

**AS PER REVISED SYLLABUS OF UNIVERSITY OF MUMBAI  
B. Com. Accounting & Finance -2013-14**

# **Auditing - Introduction planning – Paper I**

[FYBAF First Year: Second Semester]

**DR. NISHIKANT JHA**

[M.Com, Ph. D., ICWA, PGDBM (MBA), DCA, DCP]

**CA Baijul Metha** (TCSC),  
(C.A., M.B.A, D.T.M, B.Com)

## **Preface**

It is a matter of great pleasure to present this new edition of the book on “Auditing Paper – I” to the students and teachers of Bachelor Of commerce (Accounting & Finance) started by university of Mumbai. This book is written on lines of syllabus instituted by the university. The book presents the subject matter in a simple and convincing language.

The syllabus contains a list of the topics covered in each chapter which will avoid the controversies regarding the exact scope of the syllabus. The text follows the term-wise, chapter - topic pattern as prescribed in the syllabus. We have preferred to give the text of the section and rules as it is and thereafter added the comments with the intention of explaining the subject to the students in a simplified language. While making an attempt to explain in a simplified language, any mistake of

interpretation might have crept in. This book is an unique presentation of subject matter in an orderly manner. This is a student friendly book and tutor at home. We hope the teaching faculty and the student community will find this book of great use. We welcome constructive suggestions for improvement.

I am extremely grateful to Mr. Pandey of Himalya Publication for their devoted and untiring personal attention accorded by them to this publications. I gratefully acknowledge and express my sincere thanks to the following people without whose inspiration, support, constructive suggestions this book would not have been possible.

**Mr. Jitendra Singh Thakur** (Trustee Thakur College)  
**Dr. Chaitaly Chakraborty** (Principal Thakur College)  
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*Our Well Wishers .....Pls take it from our FYBAF FA-I textbook*

## 1.2.2 Auditing- Introduction and Planning - Paper I

### Modules at a Glance

Sr. No.	Modules	No. of Lectures
1	Introduction to Auditing	14
2	Audit Planning, Procedures and Documentation	12
3	Auditing Techniques	12
4	Internal Audit	12

<b>Total</b>	<b>50</b>
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<b>Sr. No.</b>	<b>Modules / Units</b>
<b>1</b>	<b>Introduction to Auditing</b>
<b>1.1</b>	<b>Basics</b>
	Financial Statements, Users of Financial Information, Definition of Auditing, Objectives of Auditing - Primary and Secondary, Expression of Opinion, Detection of Frauds and Errors, Inherent Limitations of Audit
<b>1.2</b>	<b>Errors and Frauds</b>
	Concepts, Reasons and Circumstances, Types of Errors -Commission, Omission, Principle and Compensating, Types of Frauds, Risk of Fraud and Error in Audit, Auditor's Duties and Responsibilities in Respect of Fraud
<b>1.3</b>	<b>Principles of Audit</b>
	Integrity, Objectivity, Independence, Confidentiality, Skills and Competence, Materiality and Work Performed by Others, Documentation, Planning, Audit Evidence, Accounting System and Internal Control, Audit Conclusions and Reporting
<b>1.4</b>	<b>Types of Audit</b>
	Meaning, Advantages and Disadvantages of Balance Sheet Audit, Interim Audit, Continuous Audit, Concurrent Audit, Annual Audit
<b>1.5</b>	<b>Miscellaneous</b>
	Advantages of Independent Audit, Qualities of Auditors, Auditing Vs Accounting, Auditing Vs Investigation, View the Concept True and Fair
<b>1.6</b>	<b>Accounting Concepts Relevant to Auditing</b>
	Materiality, Going Concern
<b>2</b>	<b>Audit Planning, Procedures and Documentation</b>
<b>2.1</b>	<b>Audit Planning</b>
	Meaning, Objectives, Factors to be Considered, Sources of Obtaining Information, Discussions with Client, Overall Audit Plan
<b>2.2</b>	<b>Audit Programme</b>
	Meaning, Factors to be Considered, Advantages, Disadvantages, Overcoming Disadvantages, Methods of Work, Instruction before Commencing Works of Audit, Overall Audit Approach
<b>2.3</b>	<b>Audit working Papers</b>
	Meaning, Importance, Factors Determining Form and Contents, Main Functions / Importance, Features, Contents of Permanent Audit File, Temporary Audit File, Ownership, Custody, Access of Other Parties to Audit Working Papers, Auditors Lien on Working Papers, Auditors Lien on Client's Books
<b>2.4</b>	<b>Audit Notebook</b>
	Meaning, Structure, Contents, General Information, Current Information and Importance

<b>3</b>	<b>Auditing Techniques</b>
<b>3.1</b>	<b>Test Check</b>
	Test Checking Vs Routing Checking, Test Check Meaning, Features, Factors to be Considered, When Test Checks can be Used, Advantages, Disadvantages and Precautions.

<b>3.2</b>	<b>Audit Sampling</b>
	Audit Sampling, Meaning, Purpose, Factors in Determining Sample Size -Sampling Risk, Tolerable Error and Expected Error, Methods of Selecting Sample Items Evaluation of Sample Results Auditors Liability in Conducting Audit based on Sample
<b>3.3</b>	<b>Internal Control</b>
	Meaning and Purpose, Review of Internal Control, Advantages, Auditors Duties, Review of Internal Control, Inherent Limitations of Internal Control, Internal Control Samples for Sales and Debtors, Purchases and Creditors, Wages and Salaries
<b>3.4</b>	<b>Internal Checks Vs Internal Control, Internal Checks Vs Test Checks</b>
<b>4</b>	<b>Internal Audit</b>
<b>4.1</b>	Meaning, Basic Principles of Establishing Internal Audit, Objectives, Evaluation of Internal Audit by Statutory Auditor, Usefulness of Internal Audit
<b>4.2</b>	Internal Audit Vs External Audit, Internal Checks Vs Internal Audit

## Question Paper Pattern

Maximum Marks: 60

Questions to be Set: 04

Duration: 2 Hrs.

All Questions are Compulsory Carrying 15 Marks each.

Q-1	Full Length Question	15 Marks
Q-1	OR	15 Marks
	Full Length Question	
Q-2	Full Length Question	15 Marks
Q-2	OR	15 Marks
	Full Length Question	

Q-3	Full Length Question	15 Marks
Q-3	OR Full Length Question	15 Marks
Q-4	Objective Questions*	15 Marks
Q-4	(*Multiple Choice / True or False / Match the Columns / Fill in the Blanks)  OR Short Questions / Short Notes)	15 Marks

Note: Full Length Question of 15 Marks may be Divided into Two Sub Questions of 08 and 07 Marks.

## *Chapter no. 1 Introduction to Auditing*

### **1.1 Basic**

#### **1. Financial statement:**

It is said that Auditing begins where Accountancy ends. As a student of Finance, you know that every economic unit, with or without profit motive, maintains Books of Accounts to record the financial transactions and prepare financial statements. The International Accounting Standards committee has defined the term “Financial Statements” to cover Balance Sheets, Profit and Loss Accounts or income statements, statements of changes in financial position, notes and other statements and explanatory material which are identified as part of the financial statement. Financial Statements reflect the financial position and performance of any organization. Generally, users of accounting information through Financial Statement fall into two categories:

(a) Internal managers who use the information for day-to-day operating decisions.

(b) External parties, such as investors, banks, suppliers, and Government authorities etc, who use the information for making decisions about the company. Keeping in view, the significance of various accounting information and Financial Statements the reliability and authenticity of the Accounts must be ensured. Auditing plays an important role in ensuring the authenticity of accounting data. A person who conducts audit is called auditor. The Auditor expresses his opinion about truthfulness and fairness of the Financial Statements through an audit report

#### **2. Evolution**

The word “audit” has been derived from the Latin word “audire” meaning “to hear”, “listen” or “give credence to”. In ancient days an Auditor used to listen to the accounts read out by the accountant in order to check them.

Auditing was used in all countries such as Mesopotamia, Egypt, Greece, Rome, U.K. and India. The Egyptians, the Greek and the Romans used to get their public accounts audited. Audit of accounts of private house was rare. Even in India Auditing from the times of Vedas, Ramayana, and Mahabharata. Basically accounting and auditing had their origin in the need for the government to control the income and expenditure of the state and the army.

The industrial revolution in the 18th century and also advent of joint stock companies increased the number and complexity of business transactions. In these companies management and ownership was different. The director manages these companies but the real owners were the shareholders. This gave stimulus to the development of auditing process.

Due to increase in the number of companies, companies act made it compulsory to audit the book of accounts and give report to the real owner i.e shareholders. In India, companies act 1913 made it compulsory of audit of accounts. After independence the companies act 1956 enlarge the scope of auditors work and a power transferred to the Institute of Chartered Accountants of India through Chartered Accountants 1949. Presently only a practicing Chartered Accountant can act company auditor.

### **3. Definitions**

Different experts and association have defined Auditing varyingly. Let us discuss and understand some of the important definitions:

The International Auditing Practices Committee defines Auditing as “The independent examination of financial information of any entity, whether profit oriented or not and irrespective of its size, or legal form, when such an examination is conducted with a view to expressing an opinion thereon.”

Auditing and Assurance Standard (AAS1) by ICAI:

“Auditing is the independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expression an opinion thereon”

### **According to Ronald Irish**

“Auditing in its modern concept, is a scientific and systematic examination of books, vouchers and other financial and legal records in order to verify and report upon the facts regarding the financial condition disclosed by the balance sheet and the net income revealed by the profit and loss account.”

## **4. Objective of Auditing**

“The main object of an audit is to ascertain that the Balance Sheet and Profit & Loss Account of an undertaking is showing true and fair view of its financial positions and earnings.” However objectives of audit can be divided into two different parts:

1. Primary objectives
2. Secondary objectives

### **1 Primary objectives / Basic objectives**

The main or primary objective of Auditing is to find out the reliability and validity of the financial statements so as to render opinion on the truthfulness and fairness of the presentations in those statements. The auditor has to give an opinion on financial statements whether they are True and Fair view i.e whether a) Balance sheet shows true and fair view of the concern, b)the profit and loss accounts give a true and fair view of the profit or loss of the concern, c)all the material facts has been disclosed, d) the organization has followed all the compliance with regarding to legal requirement and e) Final accounts are made according to the recognized accounting principles and auditing standards laid down by professional bodies, like ICAI.

### **2. Secondary objectives / Incidental objectives**

The secondary objective of audit is to detect and prevent the errors and frauds. An error is generally taken to be innocent and not deliberate. Where it appears to be willfully made, it assumes the character of a fraud.

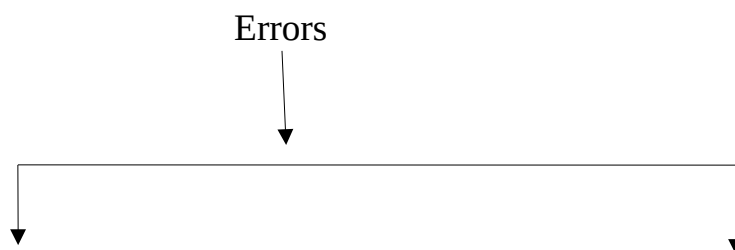
The term “fraud” refers to an intentional act by one or more individuals of management, employees or outsiders, severally or jointly, involving the use of deception to obtain an unjust or illegal advantage.

It’s not an objective of an audit to give a guarantee that all is well with the concern. A clean audit report does not imply that the management has efficient.

