1

INTRODUCTION TO AUDITING

Unit Structure:

1.0 OBJECTIVES

After studying this chapter, the students will be able to:

- Understand the Basics of auditing,
- Explain the errors and frauds,
- Discuss about the limitations of audit,
- Know the Auditors duties and responsibilities in respect of frauds,
- Understand the principles of auditing and different auditing concepts.

1.1 INTRODUCTION

Origin of the term Audit is said to be in the Latin term auditor which means to listen. In the Middle Ages whenever any fraud or misappropriation was suspected in the books of accounts, there was a system of appointment of an outside expert to verify the accounts. Such expert used to first listen to what the concerned person in the accounts department or The Manager has to say on the issue. In those days the scope of Auditing was restricted to detecting errors and frauds in the books of accounts only.

In simple terms auditing is nothing but verification of the correctness of the books of accounts. After completing writing of books of accounts, somebody else will go through them to check their correctness. This is audit. So, it is said auditing starts after accounting job is over.

Auditor is an expert in accounts and he will check whether the books of accounts are properly written and principles and rules of Book-keeping and Accounts are strictly followed. Entries in the bo0oks of accounts should be properly supported by different documents like bills, receipts, vouchers etc.

1.2 FINANCIAL STATEMENTS

1.2.1 Meaning

After the books of accounts like journal, subsidiary books, ledger etc. are written financial statements like Trial balance, Trading and Profit and Loss account and Balance Sheet etc. are prepared. In addition, these days cash flow statement is also prepared. These different financial statements are read not only by the owners of the business like the proprietors, partners and shareholders, but also by the investors, Tax Authorities, Bank officials, Trade Unions etc. From the point of view of all these people, maintenance of books of accounts correctly is important. Owners want to know whether their capital is being properly utilised, and adequate profits are being earned. Trade union leaders are interested in knowing that correct profits are shown by the company so that they can demand a reasonable bonus and rise in salary. Tax authorities are interested in knowing the correct profit of the business and that proper tax on the same is paid. Bankers who lend money, want to know that their loans are being properly utilised and can be recovered easily on due date, So, from the point of all these people maintenance of books of accounts correctly is important. So, after writing the accounts they are checked by an independent outside expert i.e., the auditor. Al these people go through the financial statements from their own different point of view.

Even the customers of the products are also interested in the correctness of the accounts because if the company is making huge profits, they can demand for lowering the prices of the products produced by the company. Thus, all these persons read the financial statements and all of them are interested in the correctness of them. This brings out the importance of audit of the accounts.

1.2.2 Users of Financial Statements

Financial statement satisfies the information requirements of a wide cross-section of the society representing corporate managers, executives, bankers, creditors, shareholders investors, labourers, consumers, and government institution. Following are the users of Financial Statements:

1. **Executives:** Financial statements provide sufficient accounting information to the executives and managers to enable them to decide on important issues facing by them. The common issues faced by the corporate managers are: efficient capital utilization, maintaining the profitability through cost control, dividend paying capacity of the company and observing credit standards. The upper-level management uses the financial statements to tackle such issues effectively.

2. **Bankers:** Bankers take precautions before advancing loans to their consumers. Every banker, before sanctioning credit, wishes to be assured the borrower's ability to repay the loans when they become due. The bankers use the financial statements to ascertain the company's ability of repaying the dues and also the ability to pay interest on time. Financial statements are useful to the bankers to ascertain the liquidity, solvency, profitability of borrower's business and his financial strength.

3. **Trade Creditors:** The information obtained from the financial statements becomes useful to ascertain the creditworthiness of the company. The manufactures or wholesalers would not provide credit facilities indiscreetly to everyone. Before providing such facilities the manufacturer and wholesaler studies the financial statements of the trader.

4. **Shareholders and Prospective Investors:** Shareholders, who have permanent interest in the life and operations of the company, are ever desirous of knowing about the company's financial affairs. The financial statements provide the share-holders all the information they require.

5. **Labourers:** Labourers contribute to the earnings of the company and they are the people who work on raw materials with the aid of capital goods to produce wealth. They are also interested in their wages and salaries, bonus and working conditions. As far as bonus, working conditions and other incentives are concerned, they largely depend on the company's profitability and liquidity. The financial statements become useful toe labourers to know the financial position of the entity.

6. **Consumers and society:** Consumers attempt to find out whether they are being exploited by the producers. Society is interested in an enterprise's that result in the increase of employment opportunities, wealth and standard of living of the people. They are also concerned about the enterprise's contribution to social welfare, environment and national wealth and prestige. Study of financial statements enables the consumers and the society to gain knowledge on these matters.

1.3 DEFINITION AND OBJECTIVES OF AUDITING

1.3.1 Meaning and Definition

Different authors have defined auditing in different words. We may consider the following few important selected definitions :

1) Spicer and Pegler :

"Auditing is an examination of books of accounts and voucher of a business as will enable the auditor to satisfy himself that the balance sheet is properly drawn up, so as to give a true and fair view of the state of affairs of the business and the profit and loss account gives a true and fair view of the profit or loss for the financial year or period."

2) Prof. Dickers :

"Audit is an examination of accounting records, undertaken with a view to establishing whether they correctly and completely reflect the transactions to which they purport to relate."

3) Arthur W. Holme :

"Long range objectives of an audit should be to serve as a guide to management's future decisions in all financial matters such as controlling, forecasting analysing and reporting. These objectives help the business unit to improve its performance."

4) R. R. Mautz :

"Auditing is concerned with the verification of accounting data, determining the accuracy and reliability of accounting statements and reports."

Long range objectives of an audit should be to serve as a guide to the management's future decisions in all financial matters such as controlling, forecasting, analyzing, and reporting.

To put it in a nutshell, auditing is a through intelligent systematic and critical examination of books of accounts. Audit may be done throughout the year or periodically.

1.3.2 Objectives of Auditing :

Objectives of auditing are changing with the changes in the business techniques. Earlier it was only checking of correctness of accounts. It was then expanded to detection of frauds. The main objective of audit is to find the reliability of financial position and profit and loss statement. Objectives of audit can be divided in to two parts. Main and subsidiary or secondary objectives.

Objectives of Audit

Main objects

1) Verification of accounts and financial statements

Subsidiary objects

1) Detection and prevention of Frauds
2) Detection and prevention of Errors

A) Main objects of Audit:

1. Verification of Accounts and Financial Statements:

The main or principal objective of audit is to verify and establish that at a given date the balance sheet presents true and fair view of financial position of the business and the profit and loss account gives the true and fair view of profit or loss for the accounting period.

Under the Indian Companies Act Books of accounts must be kept according to the provisions of the Act and they should reveal true and fair view of the state of affairs of the company.

2. Checking of the entries with the relevant documentary evidences:

Audit involves checking the entries in the books of accounts with the relevant vouchers and other supporting documents. This is the main job of the auditor. Entries in the books of accounts are verified with the bill's vouchers and receipts. He will also check whether all the money received is accounted for or not and all payments made have proper supporting vouchers. During such routine checking errors and frauds can be detected.

3. Taking independent review of the financial statements:

He conducts an independent review of financial statements. He has to be personally satisfied about their reliability and he should be able to form his opinion about them. He must examine the existing internal control and internal check system prevailing in the organisation. He must check the arithmetical accuracy of the books of accounts. These days this aspect has lost its relevance as machines and computers are mostly used for this purpose by almost all organisations. Auditor has also to check the physical existence of various assets shown in the accounts and see that they are valued correctly.

In short, he has to assess the internal check system, check posting balancing etc. and verify the correctness of the entries with supporting documents. Capital and revenue items should be correctly classified. In the case of certain institutions, there are specific laws which contain rules regarding maintenance of accounts. Then the auditor should see that those legal provisions are complied in maintaining the books of accounts.

B) Subsidiary or Secondary objects of Audit :

1) Detection and prevention of errors and frauds:

The main difference between the two is that errors are committed due to negligence or lack of knowledge and the frauds are committed knowingly for some ulterior motive of getting some benefit.

2) **Expression of Opinion:**

After going through the accounts, the auditor should express his opinion on the maintenance of books of accounts. If he finds any lacuna or defect in the same, he must be frank enough to express his real opinion and suggest to the managements the steps to be taken to set right the same. Auditor should not come under anybody's pressure. He should be bold enough to call a spade.

1.4 ERRORS AND FRAUDS

1.4.1 Meaning of Error

Generally, they are committed due to negligence or lack of knowledge or ignorance of the principles of writing accounts of the person writing the accounts. This is an important objective of an audit. Error is generally taken to be innocent and not deliberate.

1.4.2 Reasons and Circumstances

R. K. Mautz, has classifieds the reasons and circumstances of errors and he has include fraud in the broad category of errors. The classifications are the following.

1. Ignorance on the part of employees of accounting development, generally accepted accounting principles, appropriate account classification of the necessary reconciling subsidiary ledgers with controlling accounts and of good accounting practices in general.
2. Carelessness on the part of those doing the accounting work.
3. A desire to conceal the effect of defalcations of shortage of one kind or another.
4. A tendency of the management to permit prejudice or bias to influence the interpretation of transactions or events or their presentation in the financial statements.
5. An ever presents desires to hold taxes on income to minimum.

A sixth cause may be added to those Mr. Mautz has listed and that is more serious in nature. It is the intentional effort committed by persons in positions of authority to:

I. Show up the picture depicted by the statements;

II. Depress the picture depicted by the statements; and

III. Convert the error to a personal benefit.

1.4.3 Types of Errors

Errors can be classified in to following five categories:

1) Errors of principle
2) Errors of omission
3) Errors of commission

4) Errors of duplication

5) Compensating errors

1. **Errors of Principle :**

These errors are usually committed due to lack of knowledge of science of Book-keeping. E.g., wrong classification of expenses into capital and revenue, treating personal income or expenditure as those of business or vice versa, providing less or more depreciation than reasonably necessary, not taking into account all outstanding income or expenditure etc. Such errors are not disclosed in the trial balance. They can only be detected by thorough checking of each and every transaction in the books of accounts. Errors of principle affect the correctness and reliability of financial statements. To prevent occurrence of such errors, the job of writing accounts should be assigned to a duly qualified person only. He must have good knowledge and experience in the field of dealing with accounts.

2. Error of Omission:

Here a particular transaction is not at all recorded in the books of accounts. Such errors may be committed through oversight or even intentionally. They affect the profit or loss of the year. Trial balance will tally in spite of such errors. Hence it is difficult to defect them.

