



THEORY & PRACTICE OF AUDITING

Notes

THEORY & PRACTICE OF AUDITING

SYLLABUS

Section-A

1. Auditing : Meaning, Objects, Fraud, errors : Book-keeping, Accounting and Auditing; Classification of audits; Planning and procedure of audit; Audit programmes; Auditor's working papers, Test checking; Routine checking.
2. Internal control : meaning, objective and evaluation of internal control; internal check and internal audit; Internal control regarding sales, purchases, assets, liabilities and salaries and wages; vouching.
3. Verification and valuation of assets and liabilities; Rules laid down in Kingston Cotton Mills Co. Ltd. (1896); Irish Woolen Co. Ltd. (1901); Westminster Road Construction & Engineering Ltd. (1941) and Thomas Gerard and Sons Ltd. (1967).

Section-B

1. Audit of sole proprietorship and partnership concerns. Educational institutions, Cinemas, Clubs and Hospitals.
2. Audit of joint stock companies : Appointment, removal and remuneration of company auditor; Audit of share capital, debentures and managerial remuneration, Audit for the purpose of Statutory Report and Prospectus; Audit of Government Companies with reference to Section 619 to the companies Act, 1956.

Section-C

1. Rights, duties and liabilities of an auditor and Rules laid down in London and General Bank Case (1895); Hedley yrne and Co. Ltd. v/s Heller and Partners Ltd. (1863); CIT v/s G.M. Dandekar (1952); Anupam Roy v/s P.K. Mukherjee (1956).
2. Divisible profits including audit of Reserves and Provisions.
3. Audit Reports and Audit Certificates.
4. Investigation : Meaning, objectives procedure; Investiation on behalf of perspective purchaser of business, banker and prospective investor.
5. Cost Audit : Meaning, Nature, Objective, Scope and types of cost audit.

Section -A

Auditing

Q. 1 Explain in brief meaning and objects of audit.

Ans

- (i) Audit is critical and comparative examination of books of accounts, records, and statements.
- (ii) It is done by on Independent agency.
- (iii) It is done with the help of relative documentary evidences (vouchers)
- (iv) It is done to ascertain true and fair view of affairs /financial position of organization.
- (v) This examination is done on a particular data and certifying the financial position on this date.
- (vi) Making a report on findings of audit to the management of a company (To all stake holders thorough AGM)

Objective of Audit

1. To ascertain and certify true and fare financial position and business.

2. To detect errors

- Errors of omission.
- Errors of Commission.
- Errors of Duplication
- Compensatory errors.
- Errors of Principles

3. To detect Frauds

- Mis appropriation of cash
- Mis appropriation of goods, assets.
- Manipulation of accounts

4. To avoid recurrence of errors and frauds.

5. Offering suggestions to the management.

True and fare view means:

- No over or under valuation of assets.
- No material asset or liability has been left out.
- No charge on assets.

4

B/S has been prepared as per provisions of companies Act.
Accounting policies has been followed uniformly.
Contingent/exceptional/non-recurring items have been shown separately in financial statements.

Q.2 Differentiate between an error & fraud.

Ans

Difference between an error and fraud

	<u>Point of Diff.</u>	<u>Error</u>	<u>Fraud</u>
1.	knowledge	No knowledge	Done with full knowledge
2.	Intention	No Intention	Done with specific intention
3.	Planning & Implementation	No Planning is required.	Specific planning and careful Implementation
4.	Result	Not known Easy	Result is always predicted/ planned
5.	Detection	Not an offence	Difficult
6.	Offence & penalty	only civil liability can be imposed	It is offence and punishable under I.P.C.

Q.3 Explain in brief classification of audit & kinds of audit.

Ans

Classification /kinds of Audit

Depending upon the nature and scope, audit may be classified as Private Audit: - Where

- (i) organization gets its accounts audited by a person under an agreement. It is optional and qualification of auditor and his responsibilities are not prescribed by law.
- (ii) Statutory Audit: - Where getting accounts audited is statutory or compulsory under law e.g. audit of a company, trust, bank etc. There, qualifications duties and responsibilities and the appointment of auditor is as per law.
- (iii) Government audit:- Audit of govt. departments and organizations. The highest authority is comptroller & Auditor General of India appointed by President of India. He has different units under him for auditing govt. accounts. In each state there is office of Accountant General for this purpose.
Local Fund Audit Dept. which conducts audits of Panchayat Samities, Gram Panchayat & Municipal Boards.