## 5. Inherent Limitation of Auditing

1. **Test check:** Due to test check all the transaction are not checked because of this many errors and fraud are not detected.
2. **An auditor has to depend on the expert:** in many circumstances auditors has to depend on the experts like lawyers, valuers, engineers. Circumstances may be like estimation of contingent liabilities, valuation of fixed assets ets...
3. **No future assurance:** audit is basically concern with past it never predict anything on future or never give any assurance on efficiency of the management.
4. **Postmortem of accounts:** Auditing begins where accounting ends. The job of an auditor starts where an accountant finishes his task of preparation of accounts. Naturally, the auditor has to rely on different information and explanations given to him by the Accountant. In the process many times, misstatement of facts remain undiscovered even after the accounts have been audited.
5. **Inherent limitations of internal control system:** An auditor before expressing his opinion mostly relies on the internal control system of the enterprise. Internal control is the overall control environment established by Management of an enterprise for effective and efficient monitoring and control of its operation. Internal control goes beyond the accounting functions of the organization and incorporates both accounting and administrative controls.

## 1.2 Errors and Fraud



Error of principle

Clerical Error



Error of duplicate



Error of Commission



Error of Omission



Compensating Error

**The accounting errors based on their nature can be of the following types:**

1. Clerical Errors
2. Errors of Principle

### **1. Clerical Errors**

The errors which are committed by accounting clerks are called clerical errors. These errors are committed in the process of recording financial transactions. These take place due to the carelessness of the clerk responsible for recording financial transactions. Clerical errors are also called technical errors. The principal types of clerical errors are as follows:

#### *a) Errors Of Omission*

The errors committed by not recording a transaction either in the book of original entry or in the ledger book are errors of omission. Such an omission may be either complete or partial.

#### Complete Omission

Complete omission takes place if a transaction is not recorded in the journal at all. For example, goods sold to Mr. A for Rs . 10,000 were not recorded in the sales book at all. A complete omission of transaction may occur due to many reasons such as sales invoice misplaced or lost.

### Partial Omission

Partial omission occurs if a financial transaction is recorded only partially. For example, partial error of omission occurs if goods sold to Mr. A for Rs. 4000 is recorded in sales book but failed to be posted in John's account.

### *b) Errors of Commission*

The errors which are committed while recording or posting a transaction are called errors of commission. Errors of commission may take place either in the journal or in the subsidiary books, or in the ledger. Such errors include posting wrong amounts, posting on wrong side of accounts, wrong totaling or carrying forward, and wrong balancing. For example, if purchase of goods for Rs.10,000 is entered as Rs.1000 in the journal or in the ledger, such error is called errors of commission.

### *c) Compensating Errors*

compensating errors refer to two or more errors which mutually compensate the effects of one another. If one error balances the effect of another error, then the two error are called compensating errors. For example, goods sold for Rs. 5000, but wrongly posted to the customer's account as Rs. 500. Similarly, goods purchased for Rs.5000, but by chance, wrongly posted to the supplier's account as Rs. 500 . The errors in the personal account are compensated by each other, as Rs.4500 short on the debit side of the customer's account and on the credit side of the supplier's account.

### *d) Errors of Duplication*

Errors of duplication are those errors which arise because of double recording. Double posting of a transaction from journal or subsidiary books to ledger also create such errors. For example, goods sold to Mr. A, but this transaction is wrongly entered twice or more in the sales book or wrongly posted twice or more in John's account then it is called the errors of duplication.

## **2. Errors of Principle**

Errors of principle are those errors which occur by violating the principles of accounting. Errors of principle may occur due to wrong allocation between capital and revenue expenditure, or wrong valuation of assets. For example, debiting the wage account instead of machinery account for the wage paid to the mechanics used for the installation of machine and debiting the customer's account instead of cash account for the cash sales made. Errors of principle may also occur due to wrong valuation of assets by higher level staff.

## **2. Procedure to detect Errors:**

Following procedure the auditor should follow to detect errors:

1. First start with the checking of the opening balance with the last year audited balance sheet.
2. After checking of opening balance start verifying the journal entry and then checking of posting into respective ledger accounts.
3. Than verify the subsidiary books.
4. Verify all the casting and carry forwards.
5. After that verify trial balance.
6. Compare the current year trial balance with the last year trial balance.
7. Calculate the total of both the side of trial balance if difference found than divided the difference amount with 2 figure which you arrive start find the amount in the ledger. Take for example difference in the trial balance is Rs.20000 than divide the amount with 2 so amount you arrived is Rs.10000 start finding Rs.10000 in the ledger.

### 3.Frauds:

Fraud means intentional misrepresentation of financial information by management, employee or third parties.

Fraud may be of following types:

1. Fraud through defalcation.
  - a. Misappropriation of cash
  - b. Misappropriation of goods
2. Fraud through accounts
  - a. Not recording a transaction
  - b. Recording the dummy transaction
1. **Fraud through Defalcation:** following are the method of defalcation involving misappropriation of cash or goods:
  - A Misappropriation of cash**
    - a. Misappropriation of cash receipt by not recording the same,
    - b. By suppressing the cash either not recording the cash or showing them as credit sales,
    - c. Showing payment twice in the cash book
    - d. By teeming and lading procedure that is cash received from one debtor is appropriated and deficiency in that accounts of debtors is made good when cash received from second debtors and the deficiency in the second debtors is made good when cash received from third debtors and so on...

### **B Misappropriation of goods:**

- a. Goods may be misappropriated by showing dummy sales,
- b. Goods are actually received in the organization but are shown as not received and goods are misappropriated.

### **2. Fraud through accounts**

- Not recording a transaction: These types of errors are intentional like sales take place but not shown in the books of accounts.
- Recording Dummy transaction: examples of these types of errors are showing wages or salary in the dummy workers accounts.

### **4. Circumstances indicating Errors and Fraud**

The circumstance indicates that there may exist errors or fraud:

1. Management is in the hand of single person
2. Internal control in the organization in either weak or does not exist at all
3. Turnover of the accounting staff is very high,
4. Professionals in the organization like lawyers or auditors are changes very frequently,
5. Depending on the few product or few customers
6. Working capital in the organization is inadequate
7. In the need of issue of share financial picture is to be shown in the better position,
8. Investment in the product line which is subject to rapid obsolescences,
9. There are many transaction with associates, related parties etc..
10. Organization is making excessive payment for services,
11. Vouchers which are available for audit is not duly authorized or supporting document for the same is not available.

**5. Auditors responsibility for errors and fraud:** ICAI has spelt out the responsibility of an audit for errors and fraud in ASS 4.

1. **Basic responsibility of Management:** It's basically responsibility of the management to detect and prevent fraud in the book of accounts. It is for the management to prevent and detect fraud and errors in the system.

2. **Incidental objective:** Basic objective of the audit is to state whether accounts are true and fair but with the basic objective the auditor incidental objective is to state that accounts are free from fraud and errors. While doing the audit the auditor should not only audit keep in mind books are true and fair but also free from major errors and fraud.

Basic idea behind is that auditor has taken a reasonable care for detecting errors and fraud. Though he is not responsible for errors and fraud but he should not fail in his duty to find out errors and fraud.

If during the audit auditor come to see that there exist errors and fraud in the book than he should take a reasonable step to rectify it. If there is error auditor should rectify it and confirm it. If there is fraud than if material he should state in the audit report.

### **1.3 Principles of Audit**

The concept of separation of management from ownership fuelled the growth of this profession. The owners who could not participate in the day-to-day management of the enterprise wanted an assurance that the financial information prepared by the management is reliable. An audit provides such an assurance and enhances the credibility of the information. The role of audit can be depicted as follows.

1. **Integrity, Objectivity and Independences:** Integrity implies an attitude of straightforwardness, honesty, sincerity, uprightness and reliability.
2. **Confidentiality:** Auditor should not disclose the information acquired in the course of audit to any one, unless there is a legal or professional duty to do so and Consented by the client.
3. **Skills And Competence:** Audit should be conducted by persons
  - Who possess due professional care,
  - Who are adequately trained
  - With experience and competence
4. **Planning:** Planning helps an auditor to conduct an audit in an effective, efficient and timely manner. Planning includes: Acquiring knowledge about the client's business, gaining an understanding of the accounting system and revision of plan as and when required.
5. **Work Performed By Others:** An auditor cannot do all the work by himself. The work is done either through his assistants or other professionals, but he continues to be responsible for forming and expressing an opinion on the financial statements. While delegating the work to others, he will be entitled to rely on the work performed by them, provided he exercises adequate skill

and care and is not aware of any reason to believe that he should not have so relied.

6. **Audit Evidences:** An auditor should obtain sufficient (quantum) appropriate (relevance and reliable) audit evidence through the performance of compliance and substantive procedures.
7. **Documentation:** An auditor should document matters, which are important in providing evidence that the audit was conducted in accordance with the basic principles governing an audit. The auditor should maintain the documents for a reasonable period of time to meet the demands of his practice
8. **Audit Conclusions and Reporting:** Auditor draws conclusions on the basis of Review and assessment of the audit evidence obtained; and his knowledge of the business, to form his opinion on the financial statements.
9. **Assessing the Accounting System and Internal Control:** An auditor should assess the accounting system to ensure that the system is adequate to record all the accounting information.

## 1.4

## **1.5 Types of Audit**

### **1. Balance sheet audit:**

A balance sheet audit is an audit of the accounts on the balance sheet. These audits usually focus heavily on the cash, accounts payable, accounts receivable and inventory. Land, buildings, intangible assets and long term investments are very difficult to misrepresent. Accounts payable and receivables, however, can be easily misstated in either direction. Inventory can easily be misstated either by mistake or on purpose. Fortunately, inventory figures are easily verified with a little leg work.

Procedure to conduct Balance sheet Audit:

1. First step to conduct the balance sheet audit is that to see the internal control of the organization. It must be evaluated in the following manner:
  - a. Whether internal control is effective
  - b. Whether the internal controls are in proper operation
2. Auditor should carry out verification of assets and liabilities on sample basis.
3. After verifying assets and liabilities auditor should inspect documents with regards to assets and liabilities.
4. Auditors should vouch such transactions which are important according to the auditor.
5. Auditors should himself satisfy about the valuation of assets and liabilities.
6. Proper presentation of assets and liabilities are made in the final accounts.
7. Auditors should physically verified assets and investment; he also has to examine addition or deduction in the fixed assets and investment.
8. Auditors should verify debtors and creditors balances by obtaining confirmation and statements of accounts, regarding debtors auditor has to verify how the provision has been made for doubtful debts, credit limit etc..
9. Auditor should physically verify the cash balance and stock.
10. A contingent liability has to be checked with the help of proper document.

11. After verifying items in the balance sheet start compare it with the previous year or start compare it with the ratio like current ratio, debtors ratio, debt equity ratio etc..

## **2. Interim audit**

An interim audit is conducted in between two annual audits. The objective is to ascertain and declare interim figures, for some specific purpose like declaration of interim dividend. Interim audit helps in early completion of annual audit. However, it is expensive, because it involves additional work on the part of company's staff as well as auditor.

### **Interim audit being conducted:**

1. **Quarterly results:** Public limited companies list on the stock exchange having declared their quarterly results. Before publishing the results interim audit is being conducted.
2. **Interim dividend:** Companies which declares interim dividend has to conduct interim audit.
3. **Sale or acquisition of business:** in case sole proprietor who proposed to sold the business has to conduct interim audit for the purchase consideration
4. **Changes in the firm:** In case of partnership firm audit is necessary in the case of retirement of the partner or admission of partner, sale of firm etc..

### ***Procedure:***

An interim audit is conducted as part of an audit that is carried out while the accounting period of the full audit is still in process. Financial statements of this nature are in a time frame of less than a year. An interim account may occur quarterly, so it does not produce final results as the fiscal year end would but gives an ideal as to how things are going and where they are heading.

