

# Internal Control System in Indian Enterprises: An Assessment

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## Abstract

*As the size of the operations of business entity increases and nature of business activity becomes complex, it becomes difficult for the manager of the entity to control the operation of the entity by his direct and close supervision. And even if he wishes to make it possible to control each and every activity of the business, it is not feasible in terms of time and efficiency. Thus, management is required to develop such a device which in its efficient operation provides desired control keeping in view convenience and effectiveness. Internal control system is such a device of control in the hands of management if it is designed and implemented properly. The present paper aims at evaluating the effectiveness of system of internal control in Indian enterprises in view of members of Institute of Chartered Accountants of India. The responses of 165 auditors practicing statutory audit have been analysed with the help of a structured questionnaire and an attempt has been made to assess the relevance and significance of system of internal control in Indian enterprises. It is found that internal control system is very relevant in reducing the workload of statutory auditor but not very satisfying in case of Indian business entities.*

**Key Words:** *System of Internal Control, Internal Check, Internal Audit and Surprise Checks.*

## Introduction

System of internal control is the set of various controls like internal check, internal audit, quantity or quality controls, time records and piece-wage records and so on. It facilitates efficiency and accuracy to business activities, insures successful implementation of managerial policies and plans, safeguards the property of business and helps in preventing and detecting manipulations of goods and accounts. Finally, reliability of business operations is

enhanced due to automatic creation of order, equity and self-discipline throughout the entity with the help of system of internal control if implemented properly (Tandon, 2002).<sup>11</sup>

SA 315<sup>1</sup> defines internal control as, “(i) The process designed, implemented and maintained by those charged with governance, management, and other personnel; (ii) To provide reasonable assurance about the entity’s in following categories: (a) reliability of financial reporting, (b) effectiveness and

efficiency of operations, (c) safeguarding of assets, and (d) compliance with applicable laws and regulations. “ But inherent limitations of internal control have also been depicted by SA 315 as: potential of human error, possibility of collusion, manipulations by

It is in this context that the present paper makes an attempt to assess the role of system of internal control from the view point of the various auditors visiting enterprises to conduct the statutory audit. The remaining paper has been divided into seven Sections. Section II presents the literature survey. The concept of system of internal control in India is given in Section III. Section IV discusses the legal aspect and recent developments in context of internal audit. Section V depicts the research methodology. The empirical tables and findings are compiled in Section VI and Section VII respectively. Finally, conclusion and recommendations are stated in Section VIII.

## **II Literature Survey**

Wright, Krishnamoorthy and Cohen (2002) conducted a study to analyse whether auditors are sufficiently sensitive to the type and strength of corporate governance when conducting an audit.<sup>12</sup> Agrawal and Chadha (2004) examined whether certain governance mechanisms are related to the incidence of an earnings restatement by a firm.<sup>1</sup> Ghosh and Kallapur (2004) investigated investor perceptions proxied by earning response coefficients (ERCs), of auditor independence-in-appearance as a function of audit and non-audit fees.<sup>5</sup> Desai (2006) advanced research in internal audit (IA) evaluation by developing an IA assessment model that considers interrelationship among specific factors used by external auditors when evaluating the

management and management discretion. Thus, it becomes very important to judge the effectiveness of prevailing system of internal control in the Indian business entities.

strength of the IA function.<sup>4</sup> Hoitash and Hoitash (2007) provide a detailed examination of the association of audit fees with internal control problems disclosed by public companies under provisions of Sarbanes-Oxley Act which made disclosure of internal control problems mandatory.<sup>7</sup> Krishnamoorthy, Cohen and Wright (2008) developed a case in order to alert students to the importance of non-financial information in audit process; to develop students ability to search for relevant financial and non-financial information in audit planning process; and to emphasise the importance of maintaining professional skepticism and to resist the natural tendency to over-rely financial information when conducting the financial statement audit.<sup>9</sup> Aurelia (2008) stated that internal audit concept is not tridimensional irrespective of property forming the capital bears, the entity organisation, and the operating system-private-public-banking. Its goal is unique: to ensure the degree of control upon the operations for the entity, to guide the entity in order to improve its operations and to contribute to the adding of a plusvalue.<sup>2</sup> Cohen, Krishnamurthy, Wright (2008) presented three alternative theoretical perspectives that help in better understanding of corporate governance: resource dependence (a strategic perspective), management hegemony (an entrenchment perspective), an institutional theory (a legitimation perspective).<sup>3</sup> Gupta (2011) critically examined the definition of

