of Commerce

CPA COLLEGE OF GLOBAL STUDIES PUTHANATHANI

BC6B13 AUDITING AND CORPORATE GOVERNANCE

Lecture Hours per week: 5 Credits: 4
Internal: 20, External: 80

Objective: To provide knowledge of auditing principles and techniques and to familiarize the Students with the understanding of issues and practices of corporate governance in the global and Indian context.

Module I:
Auditing – Meaning – Objects - Basic Principles and Techniques – Auditing and investigation - Classification of Audit - Audit Planning – Qualities of an auditor – Advantages and limitations of Audit - 10 hours

Module II
Audit Procedures: Vouching - Definition - Features - Examining vouchers -Vouching of cash Book - Vouching of trading transactions - Verification and valuation of assets and liabilities: Meaning - Definition and objects - Vouching v/s verification - Verification and Valuation of Different assets and liabilities – 20 hours

Module III
Internal Control - Internal Check - Internal Audit --Definitions - Necessity - Difference between Internal check and internal control - Fundamental Principles of internal check - Difference between Internal check and internal audit - Special Areas of Audit: Tax audit and Management Audit - Recent trends in auditing - Relevant Auditing and Assurance Standards (AASs) - Rights duties and Liabilities of auditor - Audit committee - Auditor's Report - Contents and types - Auditors Certificate. -20 hours

Module IV: Conceptual Framework of Corporate Governance: Meaning, Theories, Models and Benefits of Corporate Governance; Board Committees and their Functions; Insider Trading; Rating Agencies; Green Governance/E-governance; Clause 49 of Listing Agreement; Class Action; Whistle Blowing; Shareholders Activism - 20 hours

Module V
Major Corporate governance failures - BCCI (UK) - Maxwell Communication (UK) - Enron (USA – Satyam Computer Services Ltd - TATA Finance - Kingfisher Airlines - Common Governance Problems Noticed in various Corporate Failures - Codes and Standards on Corporate Governance - 10 hours

Suggested Readings:

1. Institute of Chartered Accountants of India, Auditing and Assurance Standards, ICAI, New Delhi.
2. Relevant Publications of ICAI on Auditing (CARO).
3. Gupta, Kamal and Ashok Arora, Fundamentals of Auditing, Tata Mc-Graw Hill Publishing Co. Ltd., New Delhi.
4. Ghatalia, S.V., Practical Auditing, Allied Publishers Private L td., New Delhi.
5. Singh, A. K. and Gupta Lovleen, Auditing Theory and Practice, Galgotia Publishing Company.
6. Mallin, Christine A., Corporate Governance (Indian Edition), Oxford University Press, New Delhi.
7. Rani, Geeta D., and R.K. Mishra, Corporate Governance- Theory and Practice, Excel Books, New Delhi.
8. Bob Tricker, Corporate Governance-Principles, Policies, and Practice (Indian Edition), Oxford University Press, New Delhi.
9. Sharma, J.P., Corporate Governance, Business Ethics, and CSR, Ane Books Pvt Ltd, New Delhi.

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AUDITING

Module 1

Meaning And Definition of auditing

HISTORY AND ORIGIN OFAUDITING

Auditing in its crude form originated almost simultaneously with the development of organised system of accounting. The practice of auditing accounts originated from the necessity of instituting some system of check upon persons who handle the money, record receipts of payments on behalf of others that requires some kind of checks and balances. In the past, right from 3600-3200 BC, the Mesopotamian commercial transaction indicates, tiny marks, dots, ticks and circles at the side of the figures indicating that those figures had been checked. The accounts public institutions in Egypt and Greece. The wealthy Romans who of designed an effective system of financial Administration, distinguished between person responsible for actual receipts and for payment. They had also established an elaborate system of checks and counter checks within the financial administration.

Reasons for the Development of Professional Audit

1. Renaissance
2. Introduction of double entry
3. Industrial Revolution
4. Introduction of Statutory Auditing.
5. Companies Act 1956
6. International Standard for Accounting and Auditing
7. International Standard for Accounting and Auditing
8. Computer Accounting
9. Auditing Practices.
10. The Securities and Exchange Board of India Act
11. Corporate Governance
12. Emergence of multinational companies
13. Globalization

14. Nano Technology
15. Independence of auditor
16. Removal of restrictions on taking up audit work in U.S.
17. Right to information Act
18. The new Companies Act 2013
19. The new Companies Act 2013

MEANING OF AUDITING

The word Audit is derived from the Latin word "audire" which means, "to hear". In olden days the owners of the business appointed certain person to check the accounts whenever they suspected fraud. The persons responsible for financial transaction used to satisfy auditors by their oral explanations. The Auditor used to "hear" whatever they had to say in connection with accounts. The persons to hear such explanations regarding financial transaction were known as "Auditors". Thus the term Auditor literally means "hearer, one "who hears" and is used ever since the day when public accounts were accepted and approved on the basis of hearing the accounts read.

Definition of Auditing

Spicer and Pegler: "Such an examination of the books, accounts and vouchers of a business as will enable the auditor to satisfy himself that the balance sheet is properly drown up, so as to give a true and fair view of the state of affairs of the business and whether the profit and loss accounts gives a true and fair view of the profit or loss for the financial period, according to the best of his information and the explanations given to him and as is shown by the books, and if not, in what respect he is not satisfied".

Eric and Kohler:Audit is an exploratory critical view by a public accountant of the underline internal controls and accounting records of a business enterprises or other economic unit precedent to the expressions by him of an opinion of the propriety of its financial statements".

From a detailed analysis of the definitions given above, the following important aspects are revealed.

1. Audit is an examination of books, accounts, other records and supporting vouchers.

2. The Auditor has not only to see the arithmetical accuracy of the books of accounts, but has also to go further and find out whether the transactions entered in the books of original entry are correct or not.

3. The purpose of auditing, therefore, lives in ascertaining whether the working results for a particular period as shown by profit and loss accounts and the exact financial position of the business reflected in the Balance sheet.

4. Auditing of a business house enables an auditor to satisfy himself as to whether the profit and loss accounts and Balance sheet exhibit and a true and fair view of the state of affairs of a concern.

DIFFERENCES BETWEEN AUDIT AND BOOKKEEPING:

BOOK-KEEPING	AUDITING
1. It is the art of recording the daily transactions in a set of financial books (Journal and Ledgers)	1. It is the verification of the accuracy of the entries made in the books of accounts by accounts (bookkeepers) clerks.
2. The work of Bookkeeping is done by the junior accountants or Bookkeepers.	2. The work is done by auditors.
3. Generally bookkeepers do not possess any specialised training for recording business transactions.	3. The Auditors are required to have special knowledge and training (qualified Chartered Accountants)
4. The work in bookkeeping is mainly concerned with journalising, posting, totaling and balancing various ledger accounts.	4. The main work is concerned with verification and thorough scrutiny of accounts as the recorded transactions are bona fide.
5. The work is more or less of mechanical or of routine in nature. Now computer bookkeeping machines and ledger machines are used for bookkeeping.	5. The work of auditing is of technical nature.
6. Bookkeeping is a continuous process done throughout the year.	6. Generally auditing is at the completion of the year.
7. Bookkeepers are regular and paid employees.	7. Auditors are outsiders appointed for the specific job and are paid a fixed fee.

8. Bookkeeping work is constructive in approach.	8. Audit work is critical and analytical in approach.
9. The work of bookkeeping precedes auditing.	9. The work of auditing starts where the bookkeeping ends.
10. Bookkeeping is of the current period.	10. Auditing is retrospective.
11. Bookkeepers need not prepare reports, they record transaction in various books maintained by the firms.	11. Auditors must prepare a report and sent to the person(s) who appointed him.

DIFFERENCES BETWEEN AUDITING AND ACCOUNTANCY

ACCOUNTANCY	AUDITING
1. Accountancy begins where Bookkeeping ends. 2. The man who performs the work of accountancy is called Accountant. 3. It is not necessary for the accountant to pass the Chartered Accountant's examination. 4. (It includes preparation of trial balance, making adjustments, preparing profit and loss account and Balance sheet and the analysis and interpretation of the financial statement. 5. The accountant prepares trail balance and final account of the concern. 6. The work of Accountants continuous throughout the whole financial year. 7. An Accountants has to prepare the financial statements of the concern. 8. Accountancy is a necessity.	1. Where Accountancy ends, Auditing begins 2. The man interested with the work of auditing is called an Auditor. 3. It is compulsory for him to posses a C A Degree and a membership in the Institute of Chartered Accountants. 4. Audit is concerned with the analytical and critical examinations of the books, accounts and the financial statements, to find out their accuracy. 5. The Auditor is to find out whether the final accounts exhibits a true and fair view of the state of affairs of the concern

9. An Accountant is a salaried staff and regular employee of the concern; he is an insider. 10. An Accountant is not require to submit any report to the proprietors of the business,	6. Auditing is generally undertaken after the close of the year when the final accounts have already been prepared 7. The Auditor has to verify and report the accuracy and authenticity of the accounts, and see which is drawn as per Companies Act (In the case of companies). 8. Auditing was a luxury (old concepts due to its heavy fees). Now it is a necessity. 9. An Auditor is an outsider and he is paid a fixed fee. 10. An Auditor is required to submit an Audit Report to the proprietor of the business regarding the fairness and financial.