### ***Advantages of Interim Audit***

1. Interim audit is good where the publication of the interim figure is necessary.
2. Then final audit can be completed very soon, if there has been an interim audit.
3. Errors and frauds can be detected more quickly during the final audit.
4. There is moral check on the staff of the client as the accounts are checked, say after three or six months in the interim audit.

## **Disadvantages of Interim Audit**

1. Figures may be altered in the accounts which have already been audited. It will mean that the audit staff will have to prepare notes when they finish the interim audit.
2. Interim audit is an additional work because final audit must be conducted after conducting this audit too.
3. Auditors does two audit during the year so audit becomes expensive.

### **3.Continuous audit:**

**Continuous auditing** is the independent application of automated tools to provide assurance on financial, compliance, strategic and operational data within a company. Continuous auditing uses a set of tools to assure the internal control system is functioning to prevent fraud, errors and waste. The “continuous” aspect of continuous auditing and reporting refers to the near real-time capability for financial information to be checked and shared. Not only does it indicate that the integrity of information can be evaluated at any given point of time, it also means that the information is verified constantly for errors, fraud and inefficiencies.

Each instance of continuous auditing has its own pulse. The internal management chooses for evaluation depends on the frequency of updates within the accounting information systems. Analysis of the data may be performed hourly, daily, weekly, monthly, etc. depending on the application.

#### **Business where continuous audit is applicable:**

- Where no satisfactory system of internal check is in operation.
- Where the volume of the transactions is very large.
- Where it is desired to present the account just after the close of the financial year, as in the case of a bank.
- Where the statements of accounts is required to be presented to the management after every month or quarter.

Advantage:

2. **Easy to quick discovery of errors:** Errors and frauds can be discovered easily and quickly as the auditor checks the accounts at regular intervals and in detail. As a auditor visits the client after a month or two or so on,

the number of transactions will be small and hence, the errors will be detected easily and quickly.

3. **Knowledge of technical details:** Since the auditor remains more in touch with the business, s/he is in a position to know its technical details and hence can be of great help to her/his clients by making valuable suggestions.
4. **Quick presentation of accounts:** As most of the checking works are already performed during the year, the final audited accounts can be presented to the shareholders soon after the close of the financial year at annual general meeting.
5. **Keeps the client's staff alert:** As the auditor visits the clients at regular intervals, the clerks are very regular in keeping the accounts up-to-date. They will see that there is no inaccuracy or frauds as it would be detected by the auditor at the next visit.
6. **Moral check on the client's staff:** If the auditor pays surprise visit, it will have a considerable moral check on the clerks preparing the accounts as they do not know when the auditor may pay a visit to check. Moral check will be more valuable to make staff alert and careful.

### **Disadvantages of Continuous Audit**

In spite of the above-mentioned advantages of a continuous audit, there are certain drawbacks of such and audit which are as follows:

#### **1. Alteration of figures**

Figures in the books of account which have already been checked by the auditor at previous visit, may be altered by a dishonest clerk and the frauds may be committed.

#### **2. Disturbance of client's work**

The frequent visits by the auditor may disturb the work of the client and cause inconvenience to the latter.

#### **3. Expensive**

Continuous audit is an expensive system of audit because an auditor devotes more time. So, company needs to pay more amount as the remunerations of an auditor.

#### **4. Queries may remain outstanding**

The audit clerk may lose the thread of work and the queries which s/he wanted to make may remain outstanding as there might be a long interval between two visits.

#### **5. Extensive note taking**

Extensive note taking may be necessary in order to avoid any alteration in the figures after the audit.

#### **4. Concurrent Audit:**

Concurrent audit is a systematic and timely examination of financial transaction on a regular basis to ensure accuracy, authenticity, compliance with procedures and guidelines. The emphasis under concurrent audit is not on test checking but on substantial checking of transactions. The concept of concurrent audit has been introduced to reduce the time gap between occurrences of transaction and is overview or checking. The concurrent audit serves the purpose of effective control as it is normally conducted by external agencies like chartered accountants firms.

The main objectives of concurrent audit include that any violation of procedure is brought to light. Ascertaining whether sanction for advances and expenditures is taken from competent authority. Examining books of accounts records and registers to ensure that they are maintained in accordance with the prescribed systems. Ensuring compliance of laid down systems, procedures and policies.

#### **5. Annual Audit :**

Annual audit is done at the end of the financial year when finalization of accounts has been completed and books of accounts closed. After completion of accounts, the management of enterprise calls auditor to commence the audit. Generally annual audit is completed in one interrupted session.

##### ***Advantages***

1. There is no loss of links in the audit work as entire audit is completed in a single session.

2. The audit work does not disturb the day to day accounting works of client because annual audit starts only after closing of accounts.
3. Annual audit is economical and suitable to small organizations.
4. As in the case of continuous audit, there is little scope of collusion between auditor's and client's staff members.

### ***Disadvantages***

1. Due to shortage of time, an in depth checking of accounts is not possible.
2. This audit is not suitable for large organizations where transactions are more and complicated

## **1.5 Miscellaneous**

### **Quality of auditors**

To be successful, an auditor should possess certain desirable qualities, besides having his formal qualification. His qualification requires that he should be a qualified chartered accountant. Besides, he should possess the following qualities:

1. Tactfulness
2. Cautious approach
3. Firmness.
4. Good temperament
5. Integrity etc.

He should be tactful in doing the job of auditing. While doing auditing, he should be cautious. He should have integrity, and independence.

He should possess the knowledge of common business laws. Like mercantile law partnership act, sale of goods act etc.

He should possess a thorough knowledge of taxation provisions prevalent in the country.

An auditor is required to critically comment upon the financial statements. He should possess requisite expert in that field. He should occupy the position of an expert in that field. He should have thorough knowledge of all accounting principles and procedures. He should also know the ways and means in which the business is being conducted.

By possessing these qualities, he can become a successful and effective auditor.

***DIFFERENCE BETWEEN AUDITING AND ACCOUNTING or  
DIFFERENCE BETWEEN ACCOUNTANT AND AUDITOR :-***

Factor	Accounts	Auditing
<b>1. Meaning</b>	Accounting means the maintaining of the books of accounts.	Auditing means examining the books of accounts and reporting means to report about their accuracy.
<b>2. Performance Of Work</b>	Accountant job is performed by the accountant	Auditing job is performed by the auditor
<b>3. Appointment :-</b>	Accountant is appointed by the management	Auditor is appointed by the share holders, management and even government depend upon type of audit,
<b>4. Qualification</b>	For the accountant no specific qualification is required	For the auditor specific qualification is required.
<b>5. Submission Of Report</b>	Accountant is not required to submit any report.	:Auditor is required by law to submit the report.
<b>6. Fixation Of Rights</b>	Rights and duties of accountant are fixed by the management	Rights and duties of an auditor are fixed by the law.
<b>7. Purpose</b>	Accounting purpose is to show the financial position of the business.	Auditing verifies the true picture of the financial statement.

<b>8.Record / Data</b>	Accounting is related with the present record.	Auditing is related with the past record
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### **Difference between auditing and investigation**

<b>Purpose</b>	<b>Auditing</b>	<b>Investigation</b>
<b>1. Purpose</b>	An audit is carried out for the purpose of ascertaining whether or not the balance sheet and profit and loss account show true and fair view of the state of company's affairs and its profit or loss	But an investigation aims at establishing a fact or is carried out for some particular purpose i.e. to know the financial position of the concern or the earning capacity of the concern etc.
<b>2.On Behalf</b>	An audit is carried out on behalf of the proprietor of the business,	while an investigation may be conducted on behalf proprietors when they suspect any fraud in their business or on behalf of outside parties who wish to lend money or intend to purchase business or at the instance of the government on the request of the shareholders.
<b>3.Scope</b>	An audit includes only an examination of the accounts of a business	An investigation covers not only an examination of the accounts but also an inquiry into other relevant matters connected with the

		purpose for which it is undertaken.
<b>4. Use of Techniques</b>	An audit is usually a test checking	An investigation is a much more thorough examination of the books of accounts. It goes into the depth of the problem and keeps on looking for far more definite evidence to arrive at a conclusion that it can firmly substantiate. Further, investigation may be conducted even after the audit of the accounts.
<b>5.Period</b>	An audit is related to only a year or six months	Investigation may cover several years.
<b>6. Statutory Obligation</b>	In the case of joint stock companies, audit is compulsory under law	There is no such statutory obligation with regard to investigation.
<b>7. Examination Use Of Policies</b>	In audit, an auditor has to see whether the methods of valuation and other accounting policies have been consistently followed or not and he has to ensure that all disclosures have been properly made in the	An investigation is not at all bound by accounting conventions, policies and disclosure requirements.

**Exercise:**

1. Multiple Choice Questions.

- a. Audit has been derived from the latin word\_\_\_\_\_
  - i. Audire
  - ii. Audie
  - iii. Audi
  - iv. Aude
- b. Today who can act as an auditor of the company?
  - i. Chartered accountant
  - ii. Accountant
  - iii. Practicing Chartered accountant
  - iv. 12<sup>th</sup> pass accountant.
- c. Objective of an audit of financial statement is to enable the auditor to express an opinion whether financial statement are prepared in accordance with the
  - i. Provision of income tax.
  - ii. With an identified financial reporting framework.
  - iii. System of double entry book keeping.
  - iv. With accounting policies laid down by the management.
- d. In India, companies act \_\_\_\_\_ made it compulsory of audit of accounts.
  - i. 1956
  - ii. 1972
  - iii. 1965
  - iv. 1913
- e. During the audit the opening balance will be verified with
  - i. Current year balance sheet
  - ii. Current year trial balance
  - iii. Last year balance sheet.
  - iv. Last year ledger.

- f. Fraud through account can be taken place through
  - i. Not recording a transaction.
  - ii. Recording a dummy transaction.
  - iii. None of the above
  - iv. All of the above.
- g. The risk of fraud increase when:
  - i. The auditor remain the same
  - ii. Management is in the hand of single person.
  - iii. Cash balance is very high.
  - iv. Bank balances remain low.
- h. Auditor can obtain the sufficient appropriate audit evidence through the performance of:
  - i. Vouching
  - ii. Compliance and substantive procedures.
  - iii. Reading of ledger
  - iv. None of the above.
- i. How many principles is there in AAS 1- Principle of audit.
  - i. 10
  - ii. 9
  - iii. 8
  - iv. 5
- j. Fraud through defalcation is:
  - i. Employee fraud,
  - ii. Management fraud
  - iii. Both of the above
  - iv. None of the above
- k. Auditing standards and auditing guidelines are issued the \_\_\_\_\_ board.
  - i. Government
  - ii. ICAI
  - iii. ICWA
  - iv. ICSI
- l. The errors which are committed by accounting clerks are called
  - i. Clerical error

- ii. Errors of principal
  - iii. Both of the above
  - iv. None of the above
- m. Audit of Bank is which type of audit?
  - i. Continuous audit
  - ii. Balance sheet audit
  - iii. Statutory audit
  - iv. Internal audit
- n. Final audit means
  - i. Audit done at the beginning of the financial year.
  - ii. Audit done at the end of the financial year
  - iii. Audit between two accounting year.
  - iv. Audit by the management.
- o. Internal audit means:
  - i. Audit done at the beginning of the financial year.
  - ii. Audit done at the end of the financial year
  - iii. Audit between two accounting year.
  - iv. Audit by the management
- p. Interim audit means:
  - i. Audit done at the beginning of the financial year.
  - ii. Audit done at the end of the financial year
  - iii. Audit between two accounting year.
  - iv. Audit by the management
- q. Final audit is unsuitable for \_\_\_\_\_ type of organization
  - i. Small organization
  - ii. Large organization
  - iii. Mid size firm
  - iv. None of the above.
- r. Interim audit being conducted for the following reasons:
  - i. Quarterly results
  - ii. Interim dividend
  - iii. Change in the firm
  - iv. All of the above.
- s. Balance audit only include the following things:
  - i. Verification of assets and liabilities

- ii. Vouching of income and expenditure
- iii. Verification of expenses
- iv. All of the above.