audit with special reference to AAS1 (SA 200) issued by ICAI.<sup>6</sup>

### III Concept of Internal Control System

**Internal Control System:** Spicer and Pegler, a famous authority on auditing literature defines system of internal control as: "Internal control is best regarded as a whole system of controls, financial or otherwise, established by management in conduct of a business including internal check and internal audit and other forms of controls."

Existence of internal control system in any entity provides good evidence that aims of internal control system like adherence to policies, safeguarding of assets, prevention of error and fraud, reliability and completeness of financial information might be achieved but they provide satisfaction and not assurance of fulfillment of control objectives. AAS 6 of ICAI mentions some of the possible limitations. For example, all areas may not be covered by system of internal control because of cost considerations, it is not applicable for transactions of unusual nature, it can not stand against deliberate circumvention of control process installed by management, false manipulation of transactions by entity, breach of control by staff collusion or controls may become obsolete in change scenario. Recognising this vital fact, statutory auditor should proceed to evaluate internal control system as he can not escape his liability accusing weaknesses in internal control afterwards if some error or fraud is detected. Hence, internal control reduces the auditor's work but not reduces his liabilities.

**Internal Check:** Internal check is a valuable part of internal control. It is an arrangement of duties of the staff members in such a manner that the work performed by a person is automatically checked by another. In the

opinion of Spicer and Pegler, "The system of internal check is the arrangement of staff duties, whereby no one person is allowed to carry through and to record every aspect of a transaction, so that without collusion between two or more persons, fraud is prevented and at the same time, possibility of errors is reduced to a minimum."<sup>10</sup>

Paragraph 8.05 of the Guidance Note on Terms used in Financial Statements issued by ICAI defines it as, "A system of allocation of responsibility, division of work and method of recording transactions, whereby the work of an employee or group of employees is checked continuously by correlating it with the work of others. An essential feature is that no one employee or group of employees has exclusive control over any transaction or group of transactions." Thus, it may be concluded that internal check is the term where the work is divided amongst the employees in such a manner that no single person is allowed to carry on the whole function from the beginning to the end and the work of an individual is automatically checked by another. Internal check can be proved to be very helpful if implemented properly as it is a built-in check in audit process.

**Internal Audit:** Internal audit constitutes an important element of internal control system. The Preface to the Standard and Guidance Notes on audit has defined internal audit as: "An independent management system which involves a continuous and critical appraisal of the function of the entity. The objective of the internal audit is to suggest improvement to the functions of entity and add value to and strengthen the overall governance mechanism of the entity including its strategic risk management and internal control system." Thus, internal audit not only encompasses checking matters relating

to finance but also reviews or undertakes the critical appraisal of the policies of the company. It helps in improving organizational effectiveness.

The management of the companies, banks, local bodies, insurance companies and such other body corporates delegate the responsibility to conduct internal audit to the staff members called internal auditors. These internal auditors strive to achieve the following objectives: (i) to determine the appropriateness of the internal control in safeguarding the assets and detecting errors and frauds (ii) to review compliance with policies plans, procedures, laws and regulations drawn by management (iii) to examine management information system and organisation structure (iv) to appraise the economy and efficiency with which resources are employed (v) to assess the understanding of standards by the employees and their respective implementation (vi) to identify deviations and their reasons and taking corrective actions and(vii) to review of accomplishment of goals and objectives. On the basis of such a review, the internal auditor can assist the management in developing goals and objectives for future periods. But, scope of the internal audit should be predetermined in terms of nature and industry of the entity.