OBJECTS OF AUDITING

According to changing nature and complexities of business the purpose, scope and objects of audits are subject to change. Developments in the last few decades have extended the scope of auditing. Auditing today is no longer concerned only with financial accounting records. It may also involve a review of costing records, operations and performances.

Later Auditing began to have the twin objects of prevention and detection of errors and fraud.

According to change in view from time to time the object of audit may be classified as

(a) Primary object and

(b) Subsidiary object.

Primary Object (Main or Principal object)

As Taylor and Party observes, "Today, the main object of Audit is to ensure the accounts reveal a true and fair view of business and its transactions. This leads to greater emphasize being placed on ascertaining the reliability of records from which the accounts are drawn up and also on verifying the assets, liabilities and transactions within the accounts.

In short, the primary objective of auditing is reporting to the management and to see whether the final accounts are drawn as per law.

Subsidiary objects or ancillary or incidental objects

During the course of verification of accounts, the auditor may come across many errors and frauds. No doubt, detention and prevention-of errors and frauds are also the duties of an auditor. But they are incidental or ancillary objects of auditing. The subsidiary objects of audit are:

(i) Detection and prevention of errors
(ii) Detection and prevention of frauds

Errors in accounting are to be classified as clerical errors and technical errors.

(a) Clerical errors are: - (i) Errors of omission (ii) Errors of commission (iii) Compensating errors.

(b) Technical error is error of principles.

1. **ERRORS OF OMISSION**

   The Errors of omission arise when a transaction is wholly or partly omitted being properly recorded in the books. Complete omission means omitting to record the debit and credit aspect of a transaction in the subsidiary books. Such errors do not effect the agreement of trial balances.

   Partial Omission: - This type of error occurs when one aspects of a transaction have been omitted to record (either debit or credit aspect). For example wage paid for Rs.150 is posted in the daybook but omitted to record in the wages register. When preparing the trial balance, a difference of Rs.150 will occur. Thus trial balance discloses this type of partial errors.

Detection of errors of omission and auditor's duty

If the errors of omission will materially affect the result shown by accounts or not will depend on the nature of these omissions. The omission can be detected by careful scrutiny. The auditor can detect these errors only by carrying out a thorough and efficient checking of a records such as ledger bills, receipts, invoice, correspondence accounts, debtors and creditors statement etc.... But in large business firms the auditor is forced to rely to a certain extent upon the internal checks in the business. It will help him in the performance of his duties. Thus the detection and prevention of errors of omission is an important part of the duty of an auditor.

2. **ERRORS OF COMMISSION**

   Errors of Commission generally arise when a transaction has been recorded and wrongly entered in the original entry ledger due to negligence. For example a credit sale of Rs.360 to A is entered in A's ledger Rs.630. There is a difference in A's Account of Rs.270 in excess. Rent paid Rs.1000 debited to rent account as Rs.100. There is a short of Rs.900 in the rent account. Normally the error in totaling happens as a short or excess Rs.10, 100, 1000 and so on. The totaling error on the credit side of the trial balance will affect the debit side of the trial balance.

Detection of Errors commission and Auditor's duty

The errors of commission are mistakes in casting calculations posting, carrying forward etc..... Some of such errors will be detected by disagreement of trial balance. If an error has been committed in the invoice for sale of goods, the errors will not be detected as the mistakes will appear both in the original books and in the ledger.

3. **COMPENSATING ERRORS OR OFFSETTING ERRORS**

   A compensating error or offsetting error is one, which is counter balanced by another error. For example rent paid account is overcast by Rs.1000 and rent received is over cast by Rs.1000. Another example is sales ledger under cast by Rs.100 and purchase ledger also under cast by Rs.100. Both errors are counter balanced by another error.

Detection of Error

Compensating error does not affect the agreement of trial balance. It is not easy to discover these errors as they offset each other. This error may or may not affect the profit and loss account. The detection of this type of error requires a complete and thorough checking of different books of accounts.

Auditor's Duty

Compensating errors are most dangerous and are difficult to guard against these errors do not affect the agreement of trial balance and will not be detected easily A thorough and exhaustive preparation on the part of the auditor will help to detect such errors.

4. **4.ERRORS OF PRINCIPLES**

   Errors of principles arise when entries are recorded against the accepted Fundamental principles of accountancy. The errors of principles arise in the following cases.

   (a) Valuation of assets on wrong principles, particularly stock in trade

   (b) Wrong allocation of expenditure between capital and revenue

   (C) Ignoring the outstanding assets and liabilities

   (d) Posting transactions to the wrong class of accounts. (Revenue item to the wrong class of revenue account)(e.g. Advertisement posted in the salary account)

Detection of error

Errors of principle are not disclosed by trial balance or by routine checking. This error can be detected only if the auditor makes an intelligent and searching scrutiny and a thorough independent checking and verifying the minutes book, contract agreement, etc.

Prevention of Error

The prevention of error is not the primary object of audit. The auditor is not directly involved in prevention of errors. The responsibility of the auditor rests with management. The auditor informs the weakness of internal check system and inadequacy in accountancy in the firms. The auditor can recommend the method for improvement in internal control system and accounting. By detecting error the auditor can create a sense of fear of consequences upon the staff. This will help to put a moral check upon the staff. Finally it helps indirectly to prevent errors in the future.

TYPES OF FRAUD

1. Misappropriation of Cash or Defalcation or Embezzlement of Cash

Misappropriation of cash is a very easy affair especially in big concerns where the proprietor has no direct touch with and control over the persons handling cash.

A transaction relating to the receipt of cash either goes totally unrecorded or recorded at figure less than the actual one in the cashbook Thereby the cashier takes the full amount or part of the cash easily. Similarly making fictitious payment, the total amount of that transaction is pocketed by the cunning cashier.) The Misappropriation takes place in forms of

(a) Omitting to enter a receipt (Suppression of cash receipt)

(b) Acknowledging lesser amount than actual receipts.

(c) Entering fictitious payment.

Cash can be embezzled by any of the following methods.

(1) Cash received from customer for cash sales may be misappropriated by suppressing the cash memo and voucher.

(2) Recording lesser amount than actually received.

(3) Teeming and lading: It is the concealment of shortage of cash by delaying recording. The cash received from one customer is misappropriated and later cash received from another debtor is posted to the first debtor's account. This practice is known as teeming and lading

(4) Fictitious payment: It is an easy and usual method of embezzling cash. For example, wages paid for fictitious work by inclusion of dummy names

(5) Suppression of credit notes for purchases returned to creditors.

(6) Misappropriation of the proceeds of bill discounted by showing the bill in the custody.

(7) Omitting to record unusual receipt of cash ie. Sale of waste, recovery of bad debt written off.

(8) Showing false donations and charity to misappropriate an equal amount of money.

Misappropriation of cash can be detected through checking of cash book with rough cash book, salesman’s reports, counterfoils of receipt book, agents return and other original records, wage sheet, vouchers, salary book, invoice, etc. are verified with an eye of suspicious if fraud is suspected.

In big business firms, strict control should be exercised over receipt and payment of cash. A good internal check system reduces the chances of misappropriation of cash.

Auditor's duty

(1) Prevention of Fraud:

In considering the possibility of a fraud in accounts, an auditor should be concerned more with prevention of irregular practice than detection of fraud. Through checking and careful scrutiny of cashbook, vouchers, bills, wage sheet, etc. will create a sense of fear in the minds of concerned staff. This practice will help to put a moral check upon the staff of the concern.

(2) Misappropriation of goods or Defalcation of goods:

Employees may steal goods and stores. The misappropriation of goods is made when goods are valuable and less in quantity. Goods are generally, misappropriated by actual theft of valuable goods and issuing of fictitious credit notes to customers.

Misappropriation of goods cannot easily be defected; Proper records of goods inward register and outward register must be maintained. An effective system of inter check helps to prevent this type of fraud.

To reveal the misappropriation of goods and bring fraud in to light, a thorough checking of inward and outward register, invoice, sales memo, credit note, etc. has to be made by the auditor.

(3) Fraudulent manipulation of accounts or Falsification of accounts

Falsification of accounts is generally done by directors, managers and other responsible persons and not by the subordinates. It is true that whenever such a class of fraud occurs, it involves huge amounts. It is done to show a false profit.

A high profit may be shown for the following purpose.

(1) For paying higher dividend

(2) For obtaining further bank credit

(3) For getting higher commission

(4) For selling their share holding at higher price

Manipulation of accounts may be done in any of the following ways

(1) By over valuation or under valuation of stock

(2) By not providing depreciation and assets as per rules: By providing more depreciation or less depreciation

(3) by recording fictitious sales or by omission of sales

(4) By recording fictitious purchases or suppression of purchase

(5) By providing under valuation or overvaluation of liabilities

(6) By recording revenue expenditure as capital expenditure

(7) By recording capital expenditure as revenue expenditure

(8) By charging capital receipts as revenue receipts

(9) By showing expanses of next year in the current year's profit

(10) By showing income of next year in the current year's profit

(11) By not recording the accrued income or outstanding expenses in the current year profit

(12) By window dressing of account (showing outwardly a more prosperous position than what it actually is)

(13) By utilising the secret reserve without disclosing the fact to the shareholders during the year of no profit or less profit.