3. **Error of Commission :**

Here the transaction is recorded but recorded incorrectly. E.g., amount received from A may be credited to B's account or Rs. 890 received may be recorded as Rs. 980. Some such errors may not affect the agreement of the trial balance.

4. **Errors of duplication :**

Here the same transaction is written twice. This will also not affect the agreement of the trial balance. Auditor can detect such errors only by carefully conducting the process of vouching. Such errors may be committed due to oversight or even intentionally.

5. Compensating errors :

Here there are two mistakes of the same amount, one on the debit side and the other on the credit side. The total effect of one or more errors on either side is the same. Such errors are difficult to detect as the trial balance will tally in spite of such mistakes. Careful conduct of procedure of audit alone can detect such errors.

1.4.4 Meaning and Types of Frauds :

Fraud refers to intentional misrepresentation of financial information by persons in the management, employees or third parties. It may involve manipulation or falsification of accounts, misappropriation of assets, suppression of transactions, or misapplication of accounting policies etc. Frauds are intentionally committed by people in the higher authority. So, it is more difficult to detect them than errors. Detection of frauds is one of the principal functions of the auditor.

Frauds may be classified as follows:

1) Misappropriation or embezzlement of cash.

2) Misappropriation of goods.

3) Manipulation of accounts.

1. Embezzlement of cash :

Usually this is done by theft of cash receipts, Petty cash, cheques or by showing bogus payments to workers, creditors etc. Fictitious purchases may be shown and the payment for the same may be embezzled. This type of fraud is very easy where there is no proper control over the cash box. So, in a smaller concern the cash box is handled either by the owner or his nearest relative or by a very senior trusted employee. In a large business there is no direct control of the owner in the day-to-day receipts and payments of cash. So, embezzlement on a small scale can be easily done.

However, it is difficult in a smaller business where there is direct control of the owner on the day-to-day transactions.

Embezzlement is done either by not accounting for the whole amount received from a particular party or a lesser amount is shown in the accounts and the difference is pocketed by the cashier. Secondly false payments may be shown and the amount is pocketed. To avoid such frauds, there should be strict control on the receipt and payment of cash and the work of one should be routinely checked by the other. This is called internal check system. Another method of reducing such loss of cash by embezzlement is to insure the fidelity of the cashier. You can take an insurance policy and insure the fidelity or honesty of the cashier. If there is embezzlement, then the insurance company will make good the loss.

Different innovative methods are used to embezzle cash. Fictitious purchases may be shown. Wages are shown as paid to dummy workers. Old debt recovered or amount received by selling the scrap may not be shown in the accounts. When an amount is received from a debtor or customer, a lesser amount is shown as received in the counter foil of the receipt book. Some of the cash sales may not be shown in the accounts and so on.

2. Teaming and Lading :

This is method of temporary misappropriation of cash. Teaming and lading means when an amount is received from one customer say A, it is not accounted for in the books and the cash is used by the cashier for his personal purpose. When the next customer say B, pays his dues it is shown as received from A and so on. However, finally before closing the accounts at the end of the year the money used is paid back and the cash balance is correctly shown. Thus, here there is only a temporary misappropriation of cash. Auditor should not allow or condone even such frauds. They must be brought to the notice of the owner. The auditor can easily detect such frauds by comparing the date on the receipt and the data on which the transaction is written in the books of accounts, carefully.

3. Misappropriation of goods :

Where the goods produced or sold are small in size and light in weight but of high value, such frauds are commonly committed. Normally in any business there is higher and stricter control over cash than on goods. This is a wrong policy. After all goods represent cash. To prevent such frauds, it is absolutely necessary to maintain proper record of purchases and sales of goods in prices as well as quantities. There should be a good internal control system regarding the movement of goods. Goods should not be allowed to leave the premises without the proper permission of some responsible official. Stock on hand should be physically checked from time to time. If there are any discrepancies, causes for the same should be thoroughly investigated immediately. Bin card system should be used to maintain proper control over the stock. Remedial measures wherever necessary should be immediately taken. Auditor should undertake surprise check of the physical stock and tally it with the stock shown in the accounts.

4. Manipulation of Accounts :

This type of fraud is committed by higher level management to mislead certain parties. Such frauds usually involve a huge amount and are intentionally committed after adequate preparation. Managers, Directors etc. commit such frauds.

Here accounts are falsified but no cash or goods are misappropriated. False, incorrect or fictitious entries are made in the books of accounts. For example, bogus sales, purchases or expenses are recorded in the books, closing stock is not correctly valued. It may be over or under valued. Profitability of the business or the financial position of the business is not correctly shown.

Profits may be shown as loss to reduce or avoid payment of income tax and other taxes or to deter entering of view units in the business. Value of the shares of the company in the stock Exchange may also be inflated or deflated. Profits may be shown higher than what they are to get more commission or remuneration to the Manager. Another purpose may be to deceive the investors and make them invest more funds in the company. Prices of the shares of the company in the market may be artificially pushed up to sell the shares with the management and make more profits. Financial institutions may be made to lend more money.

Falsification of accounts may also be done by showing purchases or sales more or less than what really, they are. Closing stock may be over or under valued, outstanding or prepaid expenses and outstanding and received in advance income are intentionally ignored or necessary adjustment for them may not be made in the accounts. Assets may be over or under depreciated, capital expenditure may be treated as revenue or vice – versa.

5. Window – Dressing :

Showing the financial position better than what it is called window dressing. It is done to attract more capital in the business or get more remuneration for the manager etc.

6. Secret – Reserve :

Showing the financial position worse than what it is, is called creating secret reserve. It is done to reduce tax burden or to see that no new competitors enter in the field.

Thus, these manipulations are done with different motives and by using number of different methods. So, it is rather difficult to detect the manipulation of accounts as it is systematically committed with the connivance of the top management. But never the less, it is an important duty of the Auditor to detect manipulation in accounts. If he fails to do this, he will be held responsible for certifying the false accounts and legal action may be taken against him.

1.4.5 Risk of Frauds and Error in Audit

The following events may increase the risk of fraud or error -

1. **Internal Control Faults:** Weaknesses in the design of internal control system and non-compliance with laid down control procedures, e.g., a single person being responsible for receipt of all pasts/ mails and marking it in the relevant sections or two persons responsible for receipt of all posts/ mails but the same is not followed in the practice.

2. **Doubts about the integrity or competence of the management,** e.g., domination by one-person, high rate of employee turnover, frequent change of legal counsels of Auditors, significant and prolonged understaffing of the accounts department, etc.

3. **Unusual pressures within the entity,** e.g., industry is doing well but the Company's performance is poor, heavy dependence on a single line of product, inadequate working capital, need to show more profit to support the share market price, etc.

4. **Unusual transactions** e.g., transactions with related parties, excessive payment for certain services to lawyers, etc.

5. **Problems in obtaining sufficient and appropriate audit evidence:** E.g., inadequate documentation significant differences between the figures as per accounting records and confirmation received from third parties. Etc.

1.4.6 Auditor's Duties and Responsibilities in respect of Fraud

The primary objective of an auditor is to express an opinion on the financial statements. However, the auditor while conducting the audit is required to consider the risk of material misstatements in the financial statements resulting from fraud or error.

An audit conducted in accordance with the auditing standards generally accepted in India is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. The fact that an audit is carried out may act as a deterrent, but the auditor is not and cannot be held responsible for the prevention of fraud and error.

Following are the Duties and Responsibilities of an Auditor:

1. In planning and performing his examination the auditor should take into consideration the risk of material misstatements of the financial information caused by fraud or error.

2. He should inquire with the management as to any fraud or significant error which has occurred in the reporting period, and modify his audit procedures, if necessary.

3. If circumstances indicate the possible existence of fraud and error, the auditor should consider the potential effect of the suspected fraud and error on the financial information. If he is unable to obtain evidence to confirm, he should consider the relevant laws and regulations before expressing his opinion.

4. The auditor also has the responsibility to communicate the misstatement to the appropriate level of management on a timely basis and consider the need to report to it then changed with governance.

5. He may also obtain legal advice before reporting on the financial information or before withdrawing from the engagement.

6. The auditor should satisfy himself that the effect of fraud is properly reflected in the financial information or the error is corrected in case the modified procedures performed by the auditor confirm the existence of the fraud.

7. The auditor should also consider the implications of the frauds and errors, and frame his report appropriately. In case of a significant fraud, the same should be disclosed in the financial statement. If adequate is not made, there should be a suitable disclosure in his audit report.

Check your progress:

1. Enlist the objectives of Auditing.
2. Define the following terms:
   a. Auditing
   b. Error
   c. Frauds
   d. Secret-Reserve
   e. Window-dressing
   f. Teaming and lading
3. Fill in the Blanks:
   a. Recording of bogus sales, purchases or expenses in the books means --------------------------------.
   b. Maintaining proper record of purchases and sales of goods in prices as well as quantities is essential to avoid the ------------------------of goods.
   c. ------------------------system should be used to maintain proper control over the stock.
   d. Fraud refers to------------------------of financial information.
   e. Teaming and lading mean temporary misappropriation of---------
   f. If the same transaction is written twice, it is the error of -------.
4. Give the examples of following type of errors;
   a. Error of commission
   b. Error of omission
   c. Error of duplication
   d. Compensating errors

1.5ADVANTAGES AND DISADVANTAGES OF AUDIT

9.5.1 Advantages of Audit :

Audit of accounts by a duly qualified Chartered Accountant is compulsory for the registered joint stock companies, public trusts, bigger co-operative societies only. Auditing has also been made mandatory these days for Income Tax and VAT payers above a particular limit. The limit for Income Tax payers is income above Rs. 25 lakhs and for VAT payers the limit is a turnover of above Rs. 1 Crore. These days even cost

Accounts are to be audited by a qualified Cost Accountant if the turnover is above Rs. 1 Crore. In other words, it is not compulsory for all. However though not legally compulsory, many business units these days, get their accounts Audited because there are number of advantages of Auditing.

They can be enumerated as follows:

1) **Audited accounts are considered more reliable** by the general public, Government authorities and financial institutions like banks.

2) **Errors and frauds are detected in time and immediately rectified.** Remedial action can be taken in time to avoid or prevent them in future. Quick action can be taken against inefficient or negligent staff and possible future loss can be avoided.

3) **Employers will write the accounts in time** or immediately and take sufficient care to see that there are no mistakes. They will not be easily tempted to commit frauds because they know that the accounts are to be audited at an early date by the experts in the field and they may be caught and punished.