#### **IV Legal Aspect and Recent Developments in Internal Audit**

**Compulsion of Internal Audit:** Audit of accounts by internal auditor is not compulsory in India. However, complexity and increasing size of corporations has drastically increased the role of internal auditor. Now, internal audit has assumed special significance in India with the introduction of Manufacturing and Other Companies (Auditor's Report) Order. It has

been superceded by Company's (Auditor's Report) Order, 2003. According to this Order, in case of specific companies, statutory auditor is required to report whether internal audit system commensurate with nature and size of the business of the company or not. Thus, it can be stated that importance of internal audit is now being recognized in India.

**Societal Power of Internal Audit:** Although internal audit is a critical component of the enterprise governance system and in most situations the enterprise governance system fails if internal audit fails, many will argue that internal audit has no societal power<sup>2</sup> and therefore has no social accountability. Two recent developments lead us to question this traditional view: (i) On January 6, 2010, SEBI has issued a circular requiring internal audit of credit rating agencies and submission of action taken report on internal audit observations to SEBI. Internal governance of credit rating agencies is questioned by many researchers. Therefore, SEBI's reliance on the internal audit signifies increasing societal expectations from internal audit. (ii) In December 2009, the Ministry of Corporate Affairs issued Corporate Governance Voluntary Guidelines in an endeavour to improve enterprise governance. One of the guideline is "In order to ensure the independence and credibility of the internal audit process, the Board may appoint an internal auditor and such auditor, where appointed, should not be an employee of the company". This guideline implies that appoint an outside agency for internal audit is preferable over conducting internal audit internally.

**Internal Audit as a Distinct Profession:** In India internal audit is not recognised as a distinct profession. Companies and other entities, which outsource the internal audit, appoint an accounting firm to conduct

internal audit. The current practice provides satisfactory results and therefore, the need for recognising internal audit as a distinct profession has not been felt. Recognition of internal audit as a distinct profession will accelerate the development of this body of knowledge, which will immensely improve enterprise governance. In absence of a recognised body of internal auditors having code of conduct for its members and a mechanism to sanction members who are negligent or guilty of misconduct, no mechanism exists to exact social accountability. Therefore, recognition of internal audit as a distinct profession should be considered seriously.

**SIA 17:** The Institute of Chartered Accountants of India (ICAI) has spruced up its standards on internal audit as well as other standards applicable to all. The new system for internal audit — the Standard on Internal Audit (SIA) 17 — distinguishes the internal auditor's responsibilities in relation to compliance with two different categories of laws and regulations, one that has direct effect on financial statements and the other which has significant impact on the functioning of the entity. The 17 standards, inter alia, deal with planning for an internal audit, basic principles, documentation, reporting, sampling, analytical procedures, quality assurance, terms of engagement, communication with management, evidence gathering, considerations of fraud, internal control checks, enterprise risk management, internal audit in an IT environment, knowledge of the entity and using the work of an expert.

In addition to providing performance benchmarks to the internal auditors, these SIAs aim to bring in greater consistency, standardisation and independence in the internal audit activity. As SIA codifies best practices in the field, the Institute, through

its Internal Audit Standards Board, has devoted a lot of attention and resources on the development and propagation of these standards. It is apparent that there is enough material on hand for an internal auditor to conduct an audit free of fear of favour. However, as the work of the internal auditor stops with the issue of the report and discussing it with management, in case there is something amiss in the financial statements and mentioned in the report, it is debatable as to who should inform the shareholder? In case the management feels that it is too trivial (later proved otherwise) an issue and brushes it under the carpet, should the internal auditor be given whistle-blowing powers? Can the report of the internal auditor be made a document accessible to persons who need it? Should material differences in the report be a part of the quarterly disclosures? Though not within the powers of the ICAI, the Ministry of Corporate Affairs could take an initiative on some of the possibilities.

**SRE 2410:** The ICAI has issued an Exposure Draft of Standard on Review Engagement 2410 (SRE 2410) — review of internal financial information performed by the independent auditor of the entity which advises the auditing fraternity to comply with the ethical requirements relevant to the annual audit, implement quality control procedures, obtain evidence, make inquiries of the management about internal controls, going concern concept and other matters he deems necessary, judge on materiality of misstatements, obtain a representation letter from the management that sets out things he needs to set out and, finally, communicate the findings of his audit to the management. The ICAI has been playing a proactive role in issuing norms relevant for the times. If the shadows of Satyam can be overshadowed, everyone can probably start

on a new slate with the amount of quality material on hand.