2. State whether true or false.

- a. Audit has been derived from the latin word audire.
- b. Primary objective of audit to detect and prevent the errors and frauds
- c. The term “fraud” refers to an intentional act by one or more individuals of management, employees or outsiders, severally or jointly, involving the use of deception to obtain an unjust or illegal advantage.
- d. In India, companies act 1956 made it compulsory of audit of accounts.
- e. During the audit the opening balance will be verified with the help of last year balance sheet.
- f. There are 10 principle listed in ASS1- Principles of audit.
- g. The auditor should dispose of the documents to meet the demands of his practice
- h. Planning helps an auditor to conduct an audit in an effective, efficient and timely manner.
- i. Auditor should disclose the information acquired in the course of audit to anyone.
- j. Auditor should not possess the knowledge of common business laws. Like mercantile law partnership act, sale of goods act etc.
- k. Auditor should act like a bloodhound and not a watch dog.
- l. Auditing begins where the accounting starts.
- m. Audit should be systematically planned.
- n. Audited accounts are free from errors and fraud.
- o. Auditor can take the help of valuer, branch auditor, lawyer etc..
- p. The auditor has to give an opinion on financial statements whether they are True and Fair view.
- q. The errors which are committed by accounting clerks are called error of principal.
- r. Bank audit is the internal audit.
- s. Annual audit is done at the beginning of the financial year.

- t. Final audit is unsuitable for large type of organization
- u. An interim audit is conducted in between two annual audits.
- v. Final audit cannot be completed very soon, if there has been an interim audit.
- w. A balance sheet audit is an audit of the accounts on the balance sheet
- x. Internal auditors are appointed by the management.
- y. Interim audit is not compulsory under the companies act.

### 3. Match the column

	Column A		Column B
1	Basis Principles listed in ASS1	a	Intentional error
2	Fraud	b	Systematic recording of transaction.
3	Manipulation of accounts	c	9
4	Book keeping	d	Management fraud

### 4. Match the column

1	Tax Audit	a	Internal audit
2	Audit by own staff	b	Compulsory Audit
3	Cost audit	c	Done at the end of the year
4	Statutory Audit	d	44AB
5	Final Audit	e	S 233 B
6.	Audit at regular interval	f	Voluntary audit
7	Audit of proprietor	g	Continuous audit

### 5. Check your answer

1. a. i , b.iii, c. ii, d. iv, e. iii, f. iv, g. ii, h .ii , I .ii, j. i, k. ii, l. i, m.iii, n. ii, o. iv, p.iii, q. iv, r. iv, s.i,
2. a. T, b. T, c .T, d. F, e. T, f. F, g .F, h. T. i. F, j. F, k. F, i. F, m. T, n. F, o. T, p. T, q. F, r. F, s. F, t. T, u. T, v. F , w.T , x. T , y.T , z.
3. 1- c, 2- a, 3- d, 4 - b
4. 1. d, 2. a, 3. e, 4.b, 5.c, 6. g, 7. F

6. Theory question:

1. Define audit and explain its objective in brief.
2. Explain and define the term audit.
3. Explain the term error and fraud
4. Explain various types of error found in the books of accounts.
5. Explain the term errors and procedure to detect error.
6. What is fraud and types of fraud?
7. Explain circumstances indicating errors and fraud.
8. What is advantage of audit?
9. Explain the term audit and its limitation.
10. Explain the principal of audit ( AAS- 1)
11. Explain some quality of auditor.
12. Explain any four principal of audit.
13. Explain the term “worked performed by other” in context to auditing principal.
14. Explain fraud through accounts.
15. Explain the term continuous audit.
16. Cases where continuous audit is applied.
17. Explain the advantage of continuous audit.
18. Explain the disadvantage of continuous audit.
19. What do you mean by interim audit?
20. Why the interim audit is being conducted?
21. Explain the procedure of interim audit along with its advantage.
22. What are the disadvantages of interim audit?
23. Explain in brief Balancesheet audit.
24. What are the procedures to conduct Balancesheet audit.
25. What do you mean by concurrent audit?
26. Explain the term internal audit.
27. Explain any 5 standard on internal audit.
28. What are the advantage and disadvantage of internal audit?
29. Write short note – relationship between internal auditor and external auditor.

## **Chapter 2: Audit Planning, Procedures and Documentation**

### **2.1 Audit Planning**

#### **Audit Planning (AAS 8):**

##### **1. Basis:**

"The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client's business.

Plans should be made to cover, among other things:

- (a) Acquiring knowledge of the client's accounting systems, policies and internal control procedures;
- (b) Establishing the expected degree of reliance to be placed on internal control;
- (c) Determining and programming the nature, timing, and extent of the audit procedures to be performed; and
- (d) Coordinating the work to be performed.

Plans should be further developed and revised as necessary during the course of the audit."

The purpose of this Statement is to amplify the basic principle outlined above.

##### **2. Why audit planning?**

Adequate audit planning helps to:

- \* ensure that appropriate attention is devoted to important areas of the audit;
- \* ensure that potential problems are promptly identified;
- \* ensure that the work is completed expeditiously;
- \* utilize the assistants properly; and
- \* co-ordinate the work done by other auditors and experts

### **3 Knowledge of the Client's Business**

Normally, however, internal audit operates in one or more of the following areas:

The auditor needs to obtain a level of knowledge of the client's business that will enable him to identify the events, transactions and practices that, in his judgment, may have a significant effect on the financial information. Among other things, the auditor can obtain such knowledge from:

- \* The client's annual reports to shareholders.
- \* Minutes of meetings of shareholders, board of directors and important committees.
- \* Internal financial management reports for current and previous periods, including budgets, if any.
- \* The previous year's audit working papers, and other relevant files.
- \* Firm personnel responsible for non-audit services to the client who may be able to provide information on matters that may affect the audit.
- \* Discussions with client.
- \* The client's policy and procedures manual.
- \* Relevant publications of the Institute of Chartered Accountants of India and other professional bodies, industry publications, trade journals, magazines, newspapers or text books.
- \* Consideration of the state of the economy and its effect on the client's business.
- \* Visits to the client's premises and plant facilities.

With respect to the previous year's audit working papers and other relevant files, the auditor should pay particular attention to matters that required special consideration and decide whether they might affect the work to be done in the current year.

### **4. Matters to be discussed with the client:**

Discussions with the client might include such subjects as:

- \* Changes in management, organizational structure, and activities of the client.
- \* Current Government legislation, rules, regulations and directives affecting the client.
- \* Current business developments affecting the client.
- \* Current or impending financial difficulties or accounting problems.
- \* Existence of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.
- \* New or closed premises and plant facilities.
- \* Recent or impending changes in technology, type of products or services and production or distribution methods.
- \* Significant matters arising from previous year's financial statements, audit report and management letters, if any.
- \* Changes in the accounting practices and procedures and in the system of internal control.
- \* Scope and timing of the examination.
- \* Assistance of client personnel in data preparation.
- \* Relevance of any work to be carried out by the client's internal auditors.

## **5 Development of an Overall Plan**

The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit:

- \* The terms of his engagement and any statutory responsibilities.
- \* The nature and timing of reports or other communication.
- \* The applicable legal or statutory requirements.

- \* The accounting policies adopted by the client and changes in those policies.
- \* The effect of new accounting or auditing pronouncements on the audit.
- \* The identification of significant audit areas.
- \* The setting of materiality levels for audit purposes.
- \* Conditions requiring special attention, such as the possibility of material error or fraud or the involvement of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.
- \* The degree of reliance he expects to be able to place on accounting system and internal control.
- \* Possible rotation of emphasis on specific audit areas.
- \* The nature and extent of audit evidence to be obtained.
- \* The work of internal auditors and the extent of their involvement, if any, in the audit.
- \* The involvement of other auditors in the audit of subsidiaries or branches of the client.
- \* The involvement of experts.
- \* The allocation of work to be undertaken between joint auditors and the procedures for its control and review.
- \* Establishing and coordinating staffing requirements.

## **2.2. Audit Programme:**

### **1 Meaning:**

AAS 8 says that the auditor should prepare a written audit programme setting forth the procedures that are needed to implement the audit plan. The

programme may also contain the audit objectives for each area and should have sufficient details to serve as a set of instructions to the assistants involved in the audit and as a means to control the proper execution of the work.

## **2 Points to be consider while preparing audit programme :**

1. **Internal control:** In preparing the audit programme, the auditor, having an understanding of the accounting system and related internal controls, may wish to rely on certain internal controls in determining the nature, timing and extent of required auditing procedures. The auditor may conclude that relying on certain internal controls is an effective and efficient way to conduct his audit.

However, the auditor may decide not to rely on internal controls. When there are other more efficient ways of obtaining sufficient appropriate audit evidence. The auditor should also consider the timing of the procedures, the coordination of any assistance expected from the client, the availability of assistants, and the involvement of other auditors or experts.

2. **Flexibility:** The auditor normally has flexibility in deciding when to perform audit procedures.

However, in some cases, the auditor may have no discretion as to timing, for example, when observing the taking of inventories by client personnel or verifying the securities and cash balances at the year-end

3. **Commencement of audit:** The audit planning ideally commences at the conclusion of the previous year's audit, and along with the related programme, it should be reconsidered for modification as the audit progresses. Such consideration is based on the auditor's review of the internal control, his preliminary evaluation thereof, and the results of his compliance and substantive procedures.

## **3. Advantages of audit program**

### **1. Supervision of work:**

The auditor can judge the efficiency of his audit team with the held of all audit programs. He is in a position to know the progress of the work. He can see at any time that what part of the work has been completed and what remains to be done.

## **2. Division / distribution of audit work:**

The division of audit works is very useful for the audit staff for maintaining the difference of works among senior or junior clerks according to their ability and skill so that the work is divided to get better results.

## **3. Systematic uniformity of work:**

Audit program helps in settling all the things in advance, so the systematic uniformity of work is necessary to achieve the desircice.

## **4. Basic instrument for training:**

Audit program is infect a training instruments for the audit staff and also very useful for the new auditors. It provides training and guidance to him. So it is rightly called the basic instrument for training for the staff at the time of need.

## **5. Solid legal evidence:**

Audit program and audit working papers are solid legal evidence of work done by every assistant of the audit team. It can be presented in the court of law if any action is taken against the auditor for negligence. These programmes and papers proves that the auditor has used his skills and due care in the audit of the firm so his liability can be reduced.

## **6. Fixation of responsibility:**

Audit programmes fixed the responsibilities of the staff. If any error or fraud remains undetected, the responsibility of negligence will fall on that particular assistant who has performed that job and no one can blame on each other.

## **7. Several audits may be controlled:**

The auditor controls the audit of various companies at the same time. In the absence of audit program he cannot supervise them effectively.

## **8. Easy transfer:**

The principle auditor can transfer to the any other person easily. If one assistant is unable to continue the work given to him it can be given to another person. Audit program guides him that what is done and what is remaining.

## **9. Final review:**

Before signing the report, final Review is made and for this purpose also auditing program is very useful and any deficiency or missing in steps can be identified and completed.