(4) Computer fraud

Functions of Auditor Audit Functions

1. To ascertain the system of accounting, internal control and management pattern of the organizations.

2. To examine the arithmetical accuracy of the records.

3. To conduct test check of the system of internal control to find out its soundness.

4. To review the documentary evidence in order to establish the authenticity validity and accuracy of the transactions recorded in the books of the business.

5. To verify whether all the books of accounts are maintained according to statutory requirements.

6. To verify the assets and liabilities and ensure that the assets are properly valued.

7. To examine whether the capital and revenue expenditure have been identified correctly and recorded properly in the books

8 To verify that all statutory requirements are completely met with

9. To report on the financial status of the business to the management.

10. To make recommendation to the management for improvement of the system of accounting, internal control and E.D.P environment.

11. To Conduct System Audit to the software before commencement of audit- work for knowing its effectiveness.

ADVANTAGES OF AUDITING

(1) Advantages to the business

(i)Auditing of accounts helps in detecting and preventing Errors and Fraud in accounts

(ii) It puts a moral check on employees and defalcations are avoided.

(iii) Audit ensures the accuracy of the account: Records are made up to date.

(iv) It ensures the authenticity and reliability of financial statement

(v) Loans and credits can be easily obtained from banks and financial institutions

(vi) If an auditor audits a client's account regularly he can have a close touch with the business and its accounts. Thus the auditor can suggest means for better internal check and accounting.

(vii) It is easy to complete the wealth tax, income tax, sales tax, etc. on the basis of audited accounts.
(viii) If the accounts are audited by professional and qualified auditor. The business can enjoy reputation and goodwill.

(2) Advantages to the owners of business

(i). The business owned by sole trader and partners in a partnership can rely on the audited financial statement.

(ii) In the case of shareholders of Joint Stock Companies who have no hand in the actual running business, auditing assures them of the proper maintenance of accounts and prevents directors from taking any undue advantages of their position.

(iii) In the case of a co-operative society or trust, audit assures the members that the affairs of the society or trust are conducted properly and their interests are looked after properly.

(iv) Auditor's statement of accounts provides a mutually satisfactory basis for settlement of disputes between partners. It also helps valuation of assets in admission, retirement, death of a partner, etc.

(v) As the auditor's advice can be sought by the management to improve the functioning of business particularly to introduce or strengthen internal control and thereby avoid fraud and errors eliminate wastages and losses.

(3) Advantages to the society

(i) Audited statement of accounts is more reliable to creditors and Banks for sanctioning credit and other advances (The Income tax and Sales tax authorities consider audited accounts to be reliable)

(ii) For settlement of disputes between workers regarding demand for more wage and bonus, audited accounts are considered a valuable and reliable document.

(iv) For determining fire insurance claims previous years audited financial statements are useful.

(v) The purchaser of business can easily calculate the purchase considerations on the basis of audited accounts.

(vi) The audited accounts of a joint stock company create a confidence in the minds of the investors.

LIMITATION OF AUDITING

(i) The main work of audit is checking, verifying, vouching, etc. Detecting error and fraud is its routine nature, the auditing cannot show signals about inefficiency of management and business ethics and finance.

(ii) The auditor mainly fails to detect fraud in the accounts presented before him as they are already manipulated by people at the helm of affairs of the firm in a clever manner. The auditing may not reveal such manipulations.

(iii) The valuation of stock in trade goods in progress and finished goods is not possible to fix market rate. The valuation is practically guesswork. This valuation done by the officials of the firm is accepted by the auditor. Therefore the genuineness of audit is questionable.

(iv) Due to lack of time, it is not possible to check all the accounts and auditor adopts a method of test checking. It means that audited accounts may be incomplete and incorrect.

(v) The personal judgment of auditor is sometimes, faulty. Therefore, the audited accounts may not exhibit a correct position

(vi) in the auditor is not equipped with and has not mastered in modern changes, in accounting procedure, auditing becomes a complicated affair. (vii) Auditing is usually performed at the end of the year. It has no use for the past and present, it will be useful only for future.

(vii) If the auditor is not bold and independent, the purpose of Audit will never be fulfilled.

(viii) No doubt the 'watch dog' concept of auditor limits the scope of audit.

AUDITING AND CORPORATE GOVERNANCE

Module 2

6th Semester Bcom Cooperation

Vouching

Vouching is a Technical term, which refers to the inspection of documentary evidence supporting and substantiating a transaction, by an auditor

Features of Vouching

1. Three-party relationship.
2. Subject matter.
3. Evidence.
4. Established criteria.
5. Opinion.

Objectives of Vouching

1. To Detect Errors And Frauds
2. To Know The Truth Of Account
3. To Find The Unrecorded Transactions
4. To Know That All The Transactions Are Authorized
5. To Know That Only The Business Transactions Are Recorded

Types of Vouchers

1. Primary vouchers
2. Secondary vouchers

Primary Vouchers

Primary voucher refers to the written evidence in original. Examples of primary voucher are purchase invoice, cash memo, bills, confirmation of balances, bank statements, contracts, etc

Secondary Vouchers

Secondary vouchers are those which are not related to business but also used as evidence. Such as duplicate bills, carbon copies etc

Essentials of Valid Vouchers

1. It may be express or implied

2. It must create legal relation
3. It must be definite & clear
4. It is different from invitation to offer
5. It may be specific or general
6. It should not contain negative condition
7. It must be communicated to the offeree
8. It may be subject to any terms & conditions

<u>Vouching of Credit Side of Cash Book</u>

1. Bank over draft
2. Cash purchases
3. Payment of creditors
4. Payment of wages
5. Payment of salaries
6. Directors of fees
7. Travelers commission and expenses
8. Bills payable
9. Loans advanced
10. Purchase of investment
11. Acquisition of plant and machinery
12. Purchase of land and building
13. Patents and copyright
14. Advertising
15. Interest of loan
16. Dividend paid
17. Rates and taxes
18. Payment tax
19. Petty cash book

<u>Vouching of Trading Transactions</u>

1. **Vouching of purchases ledger**

   Purchases Book is meant for recording transactions relating to credit purchases of goods. The other names of Purchases Ledger are purchases day book, purchase journal, bought book, bought daily book or invoice book

2. **Purchase Returns**

   A purchase return occurs when a buyer returns merchandise that it had purchased from a supplier. Since the return of purchased merchandise is time consuming and costly, under the periodic inventory system there will be an account Purchases Returns. This allows the company's management to see the magnitude of the returns that occurred.

3. **Credit Sales**

Credit sales are purchases made by customers for which payment is delayed. Delayed payments allow customers to generate cash with the purchased goods, which is then used to pay back the seller. Thus, a reasonable payment delay allows customers to make additional purchases. The use of credit sales is a key competitive tool in some industries, where longer payment terms can be used to attract additional customers.

4. **Sales Reruns**

A sales return is an adjustment to sales that arises from actual return by a customer of merchandise he/she previously bought from the business. It is commonly recorded under the account "Sales Returns and Allowances".

5. **Vouching of Bills Receivable Book**

If the bills raised by the organization are accepted by the customers/sundry debtors, it is called Bills receivable and the amount will be debited in the Bills Receivable Account and credited in the sundry debtors account.

6. **Goods Sent on Sale or Return System**

When goods are sent on a "sale or return" or on "approval" basis, these goods are not treated as sales unless they are approved (purchased) by the customer. However if at the inventory count date, these goods are held by its customers without approval then they are taken as unsold goods. In that case, they are included in the seller's inventory valuation but not in the figure for sales.

7. **Goods Sent On Consignment**

Consignment is a commercial agreement where a company, often called a consignee, agrees to pay a seller or consignor for selling products. Usually, consignment companies are discount stores specializing in a particular form of a consumer product.
The company purchases items for sale and agrees to pay a share of the proceeds to the retailer when they sell goods.

8. **Vouching of Journal Proper**

Journal proper is meant for recording all those transactions which cannot be recorded in the other subsidiary books via purchase book, sales book, purchase return book, sales return book, cash book, B/R book, B/P book. The following entries are recorded in the journal proper.

9. **Sales Ledger**

   Sales ledger is a ledger entry that records any sale in the book of records, even if the payment is received or not yet received. They record not only sales but also sales returns, which is a negative entry since the product that was sold is returned

10. **Purchase Ledger**

    A record of a company's purchases of goods and services showing the amounts paid and due

Verification of Assets and Liabilities

Verification means, the examinations of establishing the truth as to existence, ownership, possession, and valuation of assets and liabilities of an enterprise as disclosed in the balance sheet.