**V Research Methodology**

The present paper is based upon the study titled “Perceptions of Auditors on Various Aspects of Statutory Audit” carried out with the help of structured questionnaire. Questionnaire was sent to two-hundred members of Institute of Chartered Accountants of India (ICAI) in all which had firstly been pre-tested by ten members of ICAI. Out of two-hundred questionnaires, one hundred and sixty-eight questionnaires are returned and three questionnaires have not been included in the analysis because of incomplete

responses. Thus, analysis has been made on the basis of views of one hundred and sixty-five participant auditors that constitute 82.5 percent response. The study takes into account the responses of chartered accountants who are practicing auditors only or may have experience of both auditing profession and industry. All of the respondents are experienced in statutory audit along with other forms of audit. Information has been collected personally, through internet and by post. The responses have been analysed on the basis of simple aggregates and percentages with the help of Microsoft excel worksheet.

**VI Empirical Tables: System of Internal Control**

*Table 1: Role of Internal Control System*

<b>Responses</b>	<b>Number of Respondents</b>	<b>Percent</b>
1. Strongly Agree	94	56.97
2. Agree	53	32.12
3. Undecided	13	7.88
4. Disagree	5	3.03
5. Strongly Disagree	0	0
Total	165	100.00

*Table 2: Satisfaction Level of Internal Control System*

<b>Responses</b>	<b>Number of Respondents</b>	<b>Percent</b>
1. Very Satisfactory	32	19.39
2. Moderately Satisfactory	119	72.12
3. Less Satisfactory	13	7.88
4. Not Satisfactory	1	0.61
Total	165	100.00

*Table 3: Compulsion of Internal Audit*

<b>Responses</b>	<b>Number of Respondents</b>	<b>Percent</b>
1. Strongly Agree	121	73.33
2. Agree	37	22.43
3. Undecided	5	3.03
4. Disagree	2	1.21
5. Strongly Disagree	0	0
Total	165	100.00

**Table 4: Significance of Internal Check  
(Figures in Percentages)**

Significance	Rank 1	Rank 2	Rank 3	Rank 4	Rank 5	Rank 6	Rank 7	No Rank (0)	Total
1. Fixation of Responsibility	18.18 (30)	24.24 (40)	23.64 (39)	16.97 (28)	10.30 (17)	5.45 (9)	0.61 (1)	0.61 (1)	100 (165)
2. Increases Efficiency of Clerks	3.03 (5)	16.36 (27)	23.03 (38)	23.64 (39)	13.94 (23)	7.27 (12)	10.30 (17)	2.43 (4)	100 (165)
3. Prevention of Frauds and Errors	53.33 (88)	18.18 (30)	12.73 (21)	8.48 (14)	1.82 (3)	3.03 (5)	1.82 (3)	0.61 (1)	100 (165)
4. Reliability of Information	11.52 (19)	21.21 (35)	16.36 (27)	23.03 (38)	19.39 (32)	7.27 (12)	1.22 (2)	0 (0)	100 (165)
5. Reduces Work Load of Auditor	1.21 (2)	3.64 (6)	6.67 (11)	12.73 (21)	23.03 (38)	27.27 (45)	23.64 (39)	1.81 (3)	100 (165)
6. Increases Business Profitability	0 (0)	1.81 (3)	6.67 (11)	7.88 (13)	15.76 (26)	31.51 (52)	32.73 (54)	3.64 (6)	100 (165)
7. Keeps a Cross Check of Each Individual Work	12.73 (21)	16.36 (27)	13.94 (23)	7.88 (13)	16.36 (27)	13.94 (23)	18.79 (31)	0 (0)	100 (165)
8. Any Other	0 (0)	0 (0)	0 (0)	0 (0)	0 (0)	0 (0)	0.61 (1)	99.39 (164)	100 (165)

Note: Number of Respondents has been given in parenthesis.

