CHAPTER-8

AUDIT OF ANNUAL ACCOUNTS AND THEIR CERTIFICATION

8.01 Audit of annual accounts

8.01.01 General

In the audit of annual accounts, it is to be verified that the transactions appearing in the books of original entries represent legitimate charge and the books themselves record fully and faithfully all transactions pertaining to the organisation for the period under audit and nothing is left out. This can be ensured only by conducting audit of transactions. The procedure for transaction audit has been outlined in the preceding chapter. The instructions contained in this chapter are restricted mainly in connection with the audit of annual accounts which are to be read along with the instructions for audit of transactions. It may be noted that the audit of transactions and audit of annual accounts should be combined and conducted in one spell in cases where the C.A.G. is the sole auditor, unless for any special reason it becomes necessary to undertake audit of transactions separately from the audit of annual accounts.

8.01.02Essential features of audit of accounts

The essential features of the audit of annual accounts are as under:-

(a) to make critical review of the system of book keeping; accounting and internal control ;

(b) to make such tests and enquiries as the auditor considers necessary to form an opinion as to the reliability of the records as a basis for preparation of accounts;

(c) to compare the Income and Expenditure Account and the Balance Sheet with the underlying records in order to see whether they are in accordance therewith ;and

(d) to make a critical review of the Income and Expenditure Account and the Balance Sheet to see that a report may be made stating whether, in the opinion of the auditors, the accounts are presented and the items are described in such a way that they show not only a true but also a fair view

8.02 Certification of accounts

8.02.01 General

The certification of annual accounts means verification of the accounts with reference to the books of original entry, ledgers etc., to see that the accounts have been compiled in accordance with the books.

It is not obligatory to certify the annual accounts of the local bodies because the Director of Audit, Uttarakhand are the sole auditors for Panchayati Raj Institutions and Urban Local Bodies respectively in Uttarakhand. The certification of accounts need not be done in cases where CAG. is not the sole auditor but is doing a superimposed audit under section 20(1) irrespective of the fact whether the primary auditors are appointed on his advice/recommendation or not.

8.02.02 Comments on Accounts

The Comments on accounts will comprise of Accountant General's comments on the certified accounts of the local bodies certified by the sole auditor. The comments on certification of accounts done by the Director/Audit Nideshalaya Uttarakhand shall also be included.

8.02.03 Specific Cases of the accounts to be reported.

Though it is undesirable to certify the accounts even subject to observation, the specific points must be indicated. Cases where the fundamental correctness of cash book is in doubt or where large number of vouchers, receipt books and other supporting documents have not been made available or cases in which basic records have not been maintained or where there are clear indications of misappropriations, fraud or misrepresentation of facts in accounts or accounts as compiled are materially inaccurate requiring revision, etc., would fall in this category. In such a case the audit party must bring the points to the notice of the Chief Executive of the local bodies and also address the head office so as to enable headquarters to take appropriate action. The office of the Comptroller and Auditor General should also be kept informed of the position indicating the reasons for non-certification of the accounts.

8.03 Form of annual accounts & Financial Statements

8.03.01 Form of annual accounts

It has been decided by the Government of India, that, except where otherwise specifically authorised, every local body that receives financial assistance from Government in the form of grants/ loans, must compile the following three sets of accounts:-

(i) Receipts and Payments Account,
(ii) Income and Expenditure Account, and
(iii) Balance sheet.

While carrying out the audit of annual accounts, it is necessary to ensure that the accounts indicate sufficient details, information necessary to give an understanding of the results of working and the financial position of the organisation. A uniform accounting system and formats of accounts and registers as applicable to all local bodies in the country have been prescribed and are being brought into use. Till then, the form of annual accounts and accounting procedures to be adopted by them will be as laid down in the accounts Rules and/or instructions issued by the Government concerned.

8.03.02 Financial Statements

(i) Annual Accounts: Receipts and payments Account is to be drawn up annually. It shows the amount received and paid in the period of account, classified functionally as also the opening balance and the balance on the last day of account. It also incorporates the Appropriation Accounts, which show the amounts spent in the period of account on various functions up to the primary unit of appropriation, as compared with the amount granted through the annual budget and statement of variances. The columns of Budget Estimates for the year in the Receipts and Payments accounts and progressive total column depict amounts appropriated for the year.