4) Auditor is an expert in the science of keeping books of accounts. He is familiar with different laws governing different businesses. **So, he can guide the accounts department in time. Such timely advice is very valuable for the business**. Now a day there are number of laws and new laws are added to them from time to time. A busy businessman even though highly educated cannot keep track of such ever changing laws. Businessmen have neither time nor inclination to study and understand these laws. Auditor will come to their rescue.

5) Shareholders of joint stock companies are laymen and scattered all over the country and in the case of certain companies even all over the world. **The auditor audits the accounts of the business on behalf of these shareholders** and submits his report to them. From such reports the shareholders come to knows how their company is functioning and how their hard-earned money is being used. They can also take a decision about retaining or selling their shares in the company.

6) **Government and different tax authorities like** Sales Tax officers. Income Tax officers, Service Tax and Excise officers etc**. readily accept the audited accounts** and the matter of assessment of tax becomes simple and less time consuming.

7) When there is loss due to theft, fire, floods etc. **claim of loss from the Insurance Company is settled quickly if the accounts are audited.**

8) In the case of Partnership Firm, **when any partner retires or dies, his account can be easily and quickly settled.**

9) **Banks and other financial institutions sanction loans quickly on the basis of accounts audited** by a duly qualified auditor.

10) **Trade unions will demand bonus and rise in salary for a reasonable amount** only because the workers will believe in the accounts kept by the management if they are duly audited. If the accounts are not audited, the trade union leaders feel that the company's accounts do not reveal the real profits made by the company and they are not getting reasonable remuneration and bonus.

Due to all these advantages business organisation like sole traders and partnership firms, where audit of accounts is not legally mandatory, mostly get their accounts audited by a duly qualified Auditor.

1.5.2 Limitations of Auditing

1) **Non-detection of errors/frauds: -** Even though the accounts are carefully audited by the auditor. Sometimes the auditor fails to detect certain mistakes and frauds**.** After the entire Auditor is a watchdog and not a blood hound. So, if the accounts are prepared intentionally and thoughtfully with flaws to commit frauds, the auditor may not be able to detect them. Thus, you cannot guarantee that there are absolutely no errors or frauds in the accounts that are audited.

2) **Dependence on explanation by others: -** Auditor has to depend on the explanation, clarification and information given by the client or his staff. This information may not be necessarily always correct. Audit report is affected adversely if the explanation and information prove to be false.

3) **Dependence on opinions of others :-** Auditor has to rely on the views or opinions given by different experts viz Lawyers, Solicitors, Engineers, Architects etc. he cannot be an expert in all the fields Such opinion given by the experts may not be flawless.

4) **Conflict with others: -** Auditor may have differences of opinion with the accountants, management, engineers etc. In such a case personal judgement plays an important role. It differs from person to person.

5) **Audit is a post mortem examination. Things have already happened and nothing much can be done now.** Usual reply given by the Government Authorities for different Audit objections is "Noted for future guidance."

6) Under the Indian Companies Act, the real owners are the shareholders. They appoint the Auditor in their Annual General Meeting. **This is only in theory or on paper. In practice, he is appointed by the Directors only. So, he may not necessarily act independently**. He may try to avoid displeasing the Directors to continue to get the business.

7) **Corrupt practices to influence the auditors:** The management may use corrupt practices to influence the auditors and get a favourable report about the state of affairs of the organisation. Many Auditors are not bold enough to express their frank opinion and displease the

clients. So, they may give a clean chit or favourable opinion even though there are errors or frauds. They are not prepared to displease their clients and lose their business.

8) **No assurance: -** Auditor cannot give any assurance about future profitability and prospects of the company.

9) **Inherent limitations of the financial statements :-** Financial statements do not reflect current values of the assets and liabilities. Many items are based on personal judgement of the owners. Certain non-monetary facts cannot be measured. Audited statements due to these limitations cannot exhibit true position.

10) **Detailed checking not possible :-** Auditor cannot check each and every transaction. He may be required to do test checking.

However, in spite of the above limitations, there is no alternative to Audit and its advantages outweigh the disadvantages. So, all business units mostly get their accounts Audited by a qualified Auditor.

Expressing Opinion:

After completing his Audit work, Auditor finally expresses his Frank opinion on the quality of the accounts maintained. He suggests ways and means to further improve their quality.

1.6 DISTINCTION

1.6.1 Accounting v/s Auditing

Points of difference	Accounting	Auditing
1. Meaning	It is recording of all the day to day transactions in the books of accounts leading to preparation of financial statements.	It is the critical examination of the transactions recorded in the books of accounts.
2. Nature	It is concerned with finalization of accounts.	It is concerned with establishment of reliability of financial statements.
3. Objects	The object is to ascertain the trading results.	The object is to certify the correctness of financial statements.
4. Commencement	Accounting commences when book keeping ends.	Auditing begins when accounting ends.
5. Scope	It involves various financial statements. It	It depends upon the agreement of upon the

	involves maintenance of books of accounts. It does not go beyond books of accounts.	provisions of law. It goes beyond books of accounts.

1.6.2 Auditing v/s Investigation

Points of difference	Auditing	Investigation
1. Objects	The object is to find out whether balance sheet and profit and loss account exhibit a true and fair view of business.	It is undertaken to know the essential facts about a matter under inquiry. It is done with some special purpose of view.
2. Period	It usually covers one accounting year.	It may cover more than one accounting year.
3.Conducted	It is conducted for proprietors only.	It is carried out on behalf of any party interested in the matter.
4.Scope	It is restricted to balance sheet and profit and loss account.	It is wider in scope It may be carried out beyond balance sheet.
5. Compulsion	Audit is legally compulsory for companies.	It is voluntary. It requires under certain circumstances
6. Time	It may be conducted at the end of the year.	It may be conducted at any time in case of suspicion about any transaction
7. Report	Form of report is prescribed. It is presented to the shareholders.	Form of report is not prescribed. It is presented to the client.
8. Appointment	Owners appoint the auditors.	Even third party can appoint an investigator.
9. Qualifications	The statutory auditors must possess proper qualifications.	Even an employee preferably a chartered accountant may be appointed as investigator.
10. Rework	Re–audit is not generally undertaken	Re-investigation may be undertaken.

1.7 PRINCIPALS OF AUDIT

Following are the important concepts of Auditing :

1. Materiality
2. True and Fair
3. Independence
4. Going concern

As per the syllabus students have to study the first two concepts:

1. **Materiality Concepts:**

Material here means important. The auditor should verify every important transaction. Which is important and which is trivial or not important is to be decided by the Auditor. Here his past experience in the Audit field and his discretion will help him. In every business different things have different degree of importance. Auditor should be able to decide which things are important and which are not in a particular business unit which he is auditing. He should devote sufficient time and verify toughly all-important transactions. At the same time, he should not unnecessarily waste his time in verifying small and unimportant transactions. An auditor can achieve all objects of audit by properly following this principle.

Information is material if its misstatement or omission will affect the financial or economic decision to be taken by the users of this information i.e., Auditor's report. Materiality depends upon the size and nature of the transaction. Some matters are individually or in the aggregate are relatively more important than others in presenting a true financial position of the concern. Materiality may also be decided by some legal and regulatory requirements.

The concept of materiality is fundamental to the process of accounting. This concept is applicable in planning as well as performing audit. Auditor will insist upon more reliable evidence for passing material transactions. He will see that such items are properly and distinctly disclosed in the financial statements.

2. True and Fair :

According to Indian Companies Act, the auditor has to report whether the account statements give a true and fair view. Balance sheet should show true financial position and profit and loss account should reveal true profits made or losses incurred.

Companies Act 1913 contained the words true and correct. However, subsequently these words were substituted by True and Fair. Many a times it was found that though the accounts were true and correct, they did not disclose the position of the concern in a fair manner if they were not presented properly.

The phrase True and Fair has not been defined by the companies Act. However, the Auditor is expected to report in these words. So, the auditor should check the full background of each and every transaction. He must not restrict his attention only to the documents produced before him. He must probe deep in to the matter.

In order to show a true and fair view the auditor should ensure that:

1. The final accounts agree with the books of accounts.
2. The provision for depreciation is proper.
3. The closing stock is physically verified and valued properly.
4. Intangible assets like goodwill, patents, preliminary expenses or other deferred revenue expenses are written off properly.
5. Proper provision is made for bad and doubtful debts.
6. Capital expenses is not treated as revenue expenses and vice versa.
7. Capital receipts are not treated as revenue receipts.
8. Effect of changes in rate of foreign exchange on value of assets and liabilities is recorded in the books properly.
9. Contingent liabilities are not treated as actual liabilities and vice versa.
10. Provision is made for all known losses and liabilities
11. A reserve is not shown as a provision and vice versa
12. Cut off transactions are recorded properly, so that all sales invoices are matched with goods delivered and all purchase invoices are matched with goods received.
13. Transactions are recorded on accrual basis, i.e., outstanding expenses, prepaid expenses, income accrued and advance income are recorded properly.
14. Expected or anticipated gains are not credited to the profit and loss account.
15. Effect of events after the balance sheet date on the value of an asset and liability is disclosed in the accounts properly
16. The exceptional or non-recurring transactions are disclosed separately in the accounts.
17. If there is any charge on the assets, that should be disclosed clearly. .
18. In the case of assets, the auditor should see that they are neither over valued nor undervalued.
19. The auditor should ensure that no important asset is omitted.

20. Similarly, liabilities should not be under or overstated and no liability should be omitted. Accounting policies should be consistently followed, and all legal requirements should be complied with.

This is one of the fundamental concepts in auditing In short what constituents true and fair view is a matter of an auditor's judgment. However, all legal requirements should be strictly complied with.

1.8 SUMMARY

This chapter deals with the basic concepts of Audit. The Audit has come from a Latin term Auditor which means to hear. When a fraud was suspected, an outside expert was appointed to check the accounts. He used to hear or listen to different concerned parties before fixing the responsibility of the fraud on any one person. Hence the term Auditor which then became audit. In simple terms audit means critical checking of the account books. Audit begins, where accounting ends.

Trial balance, profit and loss account and balance sheet prepared at the end of the year are called financial statements. Besides owners, these annual statements are read by investors. Government taxation authorities, Trade Unions, financial institutions etc. They will readily believe in the accounts if they are audited by a qualified auditor. So, even where auditing is not compulsory, business people go in for auditing.