## **10. Useful for future:**

The audit programme is very useful in the future. Or completion of an audit, it serves the purpose of audit record that may be useful for future reference. In case of auditor is appointed for the same concern in any future time the

auditor can use the same audit programme with some changes.

**11. Proress of audit work:**

Audit programme is helpful to note the progress of work. Audit programme is a timetable, which can show the work done on any particular date. The pace of work is going on with the passage of time. The adjustment can be made if there is more work and less time and vice versa. In this way work can be completed in time.

**12. Supervision of audit staff:**

Audit programme is beneficial for auditor. He can supervise the activities of audit staff. He can use the audit programme as basis of supervision. Every part of audit work can be complete as per schedule. He can control the activities of audit staff through observation and direction when the audit work can be complete in time:

**13. Audit staff needed:**

Audit programme is helpful to determine the number of persons needed to do the work. The staff requirement is essential for every auditor. The shortage of staff means slow progress. The exact number of senior and junior audit clerk can be determined. In this way an auditor is able to handle the audit work properly.

**14. Same work:**

The benefit of audit programme is that new instructions are not issued due to change in staff. The nature of work remains the same. The audit clerks can know their job just by reading the written programme: The time is saved due to written instructions.

**15. Timetable:**

The benefit of audit programme is that work is complete with in stated time period, the saving of time means saving of labour. The saving of time means saving can control the cost of audit due to fixed time. He can arrange audit work of other business concerns.

**16. Reponsibility for poor work:**

The benefit of audit programme is that auditor can fix responsibility for negligence. Audit programme is a timetable of whole audit work to be done by auditors. Every staff member is given some sort of duty to do the audit work. The staff is responsible for completing of work. The performance is noted and responsibility if fixed poor work.

**17. Guide to audit assistants:**

The merit of audit programme is that it serves as a guide to audit assistants. The junior audit staff can start and complete the audit work with the help of

audit programme. There is no need to repeat the instructions every time. More ever it serves as a guide for future. The new audit programme can be developed on the basis of old work.

**18. Dealing with new clients:**

The merit of audit programme is that it helps to deal with client. The spare time of audit staff can be used for doing with new clients. The whole year time can be divided. The auditor can audit the accounts if various concerns under audit programme.

**19. Proof for audit work done:**

The merit of audit programme is that auditor can use it as proof for work done. In court of law the auditor can avoid liability for negligence. Audit programme is a permanent record of an audit process. The audit programme shows the work performed date-wise. In this way he cannot be held responsible for carelessness.

**4 Disadvantage of Audit Programme:**

**1. Not comprehensive:**

Auditors may have covered the whole tie but I cannot be said with certainty that all the necessary work has been done.

**2. Rigidity:**

Audit program loses its flexibility. While each business has a separate problem. So audit program cannot be laid down for each type of business.

**3. No initiative:**

It kills the initiative of capable persons. The assistant cannot suggest any improvement in the plan.

**4. Too mechanical:**

Such audit program is too mechanical that it ignores many other aspects like internal control.

**5. Large concerns / not suitable for small concerns:**

Audit programme is helpful in large business concerns. It has been proved that audit program is not suitable for small business concerns.

**6. New problems over looked:**

In the audit programme there is no chances to accept the changes with the passage of time new problems arise that may he over looked.

**7. Changes:**

The drawback of audit programme is that changes in it are not acceptable.

The nature of activities of concern may change. There is a need to adjust the changes in the programme. A master programme cannot be drafted.

**8. Revision:**

The demerit of audit programme is that there is no revision in it. The business changes from year to year. The working may expand or contract. The audit programme requires adjusting itself to the changing circumstances.

**9. Types:**

The demerit of audit programme is that it is not suitable for all types of business concerns. A small business may have few books of accounts. It is not necessary to prepare audit programming for small concerns.

**10. Staff:**

The accounting staff can know the working of audit. The auditor applies various methods for checking the accounting books. Having knowledge of auditing the accounting staff can devise means to record the transaction. In this way they can avoid their responsibility

**5. Audit Procedure for obtaining audit Evidences:**

There are some of the method to obtain the audit evidences they are as follows

- **Inspection:** Inspection involves examining records or documents, whether internal or external, in paper form, electronic form or other media or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability. Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets in such case inspection by vouching can be done to get a clear idea. Same way inspection of individual inventory items may accompany the observation of inventory counting.
- **Observation:** Observation consists of looking at a process or procedure being performed by others, for example, the auditor's observation of inventory counting by the entity's employees. Observation provides evidence about the performance of a process or procedure, but is limited to

point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed.

- **Inquiry:** Inquiry consists of seeking information of organization either form within the entity or outside the entity. Inquiry is used throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries.
- **Analytical Procedures:** Analytical procedures consist of evaluations of financial information made by a study ratio or comparisons between the firms or comparisons between the two years.
- **External Confirmation:** An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party for example auditor will take confirmation form the debtors directly for the balance.

### **2.3 Audit Working Paper:**

“The auditor should document matters which are important in providing evidence that the audit was carried out in accordance with the basic principles.” The purpose of Standard 3 is to amplify the basic principle outlined below:

Documentation, for purposes of this Standard, refers to the working papers prepared or obtained by the auditor and retained by him, in connection with the performance of his audit.

Working papers means: a) Aid in the planning and performance of the audit; b) Aid in the supervision and review of the audit work; and c) Provide evidence of the audit work performed to support the auditor’s opinion.

#### **1 Content required for audit working paper:**

- Working papers should record the audit plan, the nature, timing and extent of auditing procedures performed, and the conclusions drawn from the evidence obtained.
- Working papers should be designed and properly organized to meet the circumstances of each audit and the auditor’s needs in respect thereof.

- Working papers should be sufficiently complete and it should be in detailed for an auditor to obtain overall understanding of the audit.
- All significant matters which require the exercise of judgment, together with the auditor's conclusion thereon, should be included in the working papers.
- To improve audit efficiency, the auditor normally obtains and utilizes schedules, analyses and other working papers prepared by the client. In such circumstances, the auditor should satisfy himself that these working papers have been properly prepared.
- In the case of recurring audits, some working paper files may be classified as permanent audit files, which are updated currently with information of continuing importance to succeeding audits, as distinct from current audit files, which contain information relating primarily to the audit of a single period.

## **2.A permanent Audit file normally includes:**

- Information concerning the legal and organizational structure of the entity. In the case of a company, this includes the Memorandum and Articles of Association. In the case of a statutory corporation, this includes the Act and Regulations under which the corporation functions.
- Extracts or copies of important legal documents, agreements and minutes relevant to the audit.
- A record of the study and evaluation of the internal controls related to the accounting system. This might be in the form of narrative descriptions, questionnaires or flow charts, or some combination thereof.
- Copies of audited financial statements for previous years.
  - Analysis of significant ratios and trends.
- Copies of management letters issued by the auditor, if any.
- Record of communication with the retiring auditor, if any, before acceptance of the appointment as auditor.
- Notes regarding significant accounting policies.
- Significant audit observations of earlier years.

## **3 The Current File Normally Includes**

- Correspondence relating to acceptance of annual reappointment.
- Extracts of important matters in the minutes of Board Meetings and General Meetings, as are relevant to the audit.
- Evidence of the planning process of the audit and audit programme.
- Analysis of transactions and balances.
- A record of the nature, timing and extent of auditing procedures performed, and the results of such procedures.

- Evidence that the work performed by assistants was supervised and reviewed.
- Copies of communications with other auditors, experts and other third parties.
- Copies of letters or notes concerning audit matters communicated to or discussed with the client, including the terms of the engagement and material weaknesses in relevant internal controls.
- Letters of representation or confirmation received from the client.
- Conclusions reached by the auditor concerning significant aspects of the audit, including the manner in which exceptions and unusual matters, if any, disclosed by the auditor's procedures were resolved or treated.
- Copies of the financial information being reported on and the related audit reports.

#### **4 Ownership and Custody of Working Papers**

Working papers are the property of the auditor. The auditor may, at his discretion, make portions of or extracts from his working papers available to his client.

The auditor should adopt reasonable procedures for custody and confidentiality of his working papers and should retain them for a period of time sufficient to meet the needs of his practice and satisfy any pertinent legal or professional requirements of record retention.

#### **2.4 Audit Note Book:**

##### **Definition:**

Audit notebook is a diary on which auditor scribble down all important inquiries to avoid the possibility of unquestioned material facts.

##### **Importance**

Justice William throws light on the importance of audit notebook in the following words,

The audit notebook that contained detailed information proved to be very helpful to the auditor in every critical moment.

For preparing the audit report it is very useful for that auditor.

In case of negligence charge against the auditor, but note book good evidence can be presented. It may be also used for future guidance and reference. It also enables to auditor to know that what work his assistant at each audit has done.

## **Advantages of Audit Note Book**

### **1. Audit Report**

The audit notebook is helpful to prepare audit report. The auditor can record the weakness of accounting records. The queries not properly answered are started in the audit report when the auditor is satisfied he can submit a clear report.

### **2. Staff Honesty**

The audit notebook is used to determine the integrity and honesty of audit clerks. The moral and ethical value can be examined through audit work. When a person completes his work in time. Time period auditor can appreciate him. If there is pending work after the expiry of time period, he can be held responsible for it. The audit staff must be honest in his work.

### **3. Helpful for Memory**

The audit notebook is help to keep things fresh in memory. The auditor can read the book on daily basis. He can note the weakness on fingertips. The auditor can retain the data in his memory for a longer period of time. He can ask the management to clear the doubtful points before preparing audit report.

### **4. Reference**

The audit notebook is useful for reference. In future it can provide information to the audit staff. The past data gives an insight into business matters. The auditor can note the changes. He can form an opinion about the changes in the nature and size of the business.

### **5. New Auditor**

The audit notebook is useful for new auditor. They can see the weakness of previous years. The old weak points may not be repeated this year.

### **6. Court Cases:**

the audit notebook is helpful to defend an auditor in court cases. The people can go to court of law in order to fix liability for negligence of duty. The audit notebook is a written proof of work performed by an auditor.

### **Exercise:**

1.

Multiple Choice question

- a. The Board must appoint the first Auditor within \_\_\_\_\_ month from the date of registration of the company.
  - i. Two
  - ii. Three
  - iii. Four
  - iv. One
- b. "The auditor should plan his work to enable him to conduct an effective audit in an \_\_\_\_\_ manner.
  - i. An efficient and timely.
  - ii. Professional
  - iii. good
  - iv. excellent
- c. \_\_\_\_\_ says that the auditor should prepare a written audit programme setting forth the procedures that are needed to implement the audit plan.
  - i. AAS 4
  - ii. AAS 5
  - iii. AAS 8
  - iv. AAS 6
- d. \_\_\_\_\_ involves examining records or documents, whether internal or external, in paper form, electronic form or other media or a physical examination of an asset.
  - i. Observation
  - ii. Inquiry
  - iii. External confirmation.
  - iv. Inspection
- e. Working papers means
  - i. Aid in the planning and performance of the audit;
  - ii. Aid in the supervision and review of the audit work;
  - iii. Provide evidence of the audit work performed to support the auditor's opinion.
  - iv. All of the above
- f. Working papers are the property of the\_\_\_\_\_.
  - i. Management
  - ii. Auditor
  - iii. Debtors

- iv. Workers
- g. Audit working papers are prepared by the\_\_\_\_\_.

  - i. Management
  - ii. Auditor
  - iii. Debtors
  - iv. Workers

- h. The \_\_\_\_\_ is helpful to defend an auditor in court cases.