(iv)

While practically conducting audit, we may classify audit in different kinds such

as:-

(i) Complete Audits	(vii) Partial Audit
(ii) Continuous Audits	(viii) Periodical Audit
(iii) Interim Audit	(ix) Internal Audit
(iv) Efficiency Audit	(x) Propriety Audit
(v) Performance Audit	(xi) Cost Audit
(vi) Social Audit	

- (1) Complete Audit: - When accounts are fully or completely examined by the auditor, it is called complete audit. This examination may be six monthly or annual.
- (2) Partial Audit: -When only part of accounts of a business concerned are examined. This partial examination may be period wise or portion of accounts e.g. only cash transactions.
- (3) Continuous or Concurrent Audit: - When auditor visits the client at certain intervals or daily and completes, the checking of account up to his date of visit, it is known as continuous audit. In big organizations, auditor deploys his staff permanently and audit work continues nonstop. This is most common in large/ big business houses/undertakings as volume of examination is quite large.
- (4) Periodical Audit: - When audit is conducted at end after final accounts are ready and this process continues till completion of audit, it is known as periodical audit. It is also known as final audit and balance sheet audit.
- (5) Interim Audit: - Complete audit for an interim period say six months or a quarter for a specific purpose is known as interim audit. At times, it is conducted for declaring interim dividend.
- (6) Internal Audit: - Audit done by persons specifically appointed to check the accounts by internal person so that least possible errors/mistakes are observed by statutory/external auditor. This audit also aims at helping management in taking key management decisions.
- (7) Efficiency Audit :- Checking of efficiency of organization which is achieved by:
 - Optimum utilization of all available resources (financial, human, material, technological).

9

- Enhancement in profit
 - Reduction in cost without compromising on quality.
- (8) Propriety Audit:- Checking of propriety of decisions taken by the management i.e. decision has been taken wisely, taken in good faith and decision taken leads to economy in expenditure.
- (9) Performance Audit: - Means audit of actual performances of the business organization with reference to predetermined targets and costs involved. Big business houses are also preparing performance budget.
- (10) Cost Audit: - Refers to audit which aims at ascertaining and ensuring that cost of the unit has been correctly worked out. Such audit has been made compulsory in items of mass public consumption such as bread, cycle etc.
- (11) Social Audit: - Audit which evaluates social good to the society in general. It is generally resorted to examination of those schemes which has been started for common social uplift ment of poor. Recently Rajasthan govt. has started "Social Audit" of National Employment Guarantee Scheme commonly known as "NAREGA"

Q.4 What are advantages and limitations of Audit?

Ans

Advantages of Audit :-

1. Reliability and Credibility of accounts improve.
2. It leads to better discipline in staff due to audit fear.
3. Irregularities/errors/frauds are exposed and their rectification is possible.
4. True and fare view of financial position emerges.
5. Audit acts as a watchdog for investors.
6. Proves honesty and sincerity of organization- image building.
7. Audited accounts are helpful for assessment of taxes.

Limitations of Audit

1. Audit does not guarantee 100% correctness of accounts as it is done on test checking basis.
2. Many frauds done intelligently may remain undetected
3. Opinion expressed by the auditor may not be 100% correct.
4. Independence of an auditor is difficult as his appointment and remuneration are fixed by company.
5. Auditor does not see petty transactions and there may be chances of some

manipulations in such transactions.

Q.5 How you would proceed for conducting audit?

Ans **Planning & Procedure of Audit & Audit Programme.**

Before starting audit, auditor has to prepare a complete plan of audit work to be done. If present audit is second or third audit of an organization, he has to refer his earlier audit working papers. If it is first audit of a company or organization, he shall have to collect information about following:-

1. Scope of work:- Quantum of work to be done in the light of terms of appointment and provisions of law, articles of association/ bye laws.
2. Information about Organization:- in respect of the following :-
 - Technical features of business, manufacturing, trading, fixed and current assets etc.
 - Accounting system followed
 - List of books being maintained and guidelines of AAS-20 -Internal control system (internal check and internal audit.)
 - Staffing pattern and division of work amongst staff.
 - Acquire copy of bye-laws or articles of association.
3. Other Information :-
 - Type of audit whether if would be final audit or continuous audit.
 - Span of time allotted for completing audit and remuneration for audit.

Q.6 What do you understand by Audit Programme?

Ans **Audit Program :-**

After getting full knowledge of business, auditor has to prepare his work plan or audit programme. It is a predetermined flexible plan which functions as a guideline for audit.

Audit Programmers consists of:

- Out line of work to be done.
- Time to be allotted to each audit staff for completing work.
- Assignment of work to staff looking to their experiences and capability.
 - Scope of audit work and guide lines to control audit clerks/staff.

The crucial aspect of audit program is to determine as to:

- Who will do which work
- In how much time
- In what manner

A good audit program should be

- (i) Flexible -may be changed when need arises.
- (ii) Clarity in dividing work amongst staff.
- (iii) Proper classification/ assignment of work amongst audit staff.
- (iv) Logical flow of checking
- (v) Periodic review of program
- (vi) Proper monitoring of Progress.