The term audit has been defined by different people in different words. The auditor has to check the accounts and report whether they are prepared properly and there are no errors or frauds. He must also report, whether they reflect a true and fair view of the financial position of the concern.

Main object of audit is to check the accounts and the subsidiary objects are detection and prevention of different types of errors and frauds. Window dressing and creation of secret reserve both should be avoided.

There are number of advantages of Audit and it has some inherent limitations also. However, the advantages outweigh the disadvantages.

There is difference between accounting and auditing and auditing and investigation. There is also difference between book – keeping and accounting.

Auditor should have good knowledge of the science of keeping books of accounts and also different laws concerning different types of business. He must be straight forward and honest and think independently. He must be bold enough to frankly expense his mind in his report. He must not reveal the business secrets to outsiders or competitors.

He should plan his work in advance and complete the same in time. He must be able to decide what is material or important and what is not. He must concentrate on material matters. He must proceed with an assumption that the business is going to be continued for a considerable future period.

1.9 EXERCISE

1. What do you mean by auditing? Discuss its objects.
2. Distinguish between accounting and auditing.
3. Write short notes on :
   i. Compensating errors
   ii. Principles of Auditing
   iii. Window dressing
   iv. Secret reserves drop
   v. Going concern concept.
   vi. Methods of selecting sample items
   vii. Error of principle.
4. Define and explain the term auditing
5. Distinguish between auditing and investigation
6. What is a fraud? What are the different types of frauds?
7. Explain the concept of True and Fair view.
8. What are the advantages and limitations of auditing?
9. Explain in brief different types of errors.
10. **Objective type questions :**

1. Select the appropriate option and rewrite the following sentences :

i) The main object of an audit is --------------------.

a) To ensure that the final accounts are prepared.

b) Detection and prevention of frauds and errors.

c) Verification of accounts and financial statements.

d) To ensure future viability of the concern.

ii) The main objective of window – dressing is ---------------------.

a) To reduce tax ability

b) To mislead investors

c) To understate profits

d) To avoid payment of bonus to workers

iii) Auditing commences after ------------------------.

a) Investigation is over b) Accounting work is over

c) The General Meeting is over d) None of the above

iv) -------------------- is not an error of commission.

a) Arithmetical error b) Compensating error

c) Posting error d) None of the above

v) Misappropriation of goods is generally done by --------------------.

a) Auditors b) Employees

c) Shareholders d) All of the above

vi) The responsibility of adopting sound accounting policies and maintaining adequate internal control rests with -----------------.

a) Chief Accountant

b) Company Management

c) Company's internal audit department

d) Statutory Auditor

vii) Audit conclusions and reporting is --------------------.

a) Advantage of audit

b) Technique of audit

c) Limitation of audit

d) Principle of audit

2. State whether the following statements are True or False.

1. An error of principle will not affect the trial balance.
2. The term audit has been derived from the Latin term Audire.
3. The allocation of amount between capital and revenue expenditure is a compensating error.
4. Audited accounts are free from errors and frauds.

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2

TYPES OF AUDIT

Unit Structure :

2.0 OBJECTIVES

After studying the unit, the students will be able to

- Meaning, Advantages and disadvantages of Balance sheet audit
- Meaning, Advantages and disadvantages of Interim Audit
- Meaning, Advantages and disadvantages of Continuous Audit
- Meaning, Advantages and disadvantages of Annual Audit
- Meaning, Advantages and disadvantages of Statutory Audit

2.1 INTRODUCTION

In the forms of business organization where the owners are not involved in the management of the organization, they cannot ensure about the performance of the business organization. Being the owners of the organization, they can also have interest in the firm's performance. In response to this, the legislator has made a decision that limited firms are obliged to be under constant control of auditors. Auditors are assigned at a firm's general meeting. The role of the auditor is more than to control the firm. Advising on how the firm can advance its decisions and activities is a vital part of the auditor's role. Auditing consists of a review of a firm's annual reports. Auditing commences with a selection of areas to observe and assess. Principally, the area with the greatest risk for errors and inaccuracies should be reviewed most intensively. As each firm is unique, the audit needs to be adapted to be applicable to each firm's special features. The chosen way to audit a firm should reflect the most cost-efficient process of accomplishing the aim of the audit. An **audit** is a systematic and independent examination of books, accounts, statutory records, documents and vouchers of an organization to ascertain how far the financial statements as well as non-financial disclosures present a true and fair view of the concern. Audit is an appraisal activity undertaken by an independent practitioner (e.g., an external auditor) to provide assurance to a principal (e.g., shareholders) over a subject matter (e.g., financial statements) which is the primary responsibility of another person (e.g., directors) against a given criteria or framework (e.g., IFRS and GAAP).

Classification of Audit

Audit may be classified into two categories mainly ; -

(a) according to organizational structure of a business; and

(b) from practical point of view.

According to Organizational Structure of a Business

1. Statutory Audit

In case of many undertakings, audit is made compulsory under statute because these undertakings are established by statute. The audit of their accounts is termed as statutory audit. The following are the examples of such an audit:

By virtue of the organizational pattern, some business institutions appoint auditors who are made responsible to have a constant and regular review of their accounts.

From Practical Point of View :

All those forms in which audit is often conducted practically by business houses are as follows :-

1. Continuous Audit or Detailed Audit.

2. Periodical audit or Final Audit or complete Audit.

3. Interim Audit.

4. Occasional Audit.

5. Partial Audit.

6. Balance Sheet Audit.

7. Cash Audit.

8. Cost Audit.

2.2 INTERIM AUDIT

2.2.1 Meaning and Definition

Interim audit is the audit which is conducted between the two annual audits for the purpose of finding the interim dividend. It may be monthly quarterly or half yearly. For knowing the reliable results during the financial year such type of audit may be applied.

In large-scale business concern, the performance may be checked for a particular part of the year. Depending upon the amount of work the auditor may check the figures of a month or a quarter. It involves a complete examination or a review of the accounts and records of the business upto the date of the interim audit.

DEFINITION OF INTERIM AUDIT

"An interim audit is one when the auditor completes an audit up to the date of a set of interim accounts, for example quarterly or half-yearly accounts.

G. William

R. Howard defines interim audit, as this is when an audit is conducted to a particular date within the accounting period.

2.2.2 OBJECTIVES OF INTERIM AUDIT

1. To know profit or loss of interim period.
2. To declare interim dividend.
3. In case of partnership there may be admission or retirement of a partner during the year.
4. To get loan on the basis of interim account.
5. To get information about the financial position of interim period.
6. To take mid-term decisions about prices, investments or profits.

2.2.3 ADVANTAGES OF INTERIM AUDIT

1. **Suitable For Big Firms:** Interim audit is very suitable for large and dynamic type of business organizations.

2. **Moral check:** There is a moral check on the staff of the client as the accounts are checked after three or six months. An auditor checks the work of every person. It creates moral pressure on the employees to perform accounting jobs effectively.

3. **Detection of frauds and Correction of errors:** It helps to eliminate mistakes and frauds. The time between compiling and checking accounts is very short. Therefore, location of fraud is possible, as sufficient time is not given to employees. The interim audit is also helpful for correction of errors.

4. **Helpful for Final Audit**: The interim audit is helpful for the early completion of the final audit.

5. **Interim dividend:** The interim audit is conducted to declare the interim dividend. The management can prepare interim accounts for dividend purpose.

6. **Publication of Interim Figures:** In some cases, the publication of interim figures is compulsory. So, in such cases interim audit is very useful.

7. **Admission, retirement or death of a partner:** The admission or retirement of a partner during the year is possible due to interim audit. A partner may expire at any time during business life. Due to the interim audit to determine the fair value of assets and liabilities during the year becomes possible. Thus, interim audit helps all partners to settle conditions.

8. **Convenient for the management:** Interim audit provides midyear financial information. Therefore, it becomes helpful for the management to take the price or profit related decisions.

9. **Encourages Investment :-**Due to interim audit investor rely more on the company performance. He purchases and sells the shares keeping in view the audit report.

10. **Up to date record:** The benefit of the interim audit is that accounting record is kept up to date. The accounting staffs have a duty to complete their work for interim audit. Thus, delay in accounts is not possible.

11. **Suggestions Implementation:** The accounting staff can follow auditor's suggestion. In case of interim audit auditor's suggestions can be quickly implemented.

2.2.4 DISADVANTAGES

1. **Additional work:** The interim is not a part of the final audit. Final audit must be conducted after conducting this audit too. So, it is an additional workload on audit staff.

2. **Alteration of Figure:** Already audited accounting figure may be changed by a dishonest employee. It may create difficulty in final audit. It will mean that the audit staff will have to prepare notes when they finish the interim audit.

3. **Unsuitable For Small Firms:** Interim audit is not suitable for small business organizations with less financial transaction.

4. **Work Burden:** Audit notes have to be prepared after the completion of interim audit. It increases the burden of work.

5. **Disturbance at Work:** Interim audit disturbs the working environment in the office. Regular office activities may be hampered because of audit work.
6. **Increase Expenses:** Interim audit may prove expensive because it involves addition work on the part of the auditor. Thus, it increases the expenses of the business as it is not compulsory by law.

7. **Not useful for third parties:** The demerit of the interim audit is that it may not provide a guideline to third parties. The interim accounts are not final so the figures may not be reliable for making decisions.

2.3 CONTINUOUS AUDIT

2.3.1 Meaning and Definition

The audit which remains continue throughout the financial year is called continuous audit. In this case an audit staff may carry audit work for the whole year with equal or unequal intervals. He checks each and every transaction. The large-scale companies require constant review of their business matters or there may be a declaration of dividend during the year, it is of great help. In case the volume of the transaction is very large, the management can follow the policy of continuous audit. If the internal control system is not satisfactory then to apply continuous audit will be the best option in order to show a true and fair view of accounting record. This audit is very costly but minimizes the errors. A continuous audit is applicable in the following cases.

DEFINITION OF CONTINUOUS AUDIT

1.R. G. Williams says that continuous audit is one where the auditor, or his staff is consistently engaged in checking the accounts during the whole period, or where the auditor or his staff, attend at regular or irregular intervals during the period.

2. Waiter W. Bigg says that continuous audit is one member of auditor's staff is occupied continuously on the accounts the whole year round or where they attend at frequent interval, fixed or otherwise during the current of the financial year.

3. L. R. Howard says that continuous audit work is conducted through at the course of the financial year but is not taken to a specific accounts period as in interim audit.