  - i. Audit working paper
  - ii. Audit note book
  - iii. Audit planning
  - iv. All of the above

- i. \_\_\_\_\_ is a diary on which auditor scribble down all important inquiries to avoid the possibility of unquestioned material facts.

  - i. Audit working paper
  - ii. Audit note book
  - iii. Audit planning
  - iv. All of the above.

- j. Audit programme should be\_\_\_\_\_

  - i. Fixed
  - ii. Flexible
  - iii. Oral
  - iv. None of the above

- k. A permanent Audit file normally includes

  - i. Notes regarding significant accounting policies
  - ii. Analysis of significant ratios and trends.
  - iii. All of the above
  - iv. None of the above.

2. State whether true and false

- a. The Board must appoint the first Auditor within two month from the date of registration of the company
- b. AAS 8 says that the auditor should prepare a written audit programme setting forth the procedures that are needed to implement the audit plan.

- c. Observation consists of looking at a process or procedure being performed by others.
- d. Observation consists of seeking information of organization either forms within the entity or outside the entity.
- e. Working papers are the property of the management.
- f. Audit note book is a diary on which auditor scribble down all important inquiries to avoid the possibility of unquestioned material facts
- g. Audit programme should be fixed in nature.
- h. A permanent Audit file normally includes notes regarding significant accounting policies
- i. Analytical procedures consist of evaluations of financial information made by a study ratio or comparisons between the firms or comparisons between the two years.
- j. The audit planning ideally commences at the conclusion of the current year's audit.
- k. Audit programmes fixed the responsibilities of the staff.
- l. Inquiry is not used throughout the audit in addition to other audit procedures.
- m. Working papers should be designed and properly organized to meet the circumstances of each audit and the auditor's needs in respect thereof.

### 3. Match the column

Sr. No	Column A	Sr. No	Column B
1	AAS 8	a	Audit Procedure for obtaining audit Evidences
2	Inspection	b	A diary on which auditor scribble down all important inquiries
3	Permanent audit files	c	Dealing with audit planning
4	Audit note book	d	Copies of management letters issued by the auditor, if any

4. Match the column

Sr. No	Column A	Sr. No	Column B
1.	Audit Planning	a	It consists of seeking information
2.	Audit Programme	b	It involves examining records or documents
3.	Inspection	c	It consists of looking at a process
4.	Observation	d	It is a diary on which auditor scribble down all important inquiries.
5.	Inquiry	e	Auditor plan his work to enable him to conduct an effective audit
6.	Audit Note Book	f	It may also contain the audit objectives for each area

5. Check your answer

1. a. iv, b. I, c.iii, d.iii, e. iv, f. ii, g. ii, h. ii, i. ii, j. ii, k. iii
2. a. F, b. T, c. T, d. F, e. F, f. T, g. F, h. T, i. T, j. F, k. T, l. F, m. T.
3. 1- c, 2- a, 3. d, 4. b,
4. 1.e, 2.f, 3. b, 4.c , 5.a , 6.d ,

6. Theory Question

1. Explain the appointment of auditor in case of companies.
2. Explain the procedure for the appointment of first auditor.
3. In case of company who the casual vacancy is filled.
4. Why the auditor should plan before starting the audit?
5. What are the matters to be discussed with the client?
6. Explain the term audit programme.
7. What are the point to be consider while preparing audit programme ?
8. Explain the advantage of audit programme.

9. What are the disadvantages of audit programme?
10. What are the Audit Procedure for obtaining audit Evidences?
11. Explain the inspection as the audit procedure.
12. Explain the observation as the audit procedure.
13. What do you mean by audit programme?
14. What are content required for audit working paper?
15. What does a permanent Audit file normally includes?
16. List any 5 content of current audit file.
17. Who is the real owner of the working the paper?
18. Define the term Audit note book.
19. What are the importance of audit note book.
20. What are the advantage of audit note book?

## **Chapter- 3 Auditing Techniques**

### **3.1 Test Checking**

## **1. Meaning :**

Test checking is a substitute for detailed checking. It involves only a partial checking. The auditor normally does not check completely all the records made into the books of accounts but, through a process of sampling, selects a few items and if they are found correct, he presumes that the remaining entries would also be correct likewise.

Thus, test checking is based on a simple theme that” if a representative number of transactions, so selected at random by the auditor for test checking, is found to be correct, the remaining ones would also be correct.”

Thus, the whole system of test checking implies selecting and checking only a few selected transactions so as to enable the auditor to form his final judgment as to the whole set of transactions.

In applying ‘test check’, the selection of transactions is made by the auditor at random and no specific principles are followed in it. The choice for adoption of testing methods is fully dependent on the discretion and judgment of the auditor who will depend on the situation of individual cases.

The use of test checking is, however, dependent upon the system of internal check in operation. If this system is satisfactory, test checking can be of immense help to the auditor.

Where there is an efficient system of internal check and the business maintains a separate staff for internal audit, test checking can be a very reliable device to carry on the work of audit.

But it should be kept in mind that if the system is reliable and test check is applied but mistakes are detected, a thorough checking of books would provide an answer. Thus, given an efficient system of internal check in operation, test checking can reduce the volume of work involved in audit.

Test checking should be applied and carried out intelligently and carefully, otherwise, it may lead to dangerous consequences. But much will depend on the system of internal check and the intelligence of the auditor.

**2. Following points are to be taken into consideration while applying test check:**

1. Sample should be selected from the various books of account and of different times.
2. Transactions related to beginning and ending period of particular year should be checked in detail.
3. Transaction related to cash and stock should be checked in detail.
4. Sample selection is to be made in random basis, not in planned way.
5. Detail check of Bank Reconciliation Statement is necessary.
6. There should be no bias in selecting sample.
7. System of Internal control of organization should be studied before selecting sample this will give clear idea as what should be the size of sample.

### **3. Advantages of Test Check**

Following advantages can be obtained while applying test check:

1. Test check helps an auditor to complete work in less time because test of few transactions can be made.
2. An auditor can complete the work of audit of various organizations within stipulated time.
3. Test check saves labour, time and cost of man auditor. So, an auditor can check in detail the specific items rather than checking similar items.
4. Test check gives assurance of accuracy and reliability of transactions to some extent.
5. Accounting staffs remain alert and careful because auditor checks the transactions of various times in random basis.

### **4. Disadvantages of Test Check**

1. There are chances of living errors and frauds because transactions with frauds may be left out from audit.

2. Result presented by income statement may be incorrect and report presented to the management may not be true due to the use of test check.
3. Test check increases the responsibility of auditor because an auditor should be responsible for the undetected errors and frauds due to application of test check.
4. Test check is not suitable method for the audit of small organizations.

## **3.2 Audit Sampling**

### **1. Meaning**

According to AAS-15 on ``Audit Sampling``, it means the application of audit procedures to less than 100% of items within an account balance or class of transactions to enable the auditor to obtain and evaluate audit evidence about some characteristic of item selected in order to form or assist in forming a conclusion concerning the population.

It is important to recognize that certain testing procedures do not come within the definition of sampling .Test performed on 100% of items within a population do not solve sampling . Likewise, applying audit procedures to all items within a population which have a particular characteristic (for example, all items over a certain amount) does not qualify as audit sampling with respect to the portion of the population examined, nor with regard to the population as a whole, since the items were not selected from the total population on a basis that was expected to be representative. Such items some characteristic of the remaining portion of the population but would not necessarily be the basis for a valid conclusion about the remaining portion of the population.

### **2. Determination of sample size:**

While determining the sample size, the auditor should consider risk, the tolerable error, and the error.

3. **Sampling Risk:** sampling risk arises from the possibility that the auditor's conclusion, based on a sample, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure. The auditor is faced with sampling risk in both test of control and substantive procedures as follows:

**(a) TEST of control :**

(i) Risk of Under Reliance: The risk that, although the sample result does not support the auditor's assessment of control risk, the actual compliance rate would support such an assessment.

(ii) Risk of Over Reliance: the risk that although the sample result supports the auditor's assessment of control risk, the actual compliance rate would not support such an assessment.

**(b) Substantive Procedures:**

(i) Risk of Incorrect Rejection: The risk that, although the sample result supports the conclusion that a recorded account balance or class of transactions is materially misstated, in fact it is not materially mis-stated.

(ii) Risk of incorrect Acceptance: the risk that, although the sample result supports the conclusion that a recorded account balance or class of transactions is not materially mis-stated, in fact it is materially misstated.

The risk of under reliance and the risk of incorrect rejection affect audit efficiency as they would be willing ordinarily lead to additional work being performed by the auditor, or the entity which would establish that the initial conclusion were incorrect. The risk of over reliance and the risk of incorrect acceptance affect audit effectiveness and more likely to lead to an erroneous opinion on the financial statements than either the risk of under reliance or the risk of incorrect rejection. Sample size is affected by the level of sampling risk the auditor is willing to accept from the result of the sample.

The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

**Tolerable error:** Tolerable error is the maximum error in the population that the auditor would be willing to accept and still concludes that the result from the sample has achieved the audit objective. Tolerable error is considered during the planning stage and, for substantive procedures, is related to the auditor's judgement about materiality. The smaller the tolerable error the greater the sample size will need to be. In test of control, tolerable error is the maximum rate of deviation from a prescribed control procedure that the auditor would be willing to accept, based on preliminary assessment of control risk. In substantive procedures, the tolerable error is the maximum monetary error in an account balance or class of transaction that the auditor would be willing to accept so that when the results of all audit procedures are considered, the auditor is able to conclude, with reasonable assurance, that the financial statements are not materially misstated.

**4. Selection of the sample:** The auditor should select sample items in such a way that the sample can be expected to be representative of the population. This requires that all items in the population have an opportunity available from other procedures.

While there are a number of selection methods, three methods commonly used are:

(i) **Random selection**, which ensures that all items in the population have an equal chance of selection, for example by use of random number tables.

(ii) **Systematic selection**, which involves selecting items using a constant interval between selections, the first selection having a random start. The interval might be based on a certain number of items (e.g. every 20<sup>th</sup> voucher number) or on monetary totals (e.g. every Rs.1000 increase in the cumulative value of population). When using systematic selection, the auditor would need to determine that the population is not structured in such a manner that the sampling interval corresponds with a particular pattern in the population. For example, if in a population of branch sales, a particular branch's sales occur only as every 100<sup>th</sup> item and sampling selected is 50, the result would

be that the auditor have selected all, or none, of the sales of that particular branch.

(iii) **Haphazard selection**, which may be an acceptable alternative to random selection, provided that the auditors attempts to draw a representative sample from the entire population with no intention to either include or exclude specific units. When the auditor attempts uses this method, care should be taken to guard against making a selection that is biased, for example, toward items which are easily located, as they may not be representative.

**5. The advantages of statistical techniques, properly applied, over judgement sampling are:**

- (a) Conclusion about the total population can be stated with a known confidence and precision;
- (b) Sample size is objectively determined;
- (c) Time and money may be saved by limiting sample size to that required to achieve a given result.

For these reason, whenever the size and homogeneity of the group to be checked permits, statistical sampling is generally to be preferred to judgement sampling. Statistically sampling is most likely to be successful when the following conditions are present:

- (a) A large population to be checked;
- (b) The population consists of similar items;
- (c) Items for checked easily selected and located;
- (d) The error rate is reasonably low (e.g. good system of internal control in force).

The sample results may be evaluated as follows:

- (a) Analysis of error in sample: -The auditor should judge whether an item is error or not. If audit evidence regarding a specific sample cannot be

obtained, the auditor may adopt alternative audit procedures. The auditors should analyse cause of the error and its impact on the others phases of the audit. If there is some common features in the error, extended procedures may be carried out.