Objectives Verification of Assets and Liabilities

1. To know whether the Balance Sheet exhibits a true and fair view of the state of affairs of the business.
2. To show the correct value of assets and liabilities.
3. To find out the ownership, possession and title of the assets appearing in the Balance Sheet.
4. To find out whether assets are in existence.
5. To detect frauds and errors, if any while recording assets in the books of the concern.
6. To find out whether there is an adequate internal control regarding acquisition, utilization and disposal of assets.
7. To verify the arithmetic accuracy of the accounts.
8. To ensure that the assets have been properly recorded.

General Principles for Valuation

1. Fixed assets
2. Current assets
3. Intangible assets
4. Wasting assets

5. Fictitious assets

Classifications of Liabilities

1. Current liabilities
2. Fixed liabilities
3. Contingent liabilities

Current Liabilities

current liabilities are often understood as all liabilities of the business that are to be settled in cash within the fiscal year or the operating cycle of a given firm, whichever period is longer

Fixed Liabilities

Fixed liabilities are debts which are not likely to become mature for a long period of time, typically over a year. This includes bonds, mortgages or long-term loans. Also known as long-term liabilities, these debts are included in the business's balance sheet

Contingent Liabilities

Contingent liabilities are liabilities that may be incurred by an entity depending on the outcome of an uncertain future event such as the outcome of a pending lawsuit

Verification of Various Kinds of Assets

1. **Cash in Hand**

   Payment for goods and services in cash rather than by cheque or other means, typically as a way of avoiding the payment of tax on the amount earned
2. **Cash at Bank**

   Cash at bank and in hand refers to amounts which are held by a business in the form of notes and coins (e.g. petty cash) or which are held at a bank in the form of on demand deposits such as current accounts and savings accounts. Cash at bank and in hand is part of current assets in the balance sheet
3. **Loans Advanced**

   Loan Advance means any full or partial advance of a Loan made by Lender to or for the benefit of Borrower. Loan Advance means an extension of credit pursuant to a Line of Credit
4. **Bills Receivable**

he bills of exchange that a company will receive payment for in the future, and the part of the company's accounts that shows these bills. Bills receivable form part of a company's assets.

5. **Debtors**

   A debtor or debtor is a legal entity that owes a debt to another entity. The entity may be an individual, a firm, a government, a company or other legal person. The counterparty is called a creditor. When the counterpart of this debt arrangement is a bank, the debtor is more often referred to as a borrowed

Classification of Cost

1. Unit coat
2. Average cost
3. First in first out method (FIFO)
4. Last in first out method (LIFO)
5. Stand cost methods
6. Adjusted selling price methods
7. Base stock methods

Market Price Computation

1. Replacement cost
2. Net realizable value

MODULE 3

INTERNAL CONTROL AND INTERNAL CHECK

Internal Control

It is an overall control system internal management It is an overall plan for internal management. In this system a number of checks and controls are exercised in the business to ensure its efficient and profitable working of the firm. Internal audit and internal checks are other accounting and non-accounting controls. It is an overall planning and its practical operation is included in the definition of internal control.

INTERNAL AUDIT

Large business houses have separate departments for internal audit. This department consists of an auditor and audit clerks. They are all salaried employees of the firm.

Internal audit is the independent review of operation and other records of the firm. The review means the critical analysis of financial non-financial records. Internal Audit made compulsory to the Cos Act 2013.

Definition

Prof. Walter B. Meigs: "Internal auditing consists of a continuous critical review of financial and operating activities by a staff of auditors functioning as full time salaries employees."

OBJECTIVES OF INTERNAL AUDIT-SIGNIFICANCE

1. To ensure the management that the internal check and the accounting system are effective in design and operation.

2. It is the independent review of operation of the business both financial and non-financial.

3. It keeps a watch over the income and expenditure of the business

4. It sees that the expenditure does not exceed the budgeted amount.

5. It sees that there is no wastage of materials expenses.

6. Finally it verifies that the organization follows the policies and practices frames by management.

FEATURES OF INTERNAL AUDIT

1) Internal is compulsory.

2) It is continuous audit.

3) Internal audit is suitable to large business organizations like banks, insurance companies, local bodies etc.

4) The internal audit is generally conducted by own employees of the firm specially appointed for the purpose. Sometimes professional Chartered Accountant is also appointed for the purpose. They are called internal auditors.

5) The internal audit is conducted for ascertaining that the internal control system existed in the organization is effective.

6) To see whether operations or programs we being carried out as planned by top management.

7) The object of internal audit varies from business to business depending on its different nature.

DIFFERENCE BETWEEN INTERNAL CHECK AND INTERNAL AUDIT

INTERNAL CHECK	INTERNALAUDIT
1. The work of one clerk is automatically checked by another at the same time.	1. The work of one clerk checked by another after the former has completed the work.
2. It is device to minimize the chance of error and fraud.	2. It is a device to detect fraud and error already committed.
3. No separate staff is appointed for the purpose of internal check.	3. Internal auditors are specially appointed
4.A firm easily adopts internal check system	4. Only large firms can afford the cost of internal audit.
5. It is for the internal management.	5. It is for top management.
6. It is treated as instant audit:	

	6. It is considered as management audit or operational audit.

INTERNALAUDIT vs. INDEPENDENT AUDIT

Main Differences	Internal Audit	Independent Audit
1) Appointment	Internal auditor is appointed by management	Appointed by shareholder or Comptroller and Auditor General
2) Nature of Audit	Compulsory	Compulsory by Statute.
3) Qualifications	No Professional qualifications required	Qualification under sec. 226 of Companies Act.
4) Status of auditor	Generally staff of the organisation	Independent person
5) Manner of auditor	Continuous audit	Conducted after a period
6) Objectives	To ensure compliance with established policies, plans and procedure of the organisation	To ensure that accounts and financial statement are pre pared as per law, and they give a true and fair view of the business and balance sheet gives a true and fair view of the financial position of the business.
7) Detection and prevention of error and fraud	Important objectives	Detection and prevention of error and fraud is only incident.
8) Scope	Scope of audit is determined by management.	Defined in the statute
9) Dependency.	Dependent on man agreement.	Independent from management.
10) Determination of duty	Duty can be modified by the management	Duty cannot be modified
11) Removal of auditor	Can be removed by *management,	Can be removed by Shareholders.
12) Report	Report to management.	Report is submit ted to the shareholders.

INTERNAL CHECK

Prof. Arnold W. Johnson defines internal check as" one wherein the accounting work of one employee is complemented and verified by the work of another employee, both employees working independently and without duplication of each others work".

Objectives of internal check

1. It is the division of work among the staff.

2. The work of one of the staff is automatically checked by another.

3.No staff is allowed to do any single work from beginning to end.

4. It is aimed at preventing errors and fraud.

5. Errors and frauds are automatically discovered.

Advantages of internal check

L Advantages to the owner.

1. If there is a good internal check system, the owner of the business can rely upon the genuineness and accuracy of the accounts.

2. A good internal check leads to better efficiency and economy in operation. This will result in increasing profit and therefore the company can declare more dividends.

IL Advantages to the business

1. Division of work: Proper distribution of work among the staff according to their experience and qualification.

2. Early detection of fraud and error: It helps to detect irregularities, frauds and errors early.

3. Fixation of responsibility: Division of work helps to fix responsibility of each one of the staff.

4. Preparation of final accounts: - Internal audit helps early and quick preparation of final accounts.

5. Makes audit works easy.

III. Benefits to the Auditor

1. Need not have a detailed checking.

2. Rely on test checking.

Disadvantages or limitation of internal check

1. Not suitable for small firms.

2. Sacrifice of quality of work.

3. Tends to slacken efforts.

4. It creates chaos and disorder.

5. Risky for auditor

The principles or essentials of a good internal check system.

1. The system must be expressed and responsibility will be fixed to each one of the staff.

2. The system should be practical and simple

3. The system should be carefully designed and suitable to the nature of business.

4. The system should be economical.

5. Careful selection, proper on job training and better placement of the staff should be provided.

6 One single person should not be allowed to have an independent control over any important aspect of the business

7. The work of one of the staff should ordinary come under the review of one or two other persons.

8. Division of work among staff shall allowed on the basis of experiences and qualifications

9. No person shall be allowed to perform any work fully from beginning to the end.

10. The rotation of employees should be made frequently without giving advance notice.

11. Staffs dealing with cash, goods or records in their charge should be encouraged to go on leave at least once in a year.