2.3.2 DVANTAGES OF CONTINUOUS AUDIT

1. **Continues and through checking:** This is the main advantage of the continuous audit. The audit clerks remain busy throughout the year. The work is checked on the spot. Auditor has sufficient time to check the books of accounts thoroughly.

2. **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 an auditor visits the client regularly and the number of transactions will be small and hence, the errors will be detected easily and quickly.

3. **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.

4. **Prompt filing of returns:** The continuous audit is beneficial for the prompt filing of returns as the accounts are prepared as well as audited at the end of the year.

5. **Interim dividend:** Here it is easy to prepare the accounts for six months. Hence Continuous audit is helpful to declare interim dividend.

6. **Moral check on the client's staff:** The continuous audit is useful to develop moral check on employees. As the time between recording and checking the entries is very short, the staff cannot think to plan any fraud. As well the auditor can surprisingly visit to the client's office therefore it will have a considerable moral check on the clerks preparing the accounts.

7. **In time Auditor's advice:** The continuous audit is beneficial to seek auditor's advice. The weakness of business functions can be removed during the year by taking the guidance of the auditor.

8. **Convenient for auditor:** The continuous audit is helpful for the audit staff for distribution of workload. The work is distributed over the whole year. The audit staff can prepare their programme on the basis of time allocated to one business. The auditor gets sufficient time for important and ambiguous matter to draw a conclusion.

9. **Regularity in the staff:** The continuous audit is beneficial for business. The accounting employees become regular. The accounting record is maintained on regular basis for showing it to audit staff.

10. **Upto Date Accounts :-** Accounts of the business are kept upto date by the staff because they know that auditor may visit and check the accounts at any time.

2.3.3 ISADVANTAGES

1. **Small business:** Continuous audit is not fit for small-scale business concerns. A small business has a few transactions so there is no need of audit for the whole year. As well the continuous audit is an expensive system of audit.

2. **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. Also, the changed figures can show different results.

3. **Disturbance in the client's work:** The frequent visits by the auditor may disturb the work of the client. When the audit work starts, the work of accounting staff suffers, as the books are not spare.

4. **Staff intimacy:** The accounting staff and the audit staff work side by side for the whole year. Friendship among the employees and auditors may lead to errors and frauds. The sympathetic view of audit staff may fail to show true and fair view.

5. **Queries may remain outstanding:** The queries raised by the audit staff may not be answered on the same day. The audit clerk may lose the thread of work and the queries may remain outstanding as there might be a long interval between two visits.

2.4 ANNUAL AUDIT / FINAL AUDIT

2.4.1 Meaning and Definition

This is also known as final audit or Periodical audit. This audit is carried out often at the close of the accounting year. The final audit takes place only after the end of the trading period when all the transactions for the whole year are completely recorded and final accounts have been prepared. Therefore, there is no clash among the duties of accounting and audit staff. Here the auditor examines the accounts of the whole accounting year in one continuous session. Normally the small concerns audit their accounts under this system. If internal control is effective then the auditor can use the sampling method, otherwise cent percent checking becomes essential. The audit staff can complete the audit work within shortest possible time. There is continuity of work in checking the financial and other relevant records.

The various definitions of Final audit are as below:

DEFINITION OF FINAL AUDIT

1. **R. G. Williams** says that final audit is one which is not commenced until after the books have been closed at the end of the financial year, or which is not commenced towards the end of the financial year and carries through to completion after the end of the year.

2. **Walter W. Bigg** says that, a final audit is an audit which is not commenced before the end of financial period, and is then carried on until completed."
3. **L. R. Howard** says that final audit is carried through to completion in one continuous session. Although it may be commenced before the end of the accounting period, it is completed at least after the end of the financial year.

The basic characteristics of Final or Annual Audit are as below:

1. In case of Annual audit, generally audit work commences after the close of the financial year.

2. Audit work is carried on and completed in a continuous session.

3. Auditor visits the client's office only once in a year and keeps on doing the work until it gets over.

4. It is suitable for small scale concerns.

2.4.2 Merits of Annual audit

The following are some of the main advantages of Annual audit

1. Economical:

Periodical audit is economical and suitable particularly small sized business units. In this type of audit, the auditor makes test checking and whole work is performed once only. Hence, it is possible for the auditor to check the accounts of various business concerns at a time, and so the fee charged by audit staff is less as compared to continuous audit

2. STAFF DUTIES:

The audit work is started after the completion of accounting work. There is no clash of duties of accounting and audit staff. The accounting staffs remain busy for one year. But the audit is started after the end of accounting work.

3. PLANNED WORK:

The work of audit is completed under planning. The audit programme provides the schedule of time for audit work. According to planned work the auditor can control the audit of many business units.

4. Work continuity:

The flow of audit work goes on without any break from start till its completion. The continuity of work is beneficial for audit staff to clear their questions. The doubts become clear on the same day

5. Convenient for management:

The benefit of the final audit is that is convenient for management as well as audit staff as the auditor starts and completes an audit in one session and the queries can be cleared on the same day.

6. Less Chance to Alter Figure:

As the audit is completed in one continuous session, and once the records are delivered to the auditor, they are not accessible by the accounting staff, so there is less chance to alter figure which minimizes the chances of frauds.

7. No relations:

The merit of the final audit is that it provides no chance to audit staff to develop friendly relations with accounting staff. The accounting staffs are not in a position to get undue benefit from audit staff.

2.4.3 Demerits of Annual Audit

Followings are the disadvantages of periodical audit:

1. Unsuitable:

Big organization having large number of transactions it takes more time to complete the audit and hence presentation of accounts to the share holder may be delayed. The share holders are usually very anxious for dividends which cannot be declared until the completion of the audit. So, this type is unsuitable for big organization.

2. Possibility of Leaving Errors

Detail checking of books of accounts is not possible under this method. So, the auditor applies test check. Thus, there are chances of leaving errors and frauds.

3. Difficult to Detect Planned Frauds

Generally, the frauds are committed in the direction of top-level management. So, such frauds are committed in planned way. In this type of audit, the auditor uses the sampling method and does not check in detail. So, such planned frauds cannot be detected.

4. Late correction:

The demerit of a final audit is that errors are located after the end Of the year. The corrections of errors take time so long errors are not corrected the accounts are incomplete.

5. Low moral check:

The drawback of a final audit is that it has less moral pressure on employees of the business concern. The audit staffs come after one year. The employees are free to commit errors and frauds for the whole year.

6. Thorough checking:

The drawback of a final audit is that there may not be thorough checking. Audit sampling may be used to complete work.

7. Delay in the future planning:

As the audit work is started after the end of accounting year it takes time to check the accounting records. The audit work is completed late. So, the budgets and estimates for future may not be prepared in time.

8. In case of Final audit only the declaration of final dividend is possible declared

2.5 CONCURRENT AUDIT

2.5.1 Meaning

The word **concurrent** itself defines its meaning, concurrent means happening at the time. Concurrent Audit means doing the examination of the financial transactions at the time of happening or parallel with the transaction. The concept of Concurrent Audit has been introduced to reduce the time gap between occurrences of transactions.

2.5.2 Objectives of Concurrent Audit

1. Concurrent audit is a Systematic and timely examination of financial transactions on a regular basis to ensure accuracy, authenticity, compliance with procedures and guidelines.

2. The emphasis under concurrent audit is not on test checking but on substantial checking of transactions.

3. The concept of concurrent audit has been introduced to reduce the time gap between occurrences of transaction and the overview or checking of the transactions

4. The concurrent audit serves the purpose of effective control as it is normally conducted by external agencies like chartered accountants' firms.

5. It attempts to shorten the interval between a transaction and its examination by an independent person not in its documentation.

6. In concurrent audit, there is an emphasis in favour of substantive checking in key areas rather than test checking.

7. The concurrent audit is essentially a management process integral to the establishment of internal accounting functions and effective controls and setting the tone for a vigilance internal audit to prevent the incidence of serious errors and fraudulent manipulations.

8. The focus of concurrent audit is on adherence to laid down systems, procedures and safeguards, therefore a concurrent auditor may not sit in judgment of the decisions taken by a branch manager or an authorized official.

9. The main objective of concurrent audit is to bring to light any violation of procedure.

2.6 BALANCE SHEET AUDIT

2.6.1 Meaning

In this type of audit, the audit is commenced from the balance sheet, working back to the books of original entry and relative documents. In this type the work of audit does not start with the verification of primary books, it verifies the items appearing in the balance sheet, so this is basically a partial audit. This type of audit can be successful in those organizations where an effective internal check is in operation. Verification of all items included in the balance sheet combined with the examination of related income and expenses accounts is known as balance sheet audit. Under such an audit, the auditor checks capital, reserves, assets, liabilities, etc., given in the Balance Sheet. In this audit the items of Trading and Profits and Loss Account which have a relation with the Balance Sheet items are also checked. For example, the purchase of goods on credit will increase the liabilities to creditors, increase the stock and will be shown in the Trading Account as an increase in purchases and closing stock. So, this item will have to be verified. In short Balance sheet audit means checking the accuracy of information found in a company's balance sheet. Such an audit is popular in U.S.A.

2.6.2 Purpose of conducting Balance Sheet Audit

In large organizations the trading transactions are numerous and mostly they are entirely computerized. In such cases, the routine checking may be completely dispensed with. Where the computerized accounting system is coupled with effective internal control, detailed vouching can also be dispensed with, in such organizations; auditor conducts the balance sheet audit.

The purpose of balance audit is to making sure that:

1. The assets shown in the balance sheet are really owned by the organization.
2. All assets owned by the organization are included in the balance sheet at the correct value.
3. All liabilities are included at the appropriate values.
4. Accepted accounting principles are followed to prepare the balance sheet.
5. All items are appropriately classified as capital items and revenue items and treated accordingly.
6. All the requirements of law are duly complied with. For example, in the case of companies, the issue of share capital is correctly recorded in the books.
7. All the adjustment entries and journal entries relating to the closing of accounts and preparation of balance sheet are examined.

2.7 STATUTORY AUDIT

2.7.1 Meaning

It is a type of **audit** which is mandated by a country's Law. A statutory is also known as financial audit. It is basically an audit of the final statements of a company, i.e., the profit and loss and the balance sheet. The main purpose of this type is to ensure that the books of accounts presented to the regulators and public are true and fair and the balance sheet of the company is showing an accurate picture of the company's current financial position.