(ii) Monthly Accounts: The monthly Receipt & Payment Accounts shall be prepared by each local body, major head wise in a summary form, along with a monthly bank/ treasury reconciliation statement.

(iii) Additional Statements: (these form part of annual accounts and are common for all three levels of local bodies.)
Besides drawing up an annual statement of Receipts and Payments, the following statements are to be prepared annually:
  (a) Statement of Capital Expenditure (scheme-wise) showing expenditure for the year and progressive expenditure up to the end of the year;
  (b) Detailed statement of receivables and payables at the end of the year;
  (c) Statement of balances in various Deposit Accounts at the end of the year;
  (d) Statement of Provident Funds etc., if these are administered by local bodies at the end of the year.

(iv) Formats of Cash Book, Registers of Moveable Property, immoveable Property, Demand, Collection and Balance, Compilation Sheet, Stock Book, Consolidated Abstract, Roads and Land.

8.04 Separate Bank Account

In respect of some schemes implemented by local bodies separate bank accounts and cash books are required to be maintained scheme-wise by each implementing office. Audit should verify that this requirement has been complied with and obtain a list of bank accounts showing the name of scheme, name of bank and account number. An intelligent review of entries in the bank pass book should be conducted to find out whether anyamount from one bank has been transferred to any unauthorized bank account, if any such cases come to notice, transactions relating to those accounts should be investigated thoroughly.

8.05 Receipts and Payments Account

Receipts and Payments Account is an abstract of cash receipts and payments extracted from the cash book including the opening and closing balances. The receipts are entered on the debit side and payments on the credit side. It contains the record of all the cash receipts and payments of a particular accounting month/ year whether these receipts and payments pertain to that accounting month/ year or not. This account neither makes any distinction between capital and revenue expenditure nor shows the whole income (including accrued income) and expenditure (including outstanding expenses) for the year under audit.

8.06 Income and Expenditure Account

Since the cash transactions of the Receipts and Payments Account do not make any distinction between capital and revenue and do not enable one to quantify the income and expenditure of revenue nature, pertaining to the period under audit, it is necessary to prepare Income and Expenditure Account which is designed to measure the income for a given period for the non commercial organisation. Income and Expenditure Account is thus prepared on accrual basis where all the income of revenue nature whether received or not pertaining to the period under audit is taken credit for and the revenue expenditure whether paid or not, relating to the period is charged. Expenditure is shown on the debit (left hand) side and income (receipt) on the credit (right hand) side. The two sides of the account must tally and differences between the two sides of this account representing either excess of income over expenditure or vice versa, are taken to the liabilities or assets side, as the case may be, in the Balance Sheet.

In a number of local bodies, due to absence of trained manpower or other reasons, the cash basis of accounting is still being followed. But audit should insist on preparation ofthe annual accounts on accrual basis. In case of audit of accounts prepared on cash basis, the audit certificate should be qualified accordingly.

8.07 Balance Sheet

Whenever an Income and Expenditure Account is prepared, the Balance sheet must follow to give an understanding of the financial position of an organisation, because Balance Sheet is a statement prepared in order to get the true and fair view of the financial position of an organisation on a certain date. The left hand side of the Balance Sheet is liabilities side which indicates what money has been made available to the organisation and from where? The right hand side called “Assets” side shows how the organisation has used the money made available to it. Total assets must always be equal to total liabilities to creditors and others.

8.07.01 Capital and Revenue expenditure

The Balance Sheet comprises items of capital nature. Hence it is essential to have a clear idea of what capital means. Capital by and large, represents cost, the benefit of which does not expire during the period covered by audit, but lasts for a longer income period. Expenditure incurred on the acquisition of permanent assets, such as, land, Building, Plant and Machinery, Furniture Fixtures, stock etc., is of capital nature. Expenditure incurred on increasing or improving the earning capacity of the existing assets or to reduce the liabilities of the organisation is also capital. A part of the capital expenditure, which is treated as expired, during the accounting period is charged to revenue of the current period, the balance being carried forward in the balance sheet to future accounting years.

Revenue expenditure consists of expenditure incurred on maintenance of existing assets by way of replacements, repairs and renewals, etc., and also the current expenses ofestablishment and running of the organisation e.g., office salaries, rent, rates, carriages, advertising, depreciation of assets etc.