Advantage of Audit Program

- (i) Quality of audit improves as division of work as per ability of employee's
- (ii) Determining responsibility is easy
- (iii) Review of progress is easy.
- (iv) It ensures complete examination as planned
- (v) It ensures timely completion of audit.

Q.7 Explain various steps in conducting audit.

Ans

Starting of audit: - After preparing programme auditor asks employer/organization to keep ready following:

- Vouchers in proper file in agreement with account books.
- Completion of preliminary books and ledgers
- Trial balances and final accounts
- List of debtors & creditors and doubtful debts.
- list of investments
- schedule of closing stock
- adjustments made in accounts
- schedule of fixed assets
- details of management

After asking for getting above ready, auditor sends audit staff to start audit work. This work starts with routine checking which includes.

-Checking of casts/carry forwards, checking of trial balance, with ledgers and ensure that correct balances have been taken in to trial balance.

This routine checking ensures arithmetical correctness of account books as well as trial balances. Form trial balances, checking of trading and manufacturing accounts, profit and loss account and balance sheet is done.

Test checking:-Auditor generally resorts to test checking which means checking of sample transactions out of all if these transactions checked in sample are found in order, it is presumed that other transactions which did not form part of sample world also the correct.

Auditor resorts to test checking at his own responsibility. . Auditor's working papers /notes:

- Are personal papers which are prepared with regards to audit and information he received from his employer/organization with reference to accounts and other related aspects. A complete file is maintained in which auditor keeps all relevant paper such as:

- Agreement of appointment
- Audit programme
 - Statements , information, certificates received in connection with audit
- Copy of bye-law/articles of association
- Copy of minutes of important decisions
- list of missing vouchers
- irregularities/ deserepenceis/ errors & frauds noticed during audit
- Important points observed during vouching/verification of assets/valuation of assets
- key points for discussions with management
- copy of audit report

The working papers/notes are of immense help to the auditor to defend/protect him

Case Study No. 1

On Errors and adjustment entries

You have been appointed as a statutory auditor of the company for the year 2011-12 under Indian Companies Act. The profit & Loss Account and Balance Sheet supplied to your for certification were showing a net profit of Rs. 10 lakhs. During the course of audit, following were your observations.

1. Overvaluation of stock amounting to Rs. 1 lakh was there for obsolete goods which were valued at cost price while their realizable value was much loss.

10

2. There was a prepaid insurance for 3 months Rs,2000/-
 3. Salary to staff for march 2012 amounting to Rs. 25000/- was paid in April 2012.
 4. Interest payable to bank Rs.20000/- up to 31.03.12 was not paid.
 5. An amount of Rs. 50000/- spent on a concrete platform for installation of machinery was debited to repairs.
 6. An amount paid to creditor 'A' was debited to 'B"s account Rs. 20000/
 7. An amount of Rs. 10000/- earned as dividend on shares was credited in bank account on 31.03.12 but was not taken in to account in final accounts.
1. Explain the nature of mistake and how such mistake can be rectified?
 2. What would be the correct amount of net profit you would like to certify?

Item-2

Internal Control

Q.1 What do you understand by internal control?

Ans Meaning: - Internal control refers to controlling all functions/activities of a business in such a way so as to ensure:

- Maximizing profit
- Smooth conduct of business
- Reduce possibilities of errors, frauds, embezzlements.
- Easy rectification on detection.

According to W.W. Bigg Internal control is best regarded as indicating whole spectrum of control, financial or otherwise established for the conduct of business including internal check, internal audit and other forms of control Objective:-

- (i) Correct accounting of transaction
- (ii) Prevention of errors, frauds.
- (iii) Fixing responsibilities/creating responsibility centers.
- (iv) Safety of assets.

(v) Efficient utilization of all resources

(vi) overall improvement in performance/Internal Control can be divided in to :-

(1) Internal check

(2) Internal audit

Q.2 Explain in brief Internal Checking & Internal Audit.

Ans Internal check: - Under internal check, accounting of each transaction is divided in two different segments and accounting of each segment is performed by a different person. Hence, accounting activity of each transaction passes through several hands and work done by one man is examined by second and the work of second by third person in an automatic way. As per "De Paula" -An internal check means practically a Continues internal audit carried on by the staff

itself by means of which work of each individual is independently checked by other members of staff."

Objects of Internal check /Advantages :

- (i) Prevention of errors and frauds.
- (ii) Easy discovery of errors and fraud & their timely rectification.
- (iii) Easy fixing responsibility of each staff member
- (iv) Ensuring correct recording /accounting of transactions
- (v) Facilitating :
 - Fast preparation of final accounts
 - Smooth audit.
- (vi) Making employees cautious and honest.

Limitations/ Disadvantages.

- (i) System is expensive as more staff is required.
- (ii) Fraud's through collusion of staff are possible
- (iii) If auditor relies more on internal check, test checks, the quality of audit may become unsatisfactory.
- (iv) Owners may become careless.