12. Accounting records should not be made by those dealing with cash.

13. Preparation of wage sheet must involve several hands and careful checking.

14. Over timework should be allowed on special occasion only under strict supervision

15. Proper register should be provided and unused cheque; bills, etc. should be kept in safe custody.

16. Ledger keepers should not be allowed to remain in charge of particular ledger too long.

17. Balance of personal ledger accounts should be informed to the debtors or creditors concerned for confirmation.

18. A good stock purchase rule regarding purchase, issue, balance should be maintained

19. Annual stock taking verification should be done.

20. No member of the staff should be allowed to take away goods without proper permission.

21. There should be a system of perpetual inventory control for continuous

Position of a company auditor (Status of a Company auditor)

a) He is an agent to the shareholders.

b) He is an officer of the Company

c) He is a servant of the company

Rights and powers of an auditor

1. Right of access to books of accounts and vouchers

2. Right to visit branches

3. Right to obtain information and explanation

4. Right to correct wrong statement

5. Right to comment on the inadequacy of the accounting system

6. Right to receive notice and attend general meeting

7. Right to have legal and technical advice

8. Right to be indemnified

9. Right to receive remuneration as the first auditor

10. Right to sign the audit report

Duties of an auditor:

A) Statutory duties:

1. Duty to make enquiries

2. Duty to report on accounts audited by him

3. Duty according to the direction of the central government

4. Duty to report for prospectus

5. Duty to certify declaration of solvency

6. Duty to assist inspectors

7. Duty to assist public prosecutor.

B) Duties arising out of common law:

1. To ascertain unutilized capacities of the industry

2. Position of current assets

3. Extent of over stocking stores etc.

C) Duties arising out of professional etiquette:

1. Every auditor should carry on his duties with due regard to public interest and not his personal interest.

2. He must be honest, competent and independent.

3. He should disclose all material facts and information about the working and financial position of the company to shareholders.

4. The auditor should strictly adhere to the rules and regulations formulated by the institute of chartered accountants of India.

The other duties arising from professional etiquette are given below:

1. An auditor is not allowed to advertise or canvass business

2. An auditor is not allowed to give any share out of his remuneration to any person, in order to get business.

3. An auditor before accepting new job must get the consent of the retiring auditor

4. A Chartered Accountant cannot respond to tenders responding to the advertisement inviting applications for appointment of auditor, etc.

5. A member of Institute of Chartered Accountant of India is not permitted to designate A member himself by any other description except in as a Chartered Accountant.

D. Duties imposed by legal or court decisions.

1.lt is the duty of a company auditor to check the stock properly

2. He should perform his duties with proper care and skill

3. He should examine properly the terms of Debentures Trust Deed

4. He should physically count cash in hand on the last date of the financial year

5. He is a watch, dog, but not a blood hound; not to adopt an attitude of suspicion towards the client staff

6. An auditor should correspond in writing with the retiring auditor before accepting the appointment as an auditor in place of him

7. A non-member of the Institute of the Chartered Accountants of India and non-holder of a certificate of practice from the Council of Institute, cannot practice as an auditor.

Special Areas of Audit

Tax Audit

For certain purpose audit of financial statements is a necessity and therefore, various statues, legislations governing direct and indirect taxes provisions have been incorporated to the Income Tax Act and audit made compulsory for these firms accounts. Income Tax Act 1961 contains several sections such as 12A, 350, 35 E, 44AB, 80ID, 142(2A) etc. These sections are made compulsory for audit in the case specified categories of assesses since to assessment year 1985-86.

SPECIAL AREAS OF AUDIT

1. Audit of public Trust

Section 12 A of Income Tax Act 1961 provides tax audit for accounts of public trusts. Section 11 and 12 of Income Tax Act exempt certain incomes of the public trust, religious trust and institutions from calculating the taxable income. Section 11 and 12 of the Act provides that if he total income of the trust or institution exceeds 50,0000 is any previous year, the accounts of the trust or institutions for that year should be audited by an Accountant" (A chartered accountant). The exemption will be granted only have to accounts of the trust or institutions for the relevant year are audited. The report of audit in the prescribed form No: 10.B duly singed and verified by the auditor.

2. Audit for claiming Deduction Under Section 35D, 36E

Section 35D of Income Tax Act 1961. Provide -deductions as regards some preliminary expenditure incurred for setting up of new industrial undertaking or expansion of the existing industrial under taking. Section 36E provides deductive for expenditure for any operation regarding prospecting for or extraction of production any mineral listed in the seventh schedule of Income Tax Act.

3. Audit for claiming deductions under section 80HH Section 80HH of the Income Tax Act 1961 provides deduction

for getting up of new industrial under taking or hotels in back ward areas. According to section 80HH, deduction allowed to the assessee from his total income, of a sum of equal to 20% of the profit of such projects in back ward areas. The audit report should be made is form No. 10C.

4. Audit for claiming deduction under section 80HHB for project outside India

Sections 80HHB of Income Tax Act 1961- provides if an Indian company or a resident in India, derives profits and gains from project outside India. A part of the income is deductible from such profits and gains from 2001 to 2004 and no deduction will be allowed after 2004 and subsequent years.

Management Audit

In the words of L.R. HOWARD" Management Audit is an investigation of business from highest level downward in order to ascertain whether sound management prevails throughout thus facilitating to the most effective relationship with outside world and the most efficient organizations and smooth running of internal organisation".

Objectives:

1. To ensure the most efficient form of the operations essential for smooth running of business.

2. To assist all levels of management in the effective discharge of their duties and responsibilities.

3. To identify the overall objectives of the organisation.

4. To ensure optimum utilizations of human resources and available physical facilities.

5. To suggest improved and better methods of managerial operations.

6. To pinpoint the deficiencies and defects in functional areas, suggest improvement for better performance.

7. To review the methods used in managerial service and suggest remedies for improvement. To review the managerial services according to the requirements of the business.

8.To see that enterprise is successful in adopting itself to the technological changes.

9. To anticipate problems and suggest remedies to solve them in time.

Advantages of Management Audit

1. Management Audit helps the management to achieve target.

2. Management Audit identifies to over all objectives of an enterprise.

3. Management Audit ensures optimum utilization of men and material.

4. Management Audit aims at co-ordination between different levels of management

5. Management Audit is good tool for management control. 6. Management Audit anticipates problems and suggests remedies

Limitations of Mgt. Audit

1. It locks the management from taking risky and dynamic decisions.

2. Man agreement Audit would discourage the initiative and dynamism of Potential managers.

3. The managers and experts argue that Management Audit which serves no material use in practice it discourage the managers.

4. Manager will always try maintain the books of accounts and other records up-to-date, rather than devoting much attention to achieve hyper production.

5. Introduction of Management Audit will be costly affairs.

6. Management Audit is too expensive and not suitable for small firms.

Recent trend in Auditing

1. INFLATION AUDIT

Price instability is a common phenomenon in the business world. The accounting the effect of changing prices is known Inflation accounting. During inflation period net profit will be alarming figures than the real profit. It is due to limitation historical cost based accounting system.

CURRENT COST ACCOUNTING METHOD [C. C. A)

Current cost accounting method is a new dimension of accounting system in the recent years for changing price. This system had gained much attention in U. K and advanced countries. In India the Institute of Chartered Accountant issued a Guidance Note on Accounting for changing price in December 1982.

AUDIT OF INFLATION ACCOUNTING

The introduction of current cost accounting will not change the traditional auditing functions of auditor. The core attention is focused by the auditor on the valuation of assets. It may substitute current values in price or of historical costs. The auditor should be cautions in using his own judgment for such valuation in the current cost accounting. The valuation must be reasonable.

2. HUMAN RESOURCE ACCOUNTING AND AUDITING

Even in the computer age the manpower resource is the most potential and power assets in an organisation. The accountants are not able to develop a system to value the human resources in an undertaking

To a business organisation huge sums of amount are being spent for developing its employees. It is an organisational assets i.e., Money incurred for recruit and selection orientation and on the job training of employees. Huge amount invested in the development of human resources of an organization is neither reflected in the balance sheet nor is a meaningful information given in the state of affairs of the business.

3. SOCIAL AUDIT

Social audit is now receiving worldwide acclaim and is declared all over the world. It is a devise to measure the benefits (contributions) made by an enterprise to the society.

In the words of Bauer, the concept of social audit is a vision that at some future time corporations will assess their social performance in as systematic a manner as they now asses their financial performance."

4. ENERGY AUDIT

After the oil shock of the 1970s, the Companies Rule under Section 217 (1) (e), 1998 was amongst the first time in the country to enforce industries provide energy efficiency information in the Directors Annual report. The law concerning energy, efficiency has been reviewed several times during the 1990's. The actual enactment encompassing mandatory energy audit for industries in on the anvil, Delhi, Kerala, Tamil Nadu and West Bengal have already made energy audit mandatory for the industries sector.

5. PEER REVIEW

Peer Review system is a supervision audit. It is an audit of auditor's performance. It is conducted by another auditing firm authorised by Institute of Chartered Accountant of India. Peer Review aims at improving auditor's skill and care and also improving quality of audit work.

6. Amendment to Companies Bill 2011

The Amendment to companies bill - 2011 proposed (1) To limit the number of companies an auditor can serve to 20. (2) It has also brought in more clarity on criminal liability of auditors. (3)Appointment of Auditors for five years shall be subject to ratification by shareholders at every annual general meeting (4) Provision relating to audit of governments companies by the comptroller and Audit General of India (CAG) modified to enable CAG to performs such audit more effectively.

7. Financial Year

Order the new companies Act 2013 all companies have to follow a uniform financial year. i.e. from Ist April to 31 March those companies which follow a different financial year have to align their accounting year to 1 April to 31st March within 2 years.

8. Corporate Social responsibility

As per section 135 of the companies Act 2013 which provide that every company having a net worth of 500 crores INR (Indian Rupees) or more or a turnover of 1000 crore INR or more or net profit of 5 Crores INR or more during any financial year shall constitute the corporate social responsibility committee of the board.