(b) Projection of errors- The auditor should project the possibility of error to the entire population by a suitable method and consider the qualitative aspects of error found.

(c) Reassessing sampling risk- The auditors needs to consider whether errors in population exceed the tolerable error. If it is so, either the sampling risk may be revised or extended procedures or alternate procedures may be performed.

### **3.3 Internal Control**

#### **1. Meaning**

Internal Control is a process designed by management of an entity to provide reasonable assurance that an entity achieves its objectives in the following categories:

- Reliability of financial reporting
- Effectiveness and efficiency of operations,
- Compliance with applicable laws and regulations.

#### **2. Review of Internal Control**

1. ***Understanding the system:*** At first the auditor should understand the internal control system with the purpose to have an idea of the flow of transactions and the various controls procedures. This will help him to pinpoint those internal controls on which he might base in doing his audit. To understand the internal control system, it may be useful to choose a few transactions through the system. The auditor should also

ascertain whether the internal controls were effective and efficient throughout the period under audit.

Organization charts, procedure manuals, job description, and flow charts etc. are some of the tools to have an idea about internal controls system. The auditor can also discuss with different officials of organization. Sometimes, he may have to rely on direct observations and inquiry only. The auditor should, especially in the case of first audit, maintain a detailed written record of his observations on the internal controls system.

2. ***Test through compliance procedures:*** Having reviewed the system, the auditor may select the specific controls on which he intends to rely and which, therefore, need to be tested through compliance procedures. He may decide not to rely on certain internal controls which are defective in design, or reliance on which may not be cost effective. It is important to test the application of internal controls in practice.

For example, an auditor may take up a few sales bills at random and examine all the related documents right from the order of the customer to the payment received from the customer. At each stage, the auditor would see whether the transaction has taken place as stipulated in the flow chart or in the procedure manual. Thus, if the flow chart prescribes that the detail terms and condition of each order of customer has to be verified by a particular manager, the auditor should examine whether or not this has been done in practice.

The objective of compliance tests is to provide a fair confidence to the auditor that the internal controls procedures are being effective as prescribed. The auditor should carry out such tests in case of all procedures on which audit reliance is intended to be placed. Tests of compliance are concerned primarily with the following questions:

- Were the necessary procedures complied with?
- How were they complied with?
- By whom they were complied with?

3. ***Evaluating the system:*** Based on his observation during the tests made by him, the auditor has to make an estimate of how far he can depend on various internal controls. Normally, he should have a reasonable confidence that the system is such that the errors and fraud can be

discovered automatically. He has to ascertain whether the control procedures as designed to implement are in practice and competent in preventing or detecting material errors and fraud in the accounting system. This is essentially a question of individual judgment in a particular situation. If he finds certain errors or weaknesses in the system, he should try to evaluate the impact of the same on various transactions. Let us suppose he finds weaknesses in the system of maintaining debtors' ledger. Since this is a material item, he should ask for independent confirmations from the debtors. Thus, the auditor's evaluation of internal control system will determine the nature, timing and extent of his substantive procedures.

### **3. Techniques of Evaluation**

Different techniques may be used by an auditor to have an idea and assessing the effectiveness of an internal control system. The selection of a particular technique is a matter of the auditor's judgment. Two most common techniques of internal control evaluation are the flow charts and the internal control questionnaires. The auditor may prepare flow charts of the various categories of transactions in order to have a quick grasp of the system. An internal control questionnaire lists a series of questions which an auditor may wish to ask in order to understand and evaluate an internal control system.

### **4. Inherent Limitations of Internal Control**

1. Management's consideration that a control be cost effective.
2. The fact that most controls do not tend to be directed at transactions of unusual nature.
3. The potential for human error.
4. The possibility of circumvention of controls through collusion with parties outside the entity or with employee of the entity.
5. The possibility that a person responsible for exercising control could abuse that authority for example, a member of management overriding a control.
6. The possibility that procedures may become inadequate due to changes in conditions and compliance with procedures may deteriorate.

7. Manipulations by management with respect to transactions or estimates and judgments required in the preparation of financial statements.

## **5. Internal Control system for Purchase and creditors**

Basic considerations for having an effective internal control system for Purchase and Creditors are as follows:

1. The procedure for issuing purchase requisitions should be specified.
2. Where tenders are invited, the procedure for opening and acceptance thereof should be laid down.
3. The preparation and authorization of purchase orders should be under a senior manager.
4. Predetermine guidelines should exist for inspection of goods received, especially with regard to quantity and quality.
5. Documents showing the receipt and acceptance of goods should also be send to the accounts department.
6. The goods receipt documents should be cross checked with final purchase orders.
7. An authorize official from the accounts department should be made responsible for checking suppliers“ invoices, documents regarding purchase returns, purchase records, payments to suppliers, maintenance of ledger accounts and reconciliation of statements sent by suppliers.
8. Before payments are made to suppliers, payment documents duly authorized by a senior official, showing that the goods have been received as specified in the purchase order should be verified by the accounts department.
9. Adequate procedures should be established with regard to purchase returns, discounts on account of inferior quality of goods, and other similar adjustments.
10. Lawful policies and procedures should be implemented with regard to purchases from the companies under the same group and from the employees.
11. The accounts of various suppliers should be confirmed periodically from statements received from them.

## **6. Internal control for Sales and Debtors**

Basic considerations for having an effective internal control system for Sales and Debtors are as follows:

1. The policies and procedure for accepting customers' orders should be laid down. The authority for negotiating the various terms like prices, discounts, delivery schedules etc. should be clearly fixed.
2. The documentation processes between acceptance of the order and dispatch of goods should be well established.
3. A senior official should be made responsible for granting credit or special discounts to customers. An approved credit policy by competent authority should be circulated to all concerned.
4. An effective internal check regarding records of outward goods, customers' orders, challans and invoices should be implemented.
5. The sales ledger staff should not have access to cash, cash book or stocks. As far as practicable, duties should be so segregated that recording sales, maintaining accounts of customers, procuring orders from customers, and dispatching goods are performed by different officials.
6. Appropriate control procedures should be designed for inspecting the quality of the goods before dispatch.
7. There should be a periodic review of overdue accounts. Urgent action should be taken against defaulting customers as per credit policy.
8. The procedures for writing off bad debts should be clearly defined and approved by the competent authority.
9. Various other controls over sales and debtors are similar to those applicable to purchases and creditors.

## **7. Internal control system for Wages and Salaries**

Basic considerations for having an effective internal control system for wages and salaries are as follows:

1. All appointments, removal and fixation or revision of wages rates and salaries should be in writing and authorized by a designated official authorized by the board.
2. The jobs of preparation of wages and salary sheet should be divided among different clerks and it should be ensured that the prepared wages and salaries sheets of clerks gets automatically checked by another clerk under their due signatures.
3. Records regarding time and piece wages of permanent and casual workers should be checked by internal audit department.
4. The clerks must have rules and regulations, in writing, about the methods of calculation of wages and salaries, deductions there from (if any)

5. All the prepared wages and salaries sheets must be checked and authenticated by the internal audit department before any payment being made.
6. The shift in charge should counter sign the records as to time and piece wages amount, number of hours worked, number of pieces manufactures, overtime etc.
7. The number of employees shown in wages and salary sheet should be checked with the official list of employees with the personnel department and so also the rates of wages and salaries by internal audit department, before making any payment.
8. Close focus is needed for overtime payments which in any case should be allowed only in exceptional circumstances and after duly approved by the General Manager of the unit, in writing.
9. The Accounts department, after receiving the wages and salaries sheet, must carefully check the totals, both gross and net, of wages and salaries payable to individual employees and also ensure that deductions on account of provident fund, pension funds, insurance, income tax etc are properly made.
10. Separate arrangement should be made for withdrawing wages and salaries amount from the bank which must be equal to the net total in the wages and salaries sheet.
11. Wage and salaries payments should be made by persons who are in no way connected with the preparation of wages and salaries sheet.
12. In writing instructions should be given to pay clerks for unclaimed wages and salaries. These should include preparation of a list of unclaimed amounts and immediate deposit of the sum in the Bank in a separate account.
13. Subsequent payment of unclaimed wages and salaries should be made only after properly authorization by personnel department and accounts department.
14. An advance against wages and salaries register should be maintained by the accounts department.
15. Internal audit department should made surprise checking of wages and salaries sheets and wage and salaries payment to ensure that:
  - a) False names are not shown in wages and salaries sheets;
  - b) Wage and salaries rates are not overstated or deductions are not understated;
  - c) False overtime payments are not recorded;
  - d) Wages and salaries are paid to persons concerned only and no substitutes are allowed.

### 15.3 Difference between internal check and Test check

<b>Internal check</b>	<b>Test Check</b>
It is an arrangement of duties in such a way that work of one employee is checked by another employee.	It means to select and examine a representative sample from large number of similar items.
To prevent errors and frauds.	To detect errors and frauds without checking all transaction.
By management.	By statutory auditor.
Management change, review and control internal check.	Management does not have any control over test check.
In early detection of errors and frauds.	To reduce workload and saves time.

#### **Exercise:**

1. Multiple choice question
  - a. \_\_\_\_\_ is a substitute for detailed checking
    - i. Test Checking
    - ii. Internal control
    - iii. Internal check
    - iv. None of the above
  - b. Test checking helps the auditor in
    - i. Complete work in less time
    - ii. it saves labour and cost
    - iii. all of the above
    - iv. none of the above
  - c. While determining the sample size, the auditor should consider
    - i. risk,
    - ii. the error
    - iii. the tolerable error
    - iv. all of the above
  - d. \_\_\_\_\_ is the maximum error in the population that the auditor would be willing to accept and still concludes that the result from the sample has achieved the audit objective.

- i. Tolerable error
  - ii. Error
  - iii. Risk
  - iv. All of the above.
- e. The auditor should select sample items in such a way that the sample can be expected to be representative of the \_\_\_\_\_.
  - i. Population
  - ii. Sample
  - iii. All of the above
  - iv. None of the above
- f. \_\_\_\_\_ selection, which ensures that all items in the population have an equal chance of selection, for example by use of random number tables.
  - i. Haphazard
  - ii. Random
  - iii. Systematic
  - iv. None of the above.
- g. \_\_\_\_\_ **selection**, which involves selecting items using a constant interval between selections, the first selection having a random start
  - i. Haphazard
  - ii. Random
  - iii. Systematic
  - iv. None of the above
- h. \_\_\_\_\_ selection, which may be an acceptable alternative to random selection, provided that the auditors attempts to draw a representative sample from the entire population with no intention to either include or exclude specific units.
  - i. Haphazard
  - ii. Random
  - iii. Systematic
  - iv. None of the above
- i. \_\_\_\_\_ is a process designed by management of an entity to provide reasonable assurance that an entity achieves its objectives.
  - i. Internal control
  - ii. Internal audit

- iii. Sampling
- iv. Test checking
- j. \_\_\_\_\_ tools to have an idea about internal controls system.
  - i. Organization charts
  - ii. procedure manuals
  - iii. job description
  - iv. All of above.
- k. The documentation processes between \_\_\_\_\_ and \_\_\_\_\_ should be well established for internal control of sales and debtors
  - i. acceptance of the order
  - ii. dispatch of goods
  - iii. customers orders
  - iv. challans
- l. \_\_\_\_\_ is an arrangement of duties in such a way that work of one employee is checked by another employee.
  - i. Test Checking
  - ii. Internal check
  - iii. Test control
  - iv. None of the above
- m. An advance against wages and salaries register should be maintained by the \_\_\_\_\_ department.
  - i. Production
  - ii. sales
  - iii. account
  - iv none of the above.