**Table 5: Role of Surprise Visits**

Responses	Number of Respondents	Percent
1. Strongly Agree	59	35.76
2. Agree	81	49.09
3. Undecided	20	12.12
4. Disagree	4	2.42
5. Strongly Disagree	1	0.61
Total	165	100.00

**Table 6: Number of Surprise Visits**

Number of Surprise Visits	Number of Respondents	Percent
1. One	33	20.00
2. Two	78	47.27

3. Three	43	26.06
4. Four	10	6.06
5. Five	1	0.61
Total	165	100.00

**VII Empirical Findings: System of Internal Control**

**1 Role of Internal Control System:** An attempt has been made to know how far sound system of internal control is helpful to an auditor in minimizing his work with the help of Table 1. Table 1 indicates that nearly, nine-tenths (89.11 percent) of the auditors participated in the study confess that sound internal control system plays a vital role in minimizing the work of an auditor including nearly three-fifths (56.97 percent) of the respondents who strongly believe in this. On the other hand, not even a single participant has been found who strongly disagrees to the statement. It is because of the fact that sound internal control system includes such a set of controls which lead to simultaneous checking of transactions as soon as they are carried out. Hence, work of a statutory auditor is reduced to an extent. Moreover, sample-size for test check depends most upon sound internal control system has also been proved with the help of another part of the same study.

**2 Satisfaction Level of Internal Control System: Responses of the auditors have been analysed with the help of Table 2** to check their satisfaction level with regard to internal control system maintained by the entities visited by them. Table 2 reveals that more than seven-tenths (72.12 percent) of the respondents found internal control system maintained by the entities visited by them as moderately satisfactory only. Approximately, one-fifth (19.39 percent) of the participants also claim that it is very satisfactory in the organisations. On the

other hand, nearly, one-tenth (8.49 percent) of the chartered accountants state that it is less satisfactory including one who says it is not satisfactory. Thus, auditors are not very satisfied with the system of internal control maintained by the entities. It might be because of the reason that maintaining internal control system is not a legal requirement in India.

**3 Compulsion of Internal Audit:** Views of respondents have been analysed to know whether audit of systems and control by an internal auditor should be made compulsory in India at least for large organisations like in other countries as shown in Table 3. It is depicted by Table 3 that around three-fourths (73.33 percent) of the participants strongly support that audit of systems and control by an internal auditor should be made compulsory in India at least for large organisations. On aggregate basis, much more than nine-tenths (95.76 percent) of the respondents are in favour of making internal audit of systems and control compulsory in our country as well. This strong opinion is formed due to significance of system of internal control of which internal audit is an integral part.

**4 Significance of Internal Check:** Views of chartered accountants have been judged in relation to significance of internal check in fixing responsibility, increasing efficiency, prevention of frauds and errors, reliability of information, reduces work-load of auditor, increases business profitability and keeps a cross check. For this purpose, respondents have been specifically instructed to rank their preferences those are presented in Table 4. Table 4 indicates that more than one-half (53.33 percent) of the auditors participated in the study feel significance of



installing internal check in an organisation lies in preventing frauds and errors at the first place. Fixation of responsibility is considered to be the next best significance of internal check from the point of view of nearly, one-fourth (24.24 percent) and in aggregate, it is either first or second option of more than four-tenths (42.42 percent) of the participants. On the other hand, internal check is least significant in increasing profitability of business as per approximately one-third (32.73 percent) of the respondents. Another opinion as found in the responses in this regard is that true and fair presentation of financial statements becomes easy. Thus, internal check is most helpful in prevention of frauds and early detection of errors as it is the sole objective of installing internal check as per definition given by ICAI.

**5 Role of Surprise Visits:** Views of respondents have been evaluated to judge the significance of surprise visits<sup>3</sup> in keeping a check over the audit assistants and client's staff in Table 5. More than five-sixths (84.85 percent) of the respondents accept that surprise visits play a significant role in keeping a check over audit assistants and client's staff as shown by Table 5. Even more than one-third (35.76 percent) of the auditors strongly confirm the statement. A very few (3.03 percent) of the participants disagree to the statement. Thus, it is proved that surprise visits play a significant role in controlling audit assistants and client's staff because there is a fear in the minds of both audit assistants and client's staff that surprise visit can be made by the auditor anytime which facilitates better control.