9. Restriction to Company Auditors

Auditors are restricted from rendering other services like book. Keeping, Accounting etc. Directly or indirectly to the company or its holding company or Subsidiary company.

10. Consolidated Financial Statements (CFS):

The new companies Act 2013 new mandates consolidated financial statements for any company having a subsidiary company or associate a joint venture nfs 129(3). The manner of consolidation is required to be is the line with the requirements of Accounting standards 21 as per to draft rules.

11. Internal Audit

Internal audit made compulsory under the companies Act 2013. The act mandate the appointment of an internal Auditor who shall either be a chartered Accountant or a Cost Accountant a such other professionals as may be decided by the board to conduct internal audit of the functions and activities of the company.

12. International Financial Reporting Standard (IFRS)

The emergence of multinational companies which authorize the same auditing firm to audit. Their companies accounts worldwide to cope with new demand international Federation of Accountants was set up for coordinating worldwide accounting profession.

13. Foresenic Audit

Foresenic auditing is a recent origin in the sphere of auditing. This type auditing may be conducted for collecting evidences that can be used in a court of law or legal proceedings. Foresenic auditing is a detailed investigation of financial and non financial records regarding the allegation of financial fraud and other financial crimes of a firm or its executives.

14. GST

Goods and Service Tax one nation and one tax system for goods and services in all the states in India. A uniform tax system for all the goods and services was introduced in India.

Audit Committee

Audit committee is an independent committees formed with the board of directors of the company. Introduction of such audit committee under clause 49 of listing agreement of SEBI sections 292. A companies Act 1956 and, companies Amendment Act 2000.

The audit committee is entrusted with the authority to supervise the process of financial reporting of the enterprise including issues related to audit function review of financial policies, risk management policies etc. The audit committee is constituted in respect of the companies in India has brought about a marked change in the financial reporting process.

ROLE OF AUDITOR INAUDIT COMMITTEE

Under clause 49 of the listing agreement and section 292A of the companies Act underline the importance of audit and contributions to the corporate governance. These sections stipulate that the statutory auditor or his representative should be present as an invitee for the audit committee meeting.

AUDIT REPORT

The Auditor of a company is appointed to check the accounts, and report to the shareholders regarding the accounts audited by him.

Under section 227(2) of the Companies Act, an Auditor is required to make a report to the members of the company on the accounts examined by him and on every balance sheet and profit and loss accounts and on every other documents declared by the Act to be annexed to the balance sheet or profit and loss accounts which are laid before the company in general meeting during his tenure of office such a report is known as the Auditor's report."

CHARACTERISTICS OFAGOODAUDIT REPORT

1) The report should acquaint with true and fair state of affairs of the company.

2) It should exhibit true financial position of the company.

3) It should be based on factual information.

4) It should express the opinion of the Auditor on the state of affairs of the company.

5) It should be forceful and convincing.

6) It should be justifying the benefit of the shareholders, and not for the benefit of the directors.

7) The report should be unbiased and free from mistakes.

8) It should contain timely suggestion for improvement.

9) should be brief and not lengthy.

10) It should be the end part of the audit work, it should reflect the result of the audit work done by the auditor.

CONTENTS OF AUDIT REPORT

1) Whether the auditor has obtained all the information and explanation that he considers necessary for the audit.

2) Whether proper books of accounts required by law have been kept by the company.

3) Whether the accounts of the branches have been audited or have been exempted from audit.

4) Whether the balance sheet and profit and loss accounts are in agreement with the books of accounts and returns from branches. Whether any other statement has been included as required by the Central Government.

5) Whether the balance sheet and profit and loss account give the information as required by Companies Act and in a manner which has to give a true and fair view on

a) Whether the balance sheet gives a true and fair view of the state of affairs of the company as at the end of the financial year.

b) Whether the profit and loss account gives a true and fair view of the profit and the loss of the company for the financial year.

6) Certificate of Corporate Governance (Certificate of Compliance)

Types of audit report

1) Clean (Positive, unqualified, and conventional)

2) Qualified (Negative report, qualified)

Consequences of giving a qualified report

1). It may lead to fall in the value of shares in the market.

2). Non-renewal of appointment of directors

3). Appointment of investigators by the Central Government.

Distinction between Audit Report and Audit Certificate

(1) An Audit Report is simply an expression of opinion of financial statement, but an Audit Certificate is a certificate of truth.

(2) An Audit Report is based on facts, estimates and assumption were as Audit Certificate is based on facts and figures supported by vouchers and documentary evidences.

(3) In the accounts of the company's audit, the auditor reports his opinion, but he never certifies the accounts as 100 percent true.

(4) Audit report is only a test and not a guarantee, but the certificate is a guarantee of truth.

(5) If a signed report by an auditor happens to be wrong. He cannot be held liable, for he simply expresses his opinion. But if a signed certificate by an auditor is wrong the auditor is held liable.

Auditing and corporate governance
Module 4

Corporate governance

Corporate governance is the combination of rules, processes or laws by which businesses are operated, regulated or controlled. The term encompasses the internal and external factors that affect the interests of a company's stakeholders, including shareholders, customers, suppliers, government regulators and management

History and developments

1. Developments in 1970s
2. Developments in 19780s
3. Developments in 1990s
4. Developments in 21st century

Reason for mis-governance in India

1. Family owned business
2. Stakes of owners are more
3. Lack of professionalism
4. Transparency of operation was very less

Benefit of corporate governance

1. Encouraging positive behaviour
2. Reducing the cost of capital
3. Improving top-level decision-making
4. Assuring internal controls
5. Enabling better strategic planning
6. Attracting talented directors

Theories of corporate governance

1. Agency theory
2. Stewardship theory
3. Stakeholders theory
4. Resource dependency theory

Models of corporate governance

1. The American model
2. United kingdom / commonwealth model
3. The continental European model
4. Japanese business network model

5. Asian family based model

Board committees

1. Audit committee
2. Nomination and remuneration committee
3. Stakeholders relationship committee
4. Corporate social responsibility committee

Insider trading

Insider trading is the trading of a public company's stock or other securities based on material, nonpublic information about the company. In various countries, some kinds of trading based on insider information is illegal

Rating agencies

A rating agency is a company that assesses the financial strength of companies and government entities, especially their ability to meet principal and interest payments on their debts.
The rating assigned to a given debt shows an agency's level of confidence that the borrower will honor its debt obligations as agreed

1. Moodys investors service
2. Standard and poor (s&p)
3. Fitch rating
4. CRISIL
5. CARE
6. ICRA

Auditing and corporate governance
Module 5

MAJOR CORPORATE GOVERNANCE FAILURE

One of the prime reasons for the emergence corporate governance is the increased rate of corporate scams and scandals. Despite the various rules and regulations, the rate of accounting and financial frauds in the corporate sector was alarming. Corporate failure means when the company fails to meet the expectation of customers, investors and creditors. By meeting the needs of the customers, the companies can generate adequate cash flows and repay the creditors. Negative returns, technical insolvency and bankruptcy are the major visible symptoms of corporate failures. Following are the major corporate governance scandals which have shattered the hope of investors and regulators.

Bank of Credit and Commerce International (UK) 1991

Bank of Credit and Commerce international (BCCi) was a major international bank founded in 1972 by agha Hassan abedi, a Pakistani financier. The BCCi was incorporated in Luxembourg with head offices in Karachi and London. The bank primarily focused on serving Muslim and third-world clients. The quadrupling of oil prices in 1973-74 led to huge deposits by Arab oil producers. as a result BCCi expanded rapidly in the 1970s. BCCi also acquired parallel banks through acquisitions. BCCi entered the African markets in 1979, and Asia in the early 1980s. BCCi was among the first foreign banks awarded a license to operate in the Chinese special economic Zone of Shenzhen. By 1980, BCCi was reported to have assets of over $4 billion with over 150 branches in 46 countries. BCCi expanded rapidly and by 1991 it had 420 offices around the world and a presence in 70 countries.

Forced Closure of the Bank

Although BCCi's published results showed ever-rising profits, by the late 1970s the bank was suffering an alarming level of bad debts due to reckless lending. BCCi came under the scrutinyof numerous financial regulators and intelligence agencies in the 1980s due to concerns that it was poorly regulated. Reality was not reflected in BCCi's accounts because the losses were concealedin a Cayman Islands subsidiary, a bank within a bank known internally as 'the dustbin', safe from regulatory scrutiny. As the losses mounted Abedi resorted to more and more desperate ways of keeping the bank afloat. He tried 'proprietary trading', but the results were further huge losses. The bank only kept going by fraudulent accounting and massive misappropriations of depositors' funds. Desperately in need of new sources of deposits and revenue, from the early 1980s BCCI's Panama branch acted as money-launderer for Latin America's drug barons. Subsequent investigations and the inquiry report in June 1991 for BCCI by Price Waterhouse at the behest of Bank of England code named 'Sandstorm Report' revealed that BCCI was involved in massive money laundering and other financial crimes, and illegally gained controlling interest in a major American bank. The report indicated massive manipulation of non-performing loans, fictitious transactions and charges, unrecorded deposit liabilities, fictitious profits and concealment of losses.