The principle of distinction between capital and revenue should not be carried to an illogical extremity. It is customary in certain organisations to charge small items of expenditure of capital nature to the revenue of the year in which the expenditure is incurred e.g., library books, furniture etc. It is, however, necessary to disclose such accounting policies in the accounts. In the absence of such disclosure, the Audit Report should disclose the accounting practice followed. The important point to be seen in this connection is that the method is followed consistently, is reasonable as a going concern, and does not result in creation of secret Reserves of material amount.

8.07.02 Assets and liabilities

There are two main groups of assets. Fixed and Current. Fixed assets are acquired for long term use in the organisation. They do not vary day to day e.g., Land, Building Plant and Machinery, Furniture etc. These assets are valued at cost less accumulated depreciation. However, no depreciation is charged on land. Current assets generally include, cash, Debtors, Investments etc. They are valued at cast or market value whichever is the lower.

Liabilities are also classified as fixed and current liabilities. Fixed liabilities are those which are to be discharged after a very long time e.g., long term loan etc., while current liabilities are such as are to be discharged in the near future e.g., sundry creditors, loans, outstanding expenses, etc. There is a third category of liability also known as “Contingent Liabilities”. Contingent liabilities are those in which payment depends only on the occurrence of a particular event, such as, payment of claimed amount in a suit pending in the Court of Law, payment of loan as a surety when the loanee fails to repay it, etc.
The assets and liabilities in the Balance sheet are shown either in order of liquidity or in order of permanence.

8.08 Records for accounts audit

As all transactions ultimately take the shape of cash outflow or cash inflow, cash book constitutes the most important book of original entry. For various adjustments, journal is used. The cash book serves both as a book of original entry and also a ledger; ledger accounts are maintained for consolidating various transactions under appropriate classifications. The ledger balances are then listed in a trial balance, from where items of revenue expenditure and income are transferred to Income and Expenditure Account. The remaining items are transferred to the Balance Sheet. Normally, closing stock does not figure in the trial balance.

8.08.01 Check of trial balance

Although trial balance is not a part of the annual accounts for audit, but the checking of the accounts starts from the trial balance. The balances appearing in the trial balance are to be verified from the ledger accounts. The ledger accounts in turn will be checked with reference to the books of original entry like cash book and the journal.

8.09 Broad outline for accounts audit

The audit of annual accounts is based broadly on the following lines:-

(i) Entries in the cashbook and other books of original entries should be vouched and the castings tested.
(ii) The postings from the books of original entry to the ledger accounts should be test checked.
(iii) The justification and authority for each journal entry should be examined.
(iv) The ledger balances should be checked and agreed with schedules, like debtors schedule and creditors schedule etc.
(v) Provisions for outstanding liabilities and accrued income should be verified.
(vi) The Receipts and Payments account should be checked from the cash book.
(vii) The Income and Expenditure account should be checked with the trial balance.
(viii) The ownership and continued existence of assets appearing in the Balance Sheet should be verified and adequacy for depreciation and bad debts etc., checks.

8.10 Internal control

Before determining the extent or quantum of checks and planning the audit of annual accounts of any local body, the first task of the audit party is to assess the efficacy of the system of internal control being followed by the organisations. Internal control is a system of instituting ”checks” on the day to day transactions which operate continuously as part of the routine system whereby work of one person is proved independently or is complementary to the work of another, with the objective of prevention or early detection of errors or frauds. Another essential characteristic of the system of Internal control is the existence of skilled managerial supervision and reviews including internal audit.

In particular, the audit should see that the system of Internal control invariably covers the following aspects:-

(i) accounting of cash receipts and payments;
(ii) realisation of receipts and avoidance of loss due to negligence or delayed action, etc.;
(iii) sanctions to expenditure and watch over the progress of expenditure vis-à-vis the budget provisions;

(iv) purchase, accountal, issue, utilisation and physical verification of stores and stock;

(v) execution of construction programme;

(vi) disbursement of grants, subsidy, scholarships etc., and their utilisation by the recipients.

(vii) Utilisation of Government’s financial assistance for the specified purposes; and

(viii) review of objectives of the local body etc.