Statutory audit is mandatory if certain criteria are being met by the business. It is carried out by independent external auditors. In India, the statutory audit is recommended by Companies Act. In this audit the reports are reported to the company shareholders by the auditor. In his reports, the statutory auditor expresses his outlook on the fair values of the company's final accounts. He also confirms the observance of the financial statements according to the provision of the act. The purpose of the statutory audit is to ensure the fairness and credibility of accounting records. The auditor's appointment, his remuneration, duties are assigned by the provisions of the law, as pertinent to the organization.

2.7.2 Objectives of Statutory audit

1. Statutory audit is mandatory in case of the company because the share holders are the owners of the company, however, they do not run or manage the day-to-day affairs of the company. The management of the company is done by the board of Directors. So, the shareholders need assurance that the accounts maintained and published by the company are authentic and genuine. The independent auditor has full authority to check the financial records of the company and publish his findings via an auditor's report.

2. Other stakeholders like creditors, employees, potential investors etc also benefit from the statutory audit. They too can base their decisions on these accounts, since they are authentic.

3. An annual report is the most important basis of the decision-making process for stakeholders and is therefore expected to be correct and trustworthy. An auditor's task is to ensure that annual reports are executed correctly by applying appropriate regulations and show an accurate picture of a firm's financial situation.

2.7.3 Advantages of statutory audits

A **statutory** audit offers the following benefits:

1. It assures the management that their duties in statutory performed perfectly.
2. Statutory audit improves the reliability of the published financial statement.
3. It provides internal control's efficiency.
4. The statutory audit ensures the management that they have to abide by non-statutory requirement say Corporate Governance requirement.
5. When the internal controls are poor in a company, the statutory auditor will give the suggestion for the company's improvement which will help the company from risk and improves the company's performance.
6. It enhances the trustworthiness of published financial statements.

2.7.4 Disadvantages/Limitations of Statutory Audit

1. The cost associated with an audit can be very high. But if any audit firm is already engaged for looking after the day-to-day work including accounts preparation etc then it will charge relatively very less amount to conduct the audit as compared with the firm which is not engaged for doing the same.

2. The employees might get disrupted for performing their normal work in order to answer the day-to-day query of auditor or while providing the auditor any reports or data required to them. This might result in stretching the work of the employees beyond office hours and may sometimes cause distress among the employees.

3. The financial statements include judgemental as well as subjective matter. Judgemental issues may vary with persons. Sometimes personal business is also included.

4. There are inherent limitations of audits like it has to be done in due time, internal control within the organization, limited power of auditor, etc. One has to understand that auditors are watchdogs and not the bloodhounds. There reporting is based on the sample data and not the total data. Moreover, as frauds are the planned one so it will be more difficult to find the same.

5. There are many areas in which auditors are left with no other option than to take representation from management. This is a danger if management itself is involved in frauds as in that case they will give the manipulated representation.

6. The auditor does not assess and review the 100 % transactions. Auditor merely expresses his opinion on the financial statements and data provided to him and at no point gives total assurance.

7. An auditor comment upon the going concern of the organization but nowhere assures for its future viability. Stakeholders should not vest their money only seeing that the organization's data are being audited.

2.8 EXERCISE

Write short notes

1. Interim Audit
2. Continuous Audit
3. Concurrent Audit
4. Annual Audit
5. Statutory Audit

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3

AUDIT PLANNING AND PROCEDURES AND DOCUMENTATION

Unit Structure:

3.0 OBJECTIVES

After studying this chapter, the students will be able to:

- Understand the meaning and importance of audit planning and audit programme
- Know the advantages and disadvantages of Audit programme.
- Explain the Meaning and importance of Audit working paper.
- Discuss the factors determining form and contents of audit working paper.
- Explain the Ownership, custody, access of other parties to audit working papers.
- Understand the Auditor's lien on working papers.
- Know the Auditor's lien on client's books.
- Explain the Main functions, importance, features, contents of permanent audit file, temporary audit file.

- Understand the Meaning, structure, contents, General information, current information, Importance of Audit Note book.

3.1 INTRODUCTION

In simple terms, planning is thinking before doing. We all think before doing any importance work. We think about the best method of doing that job successfully and in time. Audit of accounts being an important job, the auditor thinks in advance before starting any audit and prepares a detailed programme to be followed to complete the job successfully in time. Institute of Chartered Accounts issued detailed instructions in this regard in 1989. The Auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. .

3.2 MEANING AND OBJECTIVES OF AUDIT PLANNING

3.2.1 Meaning

Audit planning means planning of his work by the auditor. It will help him to conduct the audit in an efficient manner and complete it in time. He has to plan about the area, scope, depth of transactions to be audited, time to be devoted for each job, persons to be deployed for different operations etc.

Audit plan should inter-alia cover the following:

1. Acquiring knowledge of the client's accounting system, policies and internal control procedures.
2. To what extent reliance should be placed on the internal control system.
3. Deciding nature timing and extent of the audit procedure to be performed.
4. Coordinating the work to be performed by different individuals.

The audit plan prepared should not be rigid. As and when necessary, it should be altered to suit the changed conditions. Planning should be continuous throughout the engagement. It involves developing an audit programme, showing nature, timing and extent of audit procedures. Changes in surrounding conditions may require revision of the overall plan. However, when there are significant changes, the auditor should state the reasons for the same. He must give reasons in support or justification of the changes made and they should be documented.

3.2.2 Objectives of Audit Planning :

Planning the audit work will immensely help the auditor to complete the work successfully and in time. Objectives or benefits of planning audit can be enumerated as follows:

1) If he thinks in advance, he can decide which things are important and which are not. Accordingly, he can devote more time and attention to important matters while actually conducting the audit.

2) If any problems are likely to crop up, the auditor can find or seek solutions for the same well in time.

3) Planning will help him to conduct his work efficiently.

4) This will also help him to select a suitable team of assistants and properly distribute the job amongst them. Each member of the team should get that part of the job which he likes and which he can complete in time. Every person has his own likes and dislikes. If a person gets a job of his liking, he will always perform it more efficiently and find pleasure in doing the same. In other words, he gets work satisfaction which is very important. Members of appropriate levels of capabilities and competence can be selected in the team.

5) Planned work can be supervised easily. Suitable directions and instructions can be given to the staff in time.

6) Co-ordination between the work done by different members of the team can be easily done.

7) Audit planning will help the auditor to utilize the services of all assistants fully and properly.

3.2.3 Factors to be considered while preparing the audit plan :

While preparing the audit plan the auditor should consider the following factors:

1) Complexity of audit

2) Environment in which the business is working at present.

3) Personal nature of the client. What is the previous experience?

4) Special features of the client's business.

Before actually framing the programme, the auditor should personally discuss with the client the proposed programme and consider his suggestions and amendments in this connection. The auditor should discuss with the client the overall plan and the procedure he wishes to follow while conducting the audit. Client's convenience should also be taken into account.

Audit plan cannot be formulated by sitting in isolation. It's a brain-storming exercise. The auditor should use his wisdom, foresight, professional knowledge, previous experience knowledge about the industry and the particular unit etc. in preparing the audit plan. The plan once prepared, should be altered as and when there are changes in the circumstances and a change is warranted.

3.3 PREPARATION FOR AUDIT

Proper execution of any work requires appropriate planning and programme of action. Before commencing any new Audit, Auditor should take the following steps.

1) Ascertain the scope of his duties.

2) Procure engagement letter.

3) Acquire complete knowledge about the business of the unit and the accounting system followed by the concern.

4) Obtain a list of responsible officers.

5) Knowledge of technical details.

6) Inquiry into special circumstances.

7) Instructions to the client.

1) Scope of duties :

To begin with the auditor should ascertain the exact nature and scope of his duties. This question does not arise in case of statutory audit because his duties are enumerated in the concerned law only. E.g., when an auditor is appointed to audit the accounts of a joint stock company, there are provisions in the Companies Act about his duties, rights and liabilities. However, if a concern in which audit is not legally mandatory, appoints an auditor, auditor should get clear instructions about the work expected from him by the appointing authority, so that he can plan his work accordingly. Auditor should discuss the scope of his duties with the person who is going to hire his services.

2) Procure engagement letter :

Before starting his work, the auditor should obtain his appointment letter from the client. Such letter should clearly mention amongst other things, his duties, remuneration, period allowed to complete the job etc. In other words, such letter leads to an audit contract. Such a letter or contract is highly desirable to avoid any misunderstanding with the client in future. Such a letter will also help if the client accuses him of not performing the work promised.

3) Knowledge about business :

Every type of business has its own special features. So, every business follows an accounting system that suits its needs. There is no one uniform accounting system that can be followed by every business unit. So, the auditor before starting his work of audit should study the special problems of the business unit and the system of account followed by it. If necessary, the auditor should visit the factory and acquaint himself with the production procedure followed by the factory. He must acquire knowledge about the raw material and the machines used in production.

An auditor should understand the broad economic environment in which his client is working. He must also study the different regulatory provisions and taxes payable by the client.

Auditor should obtain a list of all books of accounts and registers etc. maintained by the firm. He must also study the internal control system followed. If the internal control system in the concern is adequate and reliable, he need not check each and every transaction. He may adopt test check system and audit only few selected items in detail.

4) List of Principal officers :

In an Accounts department there may be different officers in charge of different books of accounts. Auditor should obtain their list so that while going through the audit procedure, if the auditor needs any information or clarification on any specific point, he can directly contact the concerned officer. Auditor should also obtain information about the extent and scope of authority of each one of them.

5) Knowledge of technical details :

He should also acquire some knowledge about the technical details if any of the business. This will enable him to grasp easily the nature of the transactions while auditing them.

6) Enquiry into special circumstances if any :

An auditor should also enquire into special circumstances surrounding his appointment. He is required to be careful about the implications of such special circumstances. In case he is appointed in place of another auditor, it is his professional duty to communicate with him.

7) Instructions to the client :

After making above preparation, he should issue following instructions to his client:

a. Accounts should be finalized and kept ready for audit.

b. Necessary schedules be prepared and made available to him. E.g., schedules of debtors and creditors, bad and doubtful debts, fixed assets, outstanding and prepaid expenses, outstanding incomes and incomes received in advance, investments, cost of acquisition and market price, stock sheets, statements of deferred revenue expenditure etc.

Then the auditor should ask for final accounts of last 2-3 years with auditor's reports.

3.4 SOURCES OF OBTAINING INFORMATION

As we have seen earlier, the auditor should acquire full information about the business of the client before the actual commencement of audit. He has to collect this information from the following sources.

Sources of information can be classified into two parts.