2. State whether true and false

- a. Test check helps an auditor to complete work in less time because test of few transactions can be made.
- b. Test check is suitable method for the audit of small organizations.
- c. The auditor should select sample items in such a way that the sample can be expected to be representative of the population.
- d. The larger the tolerable error the greater the sample size will need to be.

- e. Random selection, which ensures that all items in the population have an equal chance of selection, for example by use of random number tables.
- f. Random selection, which involves selecting items using a constant interval between selections, the first selection having a random start.
- g. Haphazard selection, which may be an acceptable alternative to random selection, provided that the auditors attempts to draw a representative sample from the entire population with no intention to either include or exclude specific units.
- h. Internal Audit is a process designed by management of an entity to provide reasonable assurance that an entity achieves its objectives.
- i. Organization charts, procedure manuals, job description, and flow charts etc. are some of the tools to have an idea about internal controls system.
- j. The preparation and authorization of purchase orders should be under a worker.
- k. All appointments, removal and fixation or revision of wages rates and salaries should be in oral.
- l. An advance against wages and salaries register should be maintained by the accounts department.
- m. The jobs of preparation of wages and salary sheet should be divided among different s clerks
- n. At first the auditor should understand the internal audit with the purpose to have an idea of the flow of transactions.
- o. To understand the internal control system, it may be useful to choose a large transactions through the system.
- p. The objective of compliance tests is to provide a fair confidence to the auditor that the internal controls procedures are being effective as prescribed.
- q. Limitation of internal control is the potential for human error.
- r. The procedure for issuing purchase requisitions should not be specific for internal control for purchase.
- s. The preparation and authorization of purchase orders should be under a junior manager under internal control system of purchase.
- t. A senior official should be made responsible for granting credit or special discounts to customers under internal control for sales.

3. Match the column

Sr. no	A	B
1.	Test Checking	maximum error in the population that the auditor

		would be willing to accept
2.	Audit sampling	acceptable alternative to random selection
3.	Tolerable error	Less than 100 of item
4.	Random selection	selecting items using a constant interval between selections
5.	Systematic selection	Substitute of detailed cheking
6.	Haphazard selection	all items in the population have an equal chance of selection

#### 4. Check your answer

1. a. i, b. iii, c. iv, d. i, e. i, f. ii, g.i, i. i, k. i & ii, l.ii, k. iii,

2. a. T, b. F, c. T, d.F, e. T, f.F, g.T, h.F, i. T, j.F, k. F, l. T, m. T n. F, o. F, p.F, q.T, r.F, s.F, t. T,

3. 1. 5, 2. 3, 3.1, 4.6, 5.4,6.2

#### 5. Theory Question

- a. What do you mean by test checking?
- b. What points are to be taken into consideration while applying test check?
- c. What are advantages of test checking?
- d. What are disadvantages of test checking?
- e. Explain audit sampling.
- f. Explain sample risk in details.
- g. What are the methods of selecting sample?
- h. What do you mean by Internal Control?
- i. How you will review of internal control system.
- j. What are the Inherent Limitations of Internal Control?
- k. Explain internal control system for Purchase and creditors.
- l. Explain internal control system for Sales and Debtors.
- m. Explain internal control system for wages and salaries.
- n. Explain difference between Internal check and test check

## Chapter - 4 Internal Audit

### 1. Meaning

The Institute of Internal Auditors (IIA) defines internal audit as follows:

“Internal Audit is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.”

The above definition leads us towards the following elements:

1. Internal audit is an independent activity.
2. It provides assurance and consulting services.
3. It helps the organization to achieve its objectives.
4. It enhances the effectiveness of processes related to internal control and risk management.
5. It is a systematic and disciplined approach

### 2. Basic Principles of Establishing Internal Audit

- 1 **High organizational status:** Whether internal audit is undertaken by an outside audit firm or by an internal audit department of the company itself, the organizational status of the internal auditor must be high. In an ideal situation, he should report to the highest authority of the company. He should have the liberty to directly communicate with the external auditor.
- 2 **Independence:** Internal auditor must have the full independence of work. There should not be any constraints or restrictions placed upon his work. Independence facilitates internal auditors to render the impartial and unbiased opinion essential to the proper conduct of audits.
- 3 **Technical competence:** The internal audit team should be professionally qualified and adequately trained. The number of staffs should appropriate.
- 4 **Due professional care:** The internal auditor should exercise due professional care in fulfilling his responsibilities. Examples of the exercise of due professional care by the internal auditor are the existence of adequate audit manuals, audit programmes and working papers.

- 5 **Reporting and follow-up:** The internal auditor should ensure that his findings with recommendations should reach to the appropriate authority of the management. He should also ensure that proper follow up actions have been taken by the management based on his reports.

### 3. Objectives

The significance of internal audit is growing day by day. Historically, internal audit was mostly confine to ensure that the accounting and allied records have been properly maintained, the assets management system is in place in order to safeguard the assets and also to see whether standing policies and procedures are duly complied with. But with the passage of time, the objectives of internal audit have been significantly changed. Now cost benefit analysis, resources utilization and their proper deployment, effectiveness of management decisions etc. are also being reviewed by the internal auditor.

Briefly, the objects of internal audit may be described as follows:

1. **Evaluation of business control system:** Internal audit is concerned with ensuring effective and efficient system of accounting control, standard cost control, budgetary control and other functional control.
2. **Compliance with standard policies and procedures:** Reporting to management about the compliance of standard policies and procedures is an important objective of internal audit.

**For example**, suppose company's standing policy is that any purchase order worth more than Rs. 4, 00,000/- cannot be awarded without asking quotation from at least three parties. If internal auditor found that this has not been strictly followed then he must report those cases to the management.

3. **Safeguarding and adequate utilization of business assets:** Internal audit has to ensure that all assets of the company are properly recorded. It has to verify assets utilization report and determine whether fixed targets have been achieved or not.

**For example**, suppose internal auditor found that valuable scrap are not being properly recorded in the books, he should include this observation in his audit report.

4. **Reliability of Management Information System (MIS):** Internal Audit ascertains the reliability of financial and operating reports prepared throughout the organization. The management relies on the reports of internal auditors as they provide an assurance as to validity of records and transactions of the enterprise.

5. **Suggesting improvements:** The ultimate objective of internal audit is to assist management in the effective discharge of their responsibilities by furnishing them with proper suggestions for improvements.

#### 4. Evaluation of Internal Audit by Statutory Auditor

In spite of the various dissimilarities between two, there are ample scope of a gainful cooperation and coordination between external auditor and internal auditor. Due to his professional standing, the external auditor acquires a wide area of experiences, whereas internal auditor has an in-depth experience of the organization. If they work in tandem, the quality of audit will improve tremendously.

Unnecessary duplications of work can also be avoided by proper audit plan. The work load of external auditor can be reduced significantly as we know that inherent objectives and approaches of both the audit are same.

In order to determine, whether and to what extent the external auditor will depend and rely on the work of an internal auditor is given by SA 610, relying upon the work of an internal auditor, issued by the Institute of Chartered Accountants of India (ICAI). The important points of the standards are summarized below:

1. **Assessing the work of internal auditor:** The external auditor should assess the quality of work done by internal auditor before relying upon the work of the latter. He should essentially consider factors such as:

- (a) Competence
- (b) Independence and
- (c) Objectivity of the internal auditor while evaluating his work.

2. **Co-ordination:** It can be achieved by:

- (a) Meetings with internal auditor
- (b) Access to relevant audit reports and
- (c) Communication by the internal auditor of any significant information, which may affect his work.

3. **Relying upon specific internal audit work:** If as a result of his evaluation and appropriate interaction with internal auditor, the external auditor intends to rely upon specific internal audit work, he should take into account the factors such as:

- (a) Scope of internal auditor's work and adequacy of related audit programmes used by him;

(b) Examine whether the work of assistants was properly supervised, reviewed and documented;

(c) Examine whether sufficient and appropriate evidence was obtained.

Thus, the degree of reliance that is placed by the external auditor on such work is a matter of professional judgment. It may be noted that the report of the external auditor is his sole responsibility and he cannot shove off this responsibility on internal auditor by relying upon his work.

## 4.2

### 1. Internal Check and Internal Audit

The main points of distinction between internal check and internal audit are as follows:

1. **Definition:** Internal check is an arrangement of jobs in such a manner that the work of each employee is checked by another and no employee is in charge of any work completely from beginning to end. Internal audit is a specific appraisal activity of operations, financial or otherwise and related records thereof.
2. **Purpose:** The main purpose of internal check is the prevention of errors and frauds. The main purpose of internal audit to find errors and frauds.
3. **Personnel:** As internal check is an inbuilt process of internal control no separate personnel are required for the job. Whereas for internal audit separate staffs are required to conduct the job.

4. **Timing:** Internal check is a continuous process. It begins the moment a transaction start and finishes after all aspects are recorded.

Internal Audit is a post mortem appraisal system and starts after the completion of recording of transactions.

## 2. Relationship or differences between internal audit and statutory audit:-

Difference between two audits is explain below:

1. The extent of the work undertaken by the internal auditor is determined by the management whereas that of the external audit arises from the responsibilities placed on him by the statutes.
2. The internal audit approach is with a view to satisfy that the accounting system is efficient, so that the accounting information presented to the management is accurate and discloses material facts.
3. The internal responsibility is to management whereas the statutory audit is responsible directly to the shareholders. It follows from this that the internal auditor being an employee of the company does not have the same independence of status which is enjoyed by the external auditor. Even the maintaining of an independent approach is necessary for the internal auditor to be useful to the enterprise employing.

### Exercise:

#### 6. Multiple choice question

- a. \_\_\_\_\_ Audit is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations
  - i. Internal
  - ii. External
  - iii. Statutory
  - iv. None of the above
- b. The internal auditor should ensure that his findings with recommendations should reach to \_\_\_\_\_
  - i. Shareholder

- ii. Customers
  - iii. Management
  - iv. Employee
- c. Due to his professional standing, the external auditor acquires a \_\_\_\_\_ of experiences, whereas internal auditor has an \_\_\_\_\_ experience of the organization
- i. Wide and in-depth
  - ii. In-depth and wide
  - iii. Small and large
  - iv. Large and small
- d. The main purpose of internal check is the prevention of errors
- i. Finding of error
  - ii. Prevention of errors
  - iii. Prevention of fraud
  - iv. None of the above
- e. The main purpose of internal audit to find errors and frauds
- i. Finding of error and fraud
  - ii. Prevention of errors
  - iii. Prevention of fraud
  - iv. None of the above

7. State whether true and false

- a. internal audit is undertaken by an outside audit firm or by an internal audit department of the company itself, the organizational status of the internal auditor must be low.
- b. The internal auditor should ensure that his findings with recommendations should reach to customers.
- c. Internal audit has to ensure that all assets of the company are properly recorded.
- d. The main purpose of internal check is the prevention of errors

8. Match the column

Sr.No.	Column A	Sr.No	Column B
1	Internal Audit	a	The management relies on the reports of internal

			auditors
2	Objectives of Internal audit	b	work of each employee is checked by another
3	Management Information System (MIS)	c	Evaluation of business control system
4	Internal check	d	It is an independent activity

9. Check your answer

1.a.i, b.iii, c.i, d.iii, e.i,

2. a. F, b. F, c. T, d. t

3. 1.d, 2.c, 3.a , 4.b ,

10.Theory Question

- a. What do you mean by Internal audit?
- b. Explain the Basic Principles of Establishing Internal Audit.
- c. What are the objectives of Internal Audit.
- d. What is difference between internal audit and statutory audit?
- e. Difference between
  - i. Internal Check and Internal auditor
  - ii. Internal audit and statutory audit.