8.11 Need for vouching of entries

Mere checking of postings in the books of accounts is no proof that the entries made therein are true and are complete without any omission, unless checked with reference to the information obtained from the original documents from which the books have been written up. This examination is called “vouching”, the salient features of which are mentioned below:-

(i) The vouching for payment includes examination of the authority for payment, reconciliation with liabilities discharged or assets acquired, verification of rates, and quantum of payee. Besides, it should also be examined that the payment voucher is addressed to the organisation and relates to the affairs of the organisation, pertains to the period covered by audit and does not bear any sign of having already been used for another payment.

(ii) Vouching for income aims at ensuring that values for supplies and services have been either received or accounted for as recoverable, that all receipts have been brought to account immediately, that the system of internal control in force does not leave scope for fraud or defalcation.

(iii) Check of classifications.

(iv) Checking of journal entries with reference to evidence, authority and narratives.

(v) The entries in other books of original entries should also be vouched subject to the nature of the organisation and the adequacy of the system of internal control.

8.12 Points to be seen in checking the final accounts.

Apart from the necessary routine checking of postings, castings and vouching, the following points should also be seen while conducting the audit of the annual accounts of an autonomous organisation:-

(i) check opening balance with the closing balance of the previous year as shown in the balance sheet;

(ii) examine transactions of exceptional nature which have resulted in charges or credits of abnormal amounts during the accounting period as compared to the previous year;

(iii) all capital expenditures to be vouched as per instructions contained in para 8.11 of this chapter;

(iv) verify the existence, possession and ownership of assets and check basis of valuation and provision for depreciation also (refer para 8.07.02 and para 7.12 of this Manual); the valuation of current assets need be considered in particular;

(v) ascertain the system of stock taking, test check stock sheets and valuation, and obtain certificate of physical verification of the stock from responsible officials;

(vi) examine the bank reconciliation statement critically, analysing the reasons for difference between the bank balance as per cash book and pass book, and verify the certificate obtained from the banks;

(vii) check the classification of capital and revenue expenditure as per provisions given in Para 8.07.01;

(viii) ensure adequacy or otherwise of provisions for outstanding liabilities, bad and doubtful debts, damage or deterioration in value of fixed and current assets;

(ix) make sure that all income has been brought to account;

(x) see that all allowances, discounts, etc., are authorised and admissible;

(xi) examine carefully commitments for capital expenditure not provided in the accounts and ensure that ascertained liabilities are not shown as contingent liabilities (for contingent liabilities refer to para 8.07.02);

(xii) review sundry debtors (persons who have received the goods/services but have not paid for them),outstanding advances, etc., analyse reasons for their pendency and ensure their recovery with a view to see that none of them represents fictitious balance;

(xiii) compare important items in the Income and Expenditure Account with corresponding items of the previous year and ascertain and analyse the reasons for significant variation; shortfall in income from a particular source should be examined in depth;

(xiv) similarly, compare the current Balance Sheet figures with the previous Balance Sheet figures to determine material changes after examining the schedules showing the composition of each item, reasons for the changes need be analysed critically;

(xv) comment on unproductive assets created or expenditure incurred during the year under audit;

(xvi) examine particularly the expenditure incurred on items which qualify for grants/ assistance to ensure that no attempt is made to secure inflated grant/assistance from the Government;

(xvii) analyse if any change has been made on the basis of accounting having material effect on the accounts of the year under audit;

(xviii) look for and comment on the charges, transactions which do not fall with-in the scope of authorised activities of the organisation;

(xix) in case the annual accounts of an autonomous body are prepared after consolidating the accounts of all its units, it should be verified that the annual accounts finally compiled do not omit any account of any unit. To ensure that the relevant details and subsidiary records pertaining to the accounts have been maintained properly, a certificate to this effect should invariably be obtained from some responsible functionary of the unit;

(xx) examine that fixed assets e.g. plant, machinery and library books etc., if received by any autonomous body as gift (free of cost), are included in the respective asset and corresponding entry on the liability side of the Balance Sheet is made under this head, “Capitalised value of gifted assets”; and

(xxi) transactions shown under “Suspense Account” should be examined in depth and details of the items and reasons for keeping them under “Suspense” analysed and action proposed to be taken for their early clearance ascertained, making a suitable comment in the audit inspection report of the unit concerned.