1. Internal sources
2. External sources.

1. Internal sources :

Examples :

a. Annual reports sent to the shareholders.

b. Minutes of Annual General Meetings and those of Directors' Board Meetings and Directors' Committee meetings.

c. Budget forecasts and projections.

d. Auditor's last year's working papers.

e. Policy manuals

f. Internal Audit reports.

2. External sources:

Examples :

a. Trade journals, magazines and news papers.

b. Text books on different subjects.

c. Publications of different professional bodies

d. Industry publications

e. Websites

3. Discussions with the management:

Next source of information is actual discussion with the management. The auditor should meet the senior management staff and discuss in detail about the special issues relating to the business of the client. He should obtain information on the following points in particular.

a. Changes in management, organisational structure and activities, if any during the year.

b. Current Government legislation, rules and regulations regarding the business of the client.

c. Current business developments affecting client.

d. Current or expected financial difficulties or accounting problems.

e. Plant facilities available.

f. Recent changes if any in technology, types of products or services and production and distribution methods.

g. Important matters arising from previous years' financial statements, audit reports and management letters.

h. Changes in accounting policies procedures and internal control made in the year under review if any.

4. Visit to client's premises for a personal discussion.

The auditor may personally visit the client's premises and get firsthand information about the plant layout, process of manufacturing and different registers etc. maintained. It is always useful to have a personal discussion with the client about his method of writing accounts and his other accounting policies.

He may ask to balance all the accounts in the ledger and prepare a trial balance as on the closing date of the accounting year. On the basis of the trial balance, the client may prepare Trading and Profit and Loss account and Balance sheet. Auditor may ask his client or his staff to prepare the following statements before he actually starts his work of audit.

a) Bank Reconciliation statement.

b) Arrange the vouchers chronologically or serially.

c) Statement of cash or goods in transit if any.

d) A statement of cheques returned from banks.

e) A schedule of Debtors and creditors.

A separate statement may also be prepared of aging debtors i.e., Debtors outstanding for a long time. All debtors may be sent a copy of their account with the client and they may be asked to confirm the correctness of the balance. Replies received from the debtors may be kept systematically.

f) A statement of Bills Receivable.

g) A schedule of investments on hand and a statement of investments sold and purchased during the year. A statement of dividend received and receivable.

h) List of inventories and their location and valuation.

i) A schedule of fixed assets and details about new assets purchased and sold during the year.

j) A schedule of prepaid expenses and outstanding expenses. Similarly, a schedule of income outstanding and the income received in advance.

k) A list of long-term liabilities etc.

If the client keeps all the above statements prepared in advance, the auditor can complete his work within a short time and submit his report to the client.

3.5 FACTORS TO BE CONSIDERED WHILE PREPARING AUDIT PLAN

While preparing the audit plan the auditor takes into account the following factors:

1. Terms of appointment :

If audit of the unit is compulsory, terms and conditions of audit are contained in the concerned Act itself. If audit of a firm is done voluntarily, then the client should give him a letter of appointment stating the terms and conditions of his appointment scope of his work etc. Auditor will take these terms in to account while preparing his audit plan.

2. Audit Report :

Auditor has to prepare his report at the end of his work. The contents of the report will vary according to the terms of his appointment. In some acts is making appointment of the auditor where mandatory, the format of the report is also given and the auditor has to submit his report to the client in that format only. Copies of his report are also to be sent to certain parties as per the provisions of the concerned act. E.g., A copy of the auditor's report of a Joint Stock Company is required to be submitted to the stock Exchanges along with annual returns.

3. Legal requirements :

If there are any special provisions in the concerned law regarding the Audit, Auditor should take them into account while preparing the audit plan.

4. Accounting Policies :

Every concern may adopt certain accounting policies to suit their needs. These policies, once decided are not usually frequently changed. However, when it becomes necessary, the firm may change these policies. The auditor should take in to account these existing policies and changes made in them during the year under consideration. If such changes, affect the final results of the year, the auditor should mention the effects of these changes in his final report.

5. **Changes in the Accounting standards :**

The Institute of Chartered Accountants has prescribed certain accounting standards. Changes are made and new additional standards are added by the Institute from time to time. Business people have to keep their books of accounts according to these standards. So, the auditor should take in to account the prevailing accounting standards while preparing his audit plan.

6. **Deciding the possible areas of errors and frauds:**

While conducting the Audit, the auditor should decide, on the basis of his past experience the possible areas where frauds are likely, and the auditor should check these items in greater details. This fact should be taken into account while preparing the audit plan.

7. **Reliance on internal control system :**

Though the accounts are audited at the end of the year, every concern has its own internal check system in at least some areas to prevent errors and frauds. A simple definition of internal check system is to follow a routine wherein the work done by one person is routinely checked by another. E.g., in a departmental store, one man sells the goods on the counter, next man prepares its bill third man packs it and finally the cashier at the counter collects the price. All these 4 people independently maintain a record of goods sold. At the end of the day records thus maintained by different employees are tallied with each other. Thus, there are checks and counter checks on sales. Auditor will study the prevalent internal control system and will decide how much to rely on it. Where there is a reliable internal check system, the auditor need not check every item in detail. He can adopt test check system and audit only certain items selected at random. Auditor should devote more time to check these items where frauds are more likely.

Considering the nature and volume of work, the auditor should decide the number of staff members required to complete the work within the time limit. He should select the staff with appropriate skill and efficiency.

Check your progress:

1. Give the examples of Internal and External sources.
2. Enlist the points to be considered while preparing the audit plan.

3.6 AUDIT PROGRAMME

3.6.1 Meaning

The auditor should prepare a written programme containing procedures needed to implement it. It should also contain audit objectives. Detailed instructions should be included so that the assistants can properly implement the programme. If the assistants follow this programme, it will be easy for the boss to control the proper execution of the same.

While preparing such a programme the auditor has to decide to what extent he can rely on the internal control system being used by the business unit. If there is a proper internal control system, auditor need not check each and every item in detail as possibilities of errors and frauds are rare. If he feels that the system is not sufficiently reliable, he must insist on production of appropriate reliable evidence for every transaction entered in the books of accounts. The auditor may also decide the timings for different procedures to be followed. He must also take into account the number of assistants he can spare for this particular assignment.

Usually, the auditor has enough freedom to decide the timing. However sometimes he was no such option. E.g., If he has to check the closing stock, he has to do it on the last working day only.

The auditor may have to make changes in the plan if there are significant changes in the circumstances. In other words, the Audit plan should be flexible.

- **Audit Programme :**

To complete his work successfully in time, the auditor should draw up an audit programme for every audit especially in the case of audit of a large concern. Audit programme is a sort of a time table containing the sequence in which the auditor wants to verify the books of accounts of the firm and the time he allots to each operation.

3.6.2 Development of an Audit Programme :

While developing an audit programme the auditor should pay special attention to the following points :

1. Internal Control :

Before preparing the audit programme the auditor should study the internal control system prevalent in the organisation and to what extent it is reliable. In the field in which the system is found to be reliable, the Auditor need not verify each and every item in detail. He can pick and choose some items at random and adopt test checking. However, in the fields where the control system is not found to be strictly followed or is not sufficiently reliable the auditor should go and check each and every item in detail and insist on reliable evidence in support of such entries. E.g., If there is proper internal control system on purchases and sales and perpetual inventory system is in vogue, the auditor need not spend more time on verification of closing stock.

2. Business of the Client :

The auditor should study the special features of the client's business and develop a suitable audit programme. E.g., Audit programme for a service industry like a bank will be entirely different from the audit programme of a factory. While auditing a bank, the auditor should pay more attention on the loans given by the bank and their recovery. Whereas in a factory he should pay more attention on purchase of machinery and its proper depreciation, purchase of raw material and its utilization etc.

3. Cost benefit :

Auditor cannot neglect the cost factor. He must take in to account the cost involved in following the procedure and the benefit that accrues. Procedure which costs the least should be naturally selected.

4. The auditor should consider all the possibilities of errors.

5. Different procedures adopted should be suitably coordinated.

6. Assistants available :

The auditor should take into account the number of assistants he can make available to complete this assignment.

7. Other Auditors :

If services of internal auditor, Branch Auditor or outside experts are available, the auditor should decide to what extent he can rely on the work done by them.

3.6.3 Advantages of an Audit Programme.

1) It will ensure that each and every book of account and the register is verified. There is absolutely no possibility of any book being left out through oversight.

2) If facilitates the work of distribution of the job by the chief auditor amongst his subordinates. He can make proper distribution of the work amongst different audit assistants. While dividing the work amongst different persons, the Auditor should take into account each person's past experience, qualifications, efficiency, likes and dislikes, level of understanding and work habits etc.

3) Chief auditor can see the day-to-day progress of the work at a glance.

4) As the work is carefully planned in advance and distributed, control over the work of the assistants becomes easy.

5) It facilitates timely completion of the work. If on any day any assistant is absent another person can continue the work as he can easily know what work the earlier person has actually completed on the previous day.

6) If later on any mistakes are noticed responsibility for the lapse can be easily fixed on the concerned person and suitable action can be taken against him. Remedial action may be taken immediately if necessary.

7) This years' programme is very useful while preparing the programme for the next year.

8) Audit programme contains instructions to the concerned staff about carrying out their work.

9) It makes the job of selection of suitable persons for different jobs easy.

10) It facilitates systematic auditing.

11) It serves as a guide for audit work in future.

12) In future if nay case is filed against the auditor for negligence in duty etc. it an be produced in the court as an evidence to prove the actual work done.

13) There is uniformity in the audit work done.

14) It enhances the efficiency of audit staff.

15) It is very useful to the Auditor, while preparing his final audit report.

16) Due to systematic working, the auditor may get more clients.

17) Potential problems are promptly identified and services of assistants can be fully and properly utilised.

18) Co-ordination of the work done by different persons becomes easy.

3.6.4 Disadvantages of an Audit Programme :

1. The work may become mechanical. A part of the audit programme may be carried out without understanding the importance of that part in the complete work of audit.

2. Programme may become rigid and inflexible. There are continuous changes in the business world. If Cognisance of these changes are not taken in to account in time, original programme itself may be carried out.

3. A hard and fast programme may kill the initiative of efficient and enterprising assistants.

4. Elaborate programming may not be necessary in the case of the audit of a comparatively smaller concern. Here programming may just amount to unnecessary waste of time and energy.

5. The job may be finished hurriedly to complete it within the time schedule. So, the quality of the work may be affected.

6. A uniform audit programme cannot be used in the audit of every company. A fresh programme unit is to be prepared for each and every audit every year. Thus, it becomes a time-consuming activity.