Maxwell Communications

Maxwell Communications Corporation was a leading British media company. It was listed on the London Stock Exchange and was a constituent of the FTSE 100 Index. The company was established in 1964 as the British Printing Corporation. In 1967 it acquired a majority stake in Haymarket Group. In July 1981 Robert Maxwell launched a dawn raid on the company acquiring a stake of 29 per cent. In 1982 he secured full control over the company and changed the name of the Company to British Printing & Communications Corporation and to Maxwell Communications Corporation in October 1987. The company acquired Macmillan Publishers, a large US publisher, in 1988 and Science Research Associates and the Official Airline Guide later that year. By the end of the 1980s the Maxwell Empire, comprising more than 400 companies was loosely organized into three clusters. The two publicly listed companies: *the Mirror Group*, which published the Daily Record, the Sunday Mail and Racing Times, as well as the Mirror newspapers; *Maxwell Communication*, the flagship company which controlled such concerns as Macmillan books, the Official Airline Guides and P.F. Collier encyclopedias; and the *Robert Maxwell Group* which was privately held and owned 100 per cent by the family whose operations included the Oxford United Football Club and publications like the European, as well as stakes in newspapers in Israel, Hungary and Kenya. All the three holding companies were also directly and indirectly linked to dozens of other family-controlled enterprises.

Enron USA

The Enron scandal, which broke out in October 2001, eventually led to the bankruptcy of the Enron Corporation, an American energy company based in Houston, Texas. It was the largest bankruptcy reorganization in American history at that time.

The primary reason for the failure of Enron was attributed to an audit failure. The problem faced by Enron was despite having structures and mechanisms in place for good corporate governance. Nobody flaunted and flouted these rules and regulations! The board of directors turned a blind eye to open violation of the code. Particularly, when it allowed the CFO to serve inspecial purpose entities (SPEs). The auditors failed to prevent suspect and questionable accounting. The auditors did not even examine the SPE transactions.

Enron shareholders filed a $40 billion lawsuit after the company's stock price fell. It achieved a high of US$90.75 per share in mid-2000, plummeted to less than $1 by the end of November 2001. On December 2, 2001, Enron filed for bankruptcy under Chapter 11 of the United States Bankruptcy Code. As a result of the scandal, the US government introduced new regulations and legislation to expand the accuracy of financial reporting for public companies. The Sarbanes-Oxley Act was introduced as a result of the Enron scandal. It increased penalties for destroying, altering, or fabricating records in federal investigations or for attempting to defraud shareholders. It also increased the accountability of audit firms to remain unbiased and independent of their clients.

Sathyam Computers Services Ltd

Satyam began facing problems from December the 16th, 2008. Its chairman Mr. Ramalinga Raju, in a surprise move announced a $1.6 billion bid for two Maytas companies. He wanted to deploy the cash available for the benefit of investors. Raju's family promoted and controlled the two companies.

The share prices plunged 55% voicing concern towards Satyam's poor corporate governance. They overturned the decision in 12 hours. This resulted in the resignation of several independent directors of the firm. Thus, this resulted in a further fall in the share prices of Satyam.

On 7th January 2009 B Ramalinga Raju, the founder of Satyam Computer Services, confessed to a Rs 7,000- crore balance sheet fraud. He had hidden it from the IT Company's board, employees and auditors for several years. He revealed in his confession that his attempt to buy Maytas companies was his last attempt to "fill fictitious assets with real ones". The government reacted to the fraud by overhauling the regulatory framework. It introduced the

New Companies Act 2013, which fixed liabilities of auditor and independent directors, among other changes. In 2014, market regulator SEBI amended Clause 49 of listing guidelines to improve corporate governance.

Tata finance

Tata finance is one of the companies operated and owned by Tata group, Indian's largest and most socially responsible business group. The company was incorporated as a private limited company in 1984 and later converted into a public ltd company. Transport and constructed sector are the major thrust areas of the company. It was basically engaged in the hire purchase business of commercial vehicles, plant and machinery, consumer durables and two wheelers. Further the company also undertakes leasing of plant and machinery for selected corporate client. During 1990s company diversified its operation by setting up a trade finance department. The trade finance department basically likes after the commercial bill discounting and other money market operations of the company. During 1st January 1992 the company merged with Tata Industrial financial corporation ltd (TIFCO). During 1994, Tata finance security ltd was establi9shed as a subsidiary. During 1997 Tata finance become the RBI complaint non banking financing company engaged in the working of hire purchase, leasing and accept deposit from public under various schemes, it has become the finance service wing of Tata group and become the first NBFC to deal with the BADLA transactions by 2000. Moreover, Tata finance agreed to float nishkalp investment and trading company as its fully owned investment subsidiary. A total 500 crores of funds has lost between Tata sons and nshkalp. The chairman of Nishkalp was committed insider trading of company shares.

Poor investment policies by the management, Insider trading by the company executives, concealment of material facts and back dated sales are major reasons of Tata Finance fiasco.

Kingfisher airlines

Kingfisher airlines were a privately owned airline company has head office at Mumbai and registered office at UB city Bangalore, India. The fifty percent of the share of the kingfisher airlines was with United Breweries UB group based in Bangalore under the leadership of ligquor barron, vijay mallya. The company has played significant role in the Indian aviation industry until 2011. It was the second largest company in Indian airlines industry. Even though the company is established in 2003 but started domestic commercial operation in 2005 from Mumbai-Delhi route. However the company started its international operation during the 2008.

Kingfisher airlines have offered three classes of passenger services such as Kingfisher first, kingfisher class and kingfisher red. King fisher first is meant for high class or luxurious expectation people. It offers a luxurious service to the passenger. Kingfisher class luxurious economy experience to the passengers. Moreover, king fisher red offers a low cost travel experience through kingfisher airlines.

Kingfisher airlines had provided luxurious service in flight travel. However Indian passenger treated the flight journey also a mode of travel. Competition from other airlines such as indigo, spice jet and Go air who operated in the same domestic segment are also result a heavy loss to the company. Further, hike in oil price also is one of the reasons of serious setback to the company. By acquiring air Deccan kingfisher has entered in the domestic air travel business. The company expected that the air Deccan is already in the budgeted airlines segment and they can bring more revenue to the organization. However, the rebranding from a more luxurious air travel business to budgeted air travel business failed miserably. As result of the problems and issues in the management the kingfisher airlines stopped their operation during 2012. Civil aviation ministry has cancelled their license on the same date.

Common governance problems noticed in various corporate failures

1. Regulators mistake
2. Supremacy of the CEO
3. Lack of vigilance by the auditors
4. Individual/ concentrated ownership
5. Incompetent board
6. Misleading accounting policies
7. Insider trading
8. Poor investment policies

9. Exorbitant rate of borrowings

Code and standards on corporate governance

In the modern the day corporate governance scenario, every countries government and regulatory agencies have established corporate governance guidelines for ensuring transparency and fair dealings. The phrase “corporate governance” was not so popular until 1970-80. The misconducts and ethical issues in the corporate sector have created dissatisfaction among investors. This has opened up the eyes of the regulators and ministries. As result committees were appointed by various governments to set up corporate governance code. UK was the first country that has set up sir Adrian Cadbury committee to formulate corporate governance code for UK. The committee has finalized and submitted the report during 1992.

Cadbury report (1992)

The major recommendation and thrust areas of Cadbury committee reports are as follows:

1. Appointment of independent non-executive directors.
2. The board has to form an audit committee with minimum of three non executive directors: majority of them should be independent.
3. Division of responsibilities between the chairman of the board and chief executive. However, if the chairman and the board are one and same the board should have strong independent elements.
4. A remuneration committee should be established to monitor the executive rewards.
5. A nomination committee with sufficient independent directors should be established to nominate new board members.
6. Comply the code of best practices.

Green bury Report (1995)

It focused on the issue of directors remunerations. The committee has recommended the following.

1. The remuneration committee should solely consist of independent non executive directors.
2. Head/ chairman of the remuneration committee should answer all the questions raised by the shareholders at annual general meeting.\
3. Annual report should mention the remuneration paid to each director.
4. Director's contact should not run for more than a year.
5. Stock option scheme for directors should be linked to long term corporate performances.

Hampel Report (1998)

Proposed suggestion on the Cadbury reports by the directors of major public companies and professional advisors.

1. Corporate governance should be based on board principles rather than rules.
2. Separation of responsibility of board chairman and chief executive should be company specific.
3. The board is accountable to company shareholders. Redefining or directors responsibility to other stakeholders group is not required.
4. Self regulation is required than further company legislation.
5. Unitary board is widely accepted in UK. Hence two tier boards are not required in UK.

UK Combined Code (1998)

During 1998 UK combined code was established and included in the listing criteria of London stock exchanges. It is the combinations of Cadbury, green bury and hampel recommendation on various matters of corporate governance. The combined code had set up clear guidelines for board composition, director's remuneration, audit and accountability to shareholders. All the companies who are listed in the London stock exchange have to follow the corporate governance code and mention the same in manual report of the companies. Apply the code or

Explain why not the major philosophical underpinning of the corporate governance code has. However, the code has no legislative basis but the companies have to follow to avoid delisting from the stock exchange. In USA, Sarbanes – Oxley Act (2002) recommended that the companies have to follow the corporate governance mandate otherwise they have to face severe penalties and imprisonment.