If internal, check system is adopted with due care and diligence and periodically reviewed, above limitation of internal check can be overcome easily.

Internal Audit:- It is audit by internal staff of organization "Internal auditing is the independent appraisal activity within an organization for the review of accounting, financial and other operations as the basis for productive and constructive services to management .In is conducted by regular employees of a business concern" This audit has to ensure that there are proper arrangements for accounting and security of assets.

In case of large scale enterprises, such internal audit has become almost a necessity by a qualified auditor .The companies Act also provide that audit has to make a mention in his audit report whether proper arrangements were there for internal audit in case of big companies with paid up share capital of Rs. 25 lakhs and more. So govt. also wants to promote internal audit.

Objects :-

- (i) To check/ensure that internal check arrangements are working properly.
- (ii) Discovering errors/frauds and preventing their recurrence.
- (iii) Facilitate statutory audit.
- (vi) Reviewing systems and procedures and suggest improvements in them.
- (v) Reviewing performance of employees departments, internal check arrangement and

to offer suggestions.

- (vi) To work as an aid to management to make the organization efficient and effective.

Internal auditor should submit periodical reports for implementation to remove flaws and loopholes.

Difference between Internal Check & Internal Audit		
Basis of Difference	Internal Check	Internal Audit
1- Nature of Job	System of recording transaction	Checking of Transaction
2- Discloser of errors & Frauds	During the course of recording	After recording of Transaction
3- Time	It is a continues process	Do
4- Type of Function	Operative function	Advisory function
5- Persons involved	Same Staff	Separate Staff
6- Purpose	Smooth & correct recording of transaction	To ensure that accounts summarized are free from errors & frauds and they reflect true & fair view of organization.
7- Process / nature	Continues process of recording transaction in books	More suggestive in nature

If internal check arrangements are efficiently arranged and internal audit has also been done by a qualified staff under him, it would greatly facilitate the work of statutory audit. However, the extent to which a statutory auditor has to rely on internal audit would be a decision to be taken by statutory auditor.

Limitations of Internal Audit:-

- (i) Lack of independence in audit
- (ii) At times, they develop intimacy with staff which adversely affects quality of

audit.

Q.3 Explain in brief internal check system to the followed for purchases, credit sales, cash receipts/payments; wages/salaries.

Ans Internal Check System for Purchase: - The main responsibility is with purchase department which has to ensure:

- Purchase of goods of best quality
- At lowest possible price
- Error free recording of purchases

In addition to purchase dept, other departments involved are:

- Stores dept.
- Material Inspection Dept.
- Accounts Dept.

Following Process are there regarding purchased

(i) Estimation of requirement of Goods to be purchased

- Store keeper collect requisition of purchase from different departments
- Compiles the requirements
- Assess total quantity of different goods to be purchased
- Placing purchase requisition to purchase dept.

(ii) Placing orders for supply of Goods :-

Main responsibility is that of purchase dept. Before placing order, it has to:

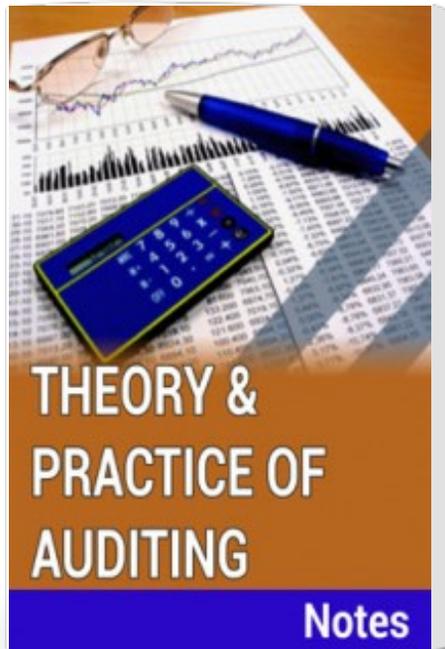
- Get quotations from different suppliers
- Compilation of rates.
- Checking of rates and quality of goods
- Approval of quotations
- Placing order as per requisition slips received from stores dept.

(iii) Receiving of Goods :- When ordered goods are received following steps are to be taken.

- Entry in goods inwards book on main gate.
- Sending the goods to stores where goods are checked (counting, measuring, weight etc.)
- Stores dept. prepares goods received note and sends it to purchase dept. and to accounts dept.

(iv) Checking the invoice and making payment: - The accounts dept would check order placed, goods receipt note, check prices in invoice and finally on reconciliation of all these documents, make payment and records the transaction in purchase book.

Theory and Practice of Auditing Notes



Publisher : ICSI

Author :

Type the URL : <http://www.kopykitab.com/product/1387>



Get this eBook