**6 Number of Surprise Visits:** To determine suitable number of surprise visits<sup>4</sup> in an audit (keeping in mind its benefits and drawbacks); opinions of auditors have been examined in Table 6 specifying the limit of

surprise visits. Table 6 states that nearly one-half (47.27 percent) of the participants are in favour of making two surprise visits in an audit only as at times, it may offend the client also because frequent visits may dislocate client's work. On the other hand, exactly, one-fifth of the participants are in support of making only one surprise check throughout the audit. But, there are participants who support three or more than three surprise visits in an audit constituting nearly, one-third (32.73 percent) of the response. Some of the respondents also state that it should be moderate while others state that it can not be specified and it depends upon factors like internal control system and size of client's business. Still, it can be concluded on the basis of four-fifths (80 percent) of the auditors participated in the analysis that at least two surprise visits should be made in an audit. The reason is that two surprise visits in an audit will facilitate better control and it may not offend the client as well.

Hence, this paper has made an attempt to judge empirically the relevance and significance of system of internal control in the Indian enterprises on the basis of the opinions of the statutory auditors participated in the study. The results indicate the importance of system of internal control in reducing the workload of the auditors but the same is not found to be very satisfactory. Therefore, compulsion of internal audit at least in large entities has also been suggested. Moreover, internal check has been found most significant in preventing frauds and errors. Furthermore, importance of surprise checks in the audit task has also been insured by the participants. In addition, at least two surprise visits in a year are necessary to keep a check on client's staff along with audit staff in comparison to at least one surprise visit as per the prevailing

view has also been indicated in the present study.

### VIII Conclusion and Recommendations

System of internal control is a very useful device in the hands of a statutory auditor. It includes not only internal audit and internal check but various other set of controls. But statutory auditor is needed to be very cautious while relying on the audit task performed by the internal auditor as he cannot escape his responsibility afterwards accusing internal audit. Therefore, an attempt has been made to determine the status of system of internal control in Indian enterprises with the help of the views of participant statutory auditors. Results indicate that internal control system plays a vital role in minimizing the workload of statutory auditor but has not been found very satisfactory in Indian entities. Some operational suggestions to improve the status of internal control in Indian enterprises are given as under:

- ❖ Effective steps are needed to be taken by authorities to strengthen the system of internal control in Indian enterprises.
- ❖ Internal audit should be made compulsory for large enterprises and meaning of “large” should be specifically predetermined.
- ❖ Attempts can also be made to make internal audit independent of management and his status is subject to reconsideration whether to give him whistle-blowing powers or not.
- ❖ Recognising internal audit as a distinct profession should be considered seriously.
- ❖ Enterprises should be provoked to make more and more use of internal

check to minimize the number of errors and frauds at hand.

- ❖ At least two surprise visits should be made by the statutory auditor to keep a check on client’s and his own staff.
- ❖ Though, specific guidelines are being prepared by ICAI in terms of internal audit by way of SIA 17 and SRE 2410 but how well these new norms will be implemented is the matter of consideration. It will be required to be examined time to time even after their implementation.
- ❖ Ministry of Corporate Affairs should also take initiative in this respect especially in the cases where ICAI lacks authority.

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<sup>1</sup> Auditing Assurance Standards (AAS) have been reclassified and renamed as Standards on Auditing (SA) with effect from 1<sup>st</sup> April, 2008 as per Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services. Accordingly, AAS 6 has become SA 315.

<sup>2</sup> A profession or institution enjoys societal power if either the society in general or a segment of the society (e.g. stakeholders of a listed company) depends on it to protect its interest or the activities of the profession or entity impact the community significantly.

<sup>3</sup> Surprise visits are also known as surprise checks made on transactions which an auditor conducts without any prior notice to the client. These are incorporated in the audit programme to determine effectiveness and reliability of internal control system. They also ensure the auditor that books and accounts have been kept up-to-date (Jha Aruna, 2011).<sup>8</sup>

<sup>4</sup> Frequency of surprise visits is the matter of professional judgement of an auditor but whenever possible surprise visit should be made at least once a year by the auditor. Thus, nothing is specified or standardized in relation to number of surprise visits to be made in an audit (Jha Aruna, 2011).<sup>8</sup>