There are various reports have published on various aspects of corporate governance. Turnbull report (1999) the trunbull report has focused on the internal control mechanism of the companies. The report has specifically asserts financial, operational, compliance and risk management. Further, the committee has identified that enterprise risk analysis and risk management is key and vital area of internal control and thereby corporate governance. Higgs report (2003) the report was basically the re examination of corporate governance practices of UK companies after the Cadbury reports. Smith report (2003) concentrated on the audit committee ofan organization. The main focus of the committee was to strengthen the role of audit committee to ensure fair dealings in an organization. Tyson (2003) has focused on the recruitment and development of directors. The committee recommends that there should be more professionalism and fairness in the selection of directors and directors should be given training.

Codes from international Agencies

Organization for economic development and corporation (OECD), international corporate governance network (ICGN) and commonwealth association for corporate governance are three agencies proposed various recommendations on corporate governance. The important recommendations are b organization for economic development Corporation.

Following are the principles of corporate governance proposed by the OECD.

1. Effective and efficient governance framework
2. Protect the shareholders interest.
3. Equitable treatment of all kinds of shareholders.
4. Role of all stakeholders should be recognized.
5. Disclosure and transparency.

Corporate governance code in India

Following are the various committees constituted in India on corporate governance

a. CII code 1998
b. Kumar managalam Birla Committee 1999
c. Naresh Chandra Committee 2002.
d. Narayan moorthy Commmitte 2003
e. Jj irani Committee 2005
f. Udya kotak Committee

CII Code 1998

The federation of Indian industries has appointed a special task force for submitting report on corporate governance in India. The task force has submitted the report titled " desirable corporate Governance : A code " which include voluntary recommendation for corporate governance practices for listed companies. It is basically for the promotion of corporate governance and thereby development of Indian corporate sector.

i. Board should consist of professionally qualified non executive directors
ii. The board should meet six times in year preferably an interval of two months.
iii. A listed company with more than one billion turnover should constitute a board with 30% non executive director, if the chairman of the board is a non executive director. If the managing director and chairman s the same person then the board should consist of 50% of the independent non executive directors.
iv. No single person should hold directorship in more than ten listed companies
v. To provide a better effort from non executive directors the company should provide.
vi. Commission over and above their sitting fees for their professional efforts.
vii. Stock option scheme as a reward for long term performance of the firm.
viii. Attendance register must be checked before reappointing a director. If the director has attended less than fifty percent of the meeting the decision to reappoint the directors should placed for voting.

ix. All the key information and reports should be to the board.

Kumar Mangalam birla Committee 1999

In early 1999, Securities and Exchange Board of India (SEBI) had set up a committee under Shri Kumar Mangalam Birla, member SEBI Board, to promote and raise the standards of good corporate governance. The report submitted by the committee is the first formal and comprehensive attempt to evolve a ‘Code of Corporate Governance', in the context of prevailing conditions of governance in Indian companies, as well as the state of capital markets.

The Committee's terms of the reference were to:

- suggest suitable amendments to the listing agreement executed by the stock exchanges with the companies and any other measures to improve the standards of corporate governance in the listed companies, in areas such as continuous disclosure of material information, both financial and non-financial, manner and frequency of such disclosures, responsibilities of independent and outside directors;
- draft a code of corporate best practices; and
- Suggest safeguards to be instituted within the companies to deal with insider information and insider trading.

The primary objective of the committee was to view corporate governance from the perspective Of the investors and shareholders and to prepare a ‘Code' to suit the Indian corporate environment.

The recommendation made by the committee has divided into two parts:

Mandatory recommendation

Non mandatory recommendations.

Mandatory and non-mandatory recommendations

The committee divided the recommendations into two categories, namely, mandatory and non- mandatory. The recommendations which are absolutely essential for corporate governance

Can be defined with precision and which can be enforced through the amendment of the listing agreement could be classified as mandatory. Others, which are either desirable or which may require change of laws, May, for the time being, be classified as non-mandatory.

Mandatory Recommendations:

- Applies To Listed Companies With Paid Up Capital Of Rs. 3 Crore And Above
- Composition Of Board Of Directors – Optimum Combination Of Executive & Non-Executive Directors
- Audit Committee – With 3 Independent Directors with One Having Financial And Accounting Knowledge.
- Remuneration Committee
- Board Procedures – At least 4 Meetings of the Board in a Year with Maximum Gap of 4 Months between 2 Meetings. To Review Operational Plans, Capital Budgets, Quarterly Results, Minutes Of Committee's Meeting. Director Shall Not Be A Member Of More Than 10 Committee And Shall Not Act As Chairman Of More Than 5 Committees Across All Companies
- Management Discussion And Analysis Report Covering Industry Structure, Opportunities, Threats, Risks, Outlook, Internal Control System
- Information Sharing With Shareholders

Non-Mandatory Recommendations:

- Role Of Chairman
- Remuneration Committee Of Board
- Shareholders' Right For Receiving Half Yearly Financial Performance Postal Ballot Covering Critical Matters Like Alteration In Memorandum Etc
- Sale Of Whole Or Substantial Part Of The Undertaking
- Corporate Restructuring
- Further Issue Of Capital
- Venturing Into New Businesses

Naresh Chandra committee 2002

Committee was constituted by ministry of corporate affairs in the light of various corporate scandals and scams. The prime objective of Naresh chnadra committee was to suggest various amendments on auditor client relationship and the role of independent directors.

Narayana Murthy Committee 2003

Narayana murthy was constituted by SEBI review corporate governance mechanism among Indian corporate sector. The committee also entrusted to review clause 49 of the listing agreement and suggest provisions of corporate governance. The committee has made certain recommendation and classified as mandatory and non mandatory.

The key mandatory recommendations focused on:

- Strengthening the responsibilities of audit committees;
- Improving the quality of financial disclosures, including those related to related party transactions and proceeds from initial public offerings;
- Requiring corporate executive boards to assess and disclose business risks in the annual reports of companies;
- Introducing responsibilities on boards to adopt formal codes of conduct; the position of nominee directors; and
- Stock holder approval and improved disclosures relating to compensation paid to non-executive directors.

Non-mandatory recommendations included:

- Moving to a regime where corporate financial statements are not qualified;
- Instituting a system of training of board members; and
- Evaluation of performance of board members.

JJ Irani Committee 2005

Committee constituted by central government to analyses various provision of company law and thereby simplify various procedures as required by the corporate sector. There are various provisions suggested by the committee for efficient corporate functioning and classified into seven parts. Following recommendations are made by the committee with regards to corporate governance and investor protection.

a. One third of the directors should be independent directors.
b. Maximum directorship for a director should be limited to 15.
c. A clear remuneration policy of directors should be implemented and it has to be clearly explained to the shareholders and investors.
d. Three essential board committees to be formed in an organization;
    i. Audit committee
    ii. Stakeholders relationship committee and
    iii. Remuneration committee.
e. Certain basic duties of directors are clearly mentioned and the list of duties are not exhaustive.
f. Related party transaction should be disclosed and subject to the board / shareholders approval.
g. To protect the interest of investor and encourage shareholders democracy.
h. Compensation to the paid to the shareholders in case of established fraud.
i. Every company must credit a regular amount to the investor education and protection fund.
j. Proper frame work for self regulation
k. No relaxation in corporate governance requirement should be given to financial institutions.
l. Electronic filing and submission of all the mandatory documents by the companies at the registration time itself to check the vanishing companies.
m. Regulators/authorities should check the system of name change.

n. Inter agency coordination system should be implemented to identify and book the person behind the corporate crime/fraud.
o. Constitution of stakeholder relationship committee.
p. Duties of directors are prescribed, annual general meeting of the company should be held at a place where company's registered office is located. The company can opt another placewhere 10% of the shareholders reside

Uday kotak Committee 2017

Uday kotak committee is a committee on corporate governs constituted by SEBI during 2017. The committee includes 21 members and submitted their reports within four months. Following are the major recommendation of Uday kotak committee.

a. Listed arms with more than 40% public shareholders should separate the role of chairmanand managing director and chairman should be a non executive director.
b. Minimum size of the board should be increased from 5 to 6 and one women whould be inthe board as independent director.
c. All listed firm should hold five board meetings in a year.
d. Succession planning and risk management should be discussed by the board at least oncein a year.
e. All listed companies should have at least half of the board members as independentdirectors and all the board members must attend half of the board meetings.
f. All listed firms must prepare a cash flow statement in every six months.
g. All the listed from must disclose consolidated earnings at every quarter.
h. Webcasting of shareholders meeting is allowed for top 100 firms.
i. A minimum of Rs. 500000 should be given to an independent director as remuneration andsitting fee of Rs. 20000-50000 for each sitting or board meeting.
j. If the annual remuneration of the executive directors from promoters exceeds rs. 5 croresor 2.5 % of the net profit of firm, the firm must obtain shareholders approval.