7. Assistants may not verify anything more than what is given in the programme.

All these disadvantages may be eliminated by imaginative supervision of the work carried on by the assistants. Assistants should be encouraged to suggest changes in the programme as and when necessary.

Secondly if we take an overall view, the advantages outweigh the disadvantages and programming is absolutely necessary atleast in the case of audit of bigger concerns.

3.6.5 Method of Work:

In order that an audit may be carried out in a systematic and efficient manner, the following steps should be taken:

1) Work may be carried on regularly. Record of time of arrival, and departure of the staff should be maintained with the actual work done by each member of the staff every day. Entries should be made in the audit note book.

2) Definite portion of the work should be completed every day.

3) Different coloured pencils should be used and different types of ticks should be done for different jobs. These should not be disclosed to the staff of the client.

4) Vouchers examined should be immediately cancelled so that the same may not be produced again.

5) Staff members should not discuss amongst themselves or with outsiders the details of the client's affairs. They should maintain absolute secrecy about these matters.

6) The auditor should collect sufficient evidence to enable him to form an opinion about:

   a. Truth and fairness of the accounts and that

   b. They are kept regularly following all necessary legal requirements.

7) All assets and liabilities should be properly classified and mentioned.

8) Details of mortgaged assets must be clearly stated.

9) Income and expenses should be properly classified and stated.

10) No material omissions should be done.

11) Errors and frauds are avoided.

12) Books of accounts should be properly kept.

3.7 AUDIT WORKING PAPERS

3.7.1 Meaning

Audit working papers constitute the link between the auditor's report and client's records. Documentation is one of the basic principles. SA 230 audit documentation refers to the record of audit procedures performed, evidence obtained and the conclusions reached by the auditor.

- **Information contained in the working papers:**

Audit working papers are also called working papers or simply work papers. They contain a record of the audit work done Inter alia (amongst other things) they contain information on the following points:

a) Evidence of audit work performed

b) Schedules prepared

c) Additional items in the accounts.

d) Information in short about the business of the client and its recent history.

- **Working papers include:**

Working papers of audit of different concerns are different. But usually they contain the following:

1) Memorandum and Articles of Association in the case of a company audit, partnership deed in the audit of a partnership firm and Trust Deed in the audit of a Trust.

2) Extracts from minute books of meetings of managing committee.

3) Trial Balance Sheet and profit and loss account.

4) Letter of appointment or engagement given to the auditor etc.

5) Correspondence done between the auditor and outsiders like banks, Insurance companies, debtors, creditors etc.

6) Details regarding valuation of stock.

7) Certificate from the management regarding stock and its valuation.

8) Bank Reconciliation statement.

9) Adjustment entries passed.

10) Details of investments.

12) Contingent liabilities.

13) Audit time budget.

14) Certificate from the management regarding accrued liabilities.

15) Any other working papers.

3.7.2 Importance of working papers:

1. The auditor can understand the sincerity of his assistants.
2. They are useful to the auditor when he finally drafts his report.
3. If there is a change in the Audit staff the new incumbent can easily continue the work i.e., link up his work with the work done by the earlier member of the staff.
4. These papers provide training to the audit staff.
5. Auditor can plan his next years programme on the basis of these papers.
6. Auditor can understand the weaknesses of the internal control system in the organisation.
7. In future, if there is a suit against the auditor accusing him of negligence in his duties, he can easily defend himself in the court of law on the basis of these papers.
8. Exercising control over the audit work is facilitated.
9. If any mistakes are noticed subsequently in the work carried on by the staff the auditor can easily fix responsibility of the same on the concerned staff member and take suitable action against him if found necessary.

In view of their importance, the auditor should keep these papers in a safe custody and retain them for a reasonable period of time.

3.7.3 Classification of working papers :

Working papers should be properly organized. All significant matters which require the exercise of judgement by the auditor should be included. The conclusions drawn by the auditor on the basis of these papers should also be recorded. Some schedules he gets prepared by the client's staff and some he prepares himself with the assistance of his own staff. Clients are mostly permanent. They do not frequently change their auditor because the auditor has secret information about their business. So, the working papers collected are classified into two parts.

1) A permanent audit file

2) The current file

1) Permanent File:

A permanent audit file normally contains papers which can be used every year. The file is updated as and when necessary. It includes the following papers:

Contents of Permanent Audit file

a. Memorandum of association. Articles of association partnership and Trust Deed etc.

b. Description of the business of the client.

c. List of books of accounts maintained and names of concerned officers.

d. Information on accounting policies like method of depreciation, valuation of stock etc.

e. Copies of continuing contracts

f. Copies of balance sheets of earlier years etc.

2) Current file or Audit administrative Papers:

These papers are concerned only with the current year's audit. All the work done in the course of audit planning, assignment of staff, evaluation of internal control and audit programme are included in this group of papers. Usually, this file contains the following papers :

a. Appointment letter

b. Discussion with the management and client.

c. Audit time budget

d. Internal control systems

e. Audit programme

f. Trial balance prepared

g. Adjustment entries passed

h. Copies of communications the auditor has with bankers, creditors, debtors etc. and replies received.

As working papers are important and are to be preserved for a longer period, there should be a standard form in which they should be prepared. There should be proper layout and space for margin. They should be complete and there should be clarity and accuracy. A good quality paper should be used for this purpose.

3.7.4 Ownership and custody of working papers :

There is a controversy amongst the different experts about the ownership of these papers. An important and relevant question arises as to who is the owner of these working papers. One set of experts say that their ownership is with the auditor whereas others argue that they belong to the client.

First category of experts argues that they are prepared by the auditor. So, he has a right over them. He can use them in future as evidence in the court of law if any case is filed against him for negligence of his duties. He has spent his time and energy on them. So, naturally their ownership should go to him.

People in the second category argue that their ownership should go to the client as these papers contain important and sometimes even secret information about his business. So, to preserve or maintain trade secrets, audit papers should be handed over to the client as soon as the job of auditing his accounts is over. He is the agent of the client and should surrender the papers to him.

Both the arguments have some substance or force in them. However, in an English case in 1938 Soekoc Kinsky Vs Bright Grahm & Co. it was held that the working papers belonged to the auditor because they were independent contractors and not agents of the client. In a second case Chantrey Martin & Co Vs Martin in 1953 it was held that working papers prepared by the Accountant for the sole purpose of producing a balance sheet belonged to the client. The court opined that where the accountant merely acted as agent of the client like in the case of corresponding between the Accountant and Income Tax Authorities, the papers belong to the client and not to the accountant.

On the basis of these judgements, we can conclude that generally an Auditor as an independent professional is entitled to the working papers prepared by him. However, where he corresponds with any third party as an agent of the client, the papers rightfully belong to the principal. But where an auditor has not been paid his fees, he can retain such papers. He has a right of particular lien upon the books of accounts and other documents also.

According to the views of the institute of Chartered Accountants, the working papers are property of the auditor. Auditor should however maintain confidentiality of the information in the papers and properly maintain these papers for a reasonable period of time He can give copies of some papers if demanded by the client.

3.8 AUDIT EVIDENCE

Audit Evidence are the information collected in the process of auditing. It is an important tool to support the conclusion given by the auditor in the audit report to the shareholders of the company. Audit evidence is not only useful to form an opinion but also useful as a defence to prove that there were no negligences on the part of the auditor. Auditing evidence is defined as a term to protect investors by promoting transparent, accurate, and independent audit reports.

Characteristics of Auditing Evidence

Quality if the auditing evidence can be measured by the understanding degree of the application of the following characteristics:

1. Sufficiency: Sufficiency takes into consideration the adequacy of the data i.e. whether or not the documents and evidences provided is of an adequate quantity for arriving at the judgement. If an auditor was given details of only three branch out of the twenty branches, it would be considered as insufficient for the financial standing of that company.
2. Reliability: Reliability answers to the query that whether or not the material can be trusted and can counted on for forming an opinion. Reliability of the information is directly correlated to the source of the information.
3. Source: As discussed earlier the source of accounting evidence can be obtained directly from the company or externally. External sources are generally regarded as more trustworthy and hence preferred.
4. Nature: Nature refers to the type of information that is received. For example, the information can be provided through legal documents, presentations, orally from employees, or through a physical confirmation.
5. Relevance: Depending on the type of audit being conducted, how pertinent the information received in its relation to the overall analysis is a guiding factor.

Audit procedures for obtaining audit evidence:

There are seven types of audit procedures:

1. Inquiry: Auditors talk with the client's senior management to gain a deeper understanding of business processes for the auditing process. Inquiry is however not restricted only to senior management; it may be done even with lower-level employee or factory workers based on the information required. Inquiry alone, however, is not considered sufficient audit evidence to reduce the audit risk.
2. Inspection. The process of inspection involves collection of evidence by the way of inspecting physical assets, records, or documents.
3. Observation. Under observation, auditors observe the client's business processes and operations in order to identify any lag or deficiencies related to the business process which can lead to errorous output.
4. External confirmation. It is the process whereby the auditors attempt to seek the information from the third parties by various means like telephonic confirmation, mail confirmation, letter confirmation etc., to verify the financial information and accounting records provided by the client. Ecxternal confirmation can be negative confirmation or positive confirmation. In negative confirmation, the third party will reply only if he doesnot
5. Recalculation. The auditors perform their own calculations to verify that the final accounting balances match those reported by the client.

6. Reperformance. Auditors may reperform certain tasks or processes to identify deficiencies and discover opportunities for further optimization.
7. Analytical procedures. Auditors analyze the client's financial records to find discrepancies.

3.9 AUDIT NOTEBOOK

An audit notebook is a component of audit working papers that keeps a record of a wide range of issues that are observed during the course of the audit and for which the client's answers are either inadequate or must be included in the audit report. The audit staff keeps a diary or register to record any errors or irregularities discovered during the audit. When the auditor sorts his work papers into permanent and current audit files. The audit notebook is part of the current working paper file because it is required to keep a new audit notebook for each fiscal year. It is one of the permanent segments of the auditor's records that is available for future reference whenever necessary. It is divided into two parts:
a. One that records general information pertaining to the audit as a whole.
b. One in which auditor enters special points discovered during the audit process of various years.

3.9.1 Contents of Audit Notebook:

Some of the points recorded in an Audit Notebook are as follows:

A. General Details:

(i) The nature of the business conducted and the important documents pertaining to the business's formation.

(ii) The client's name and the audit year.

(iii) A list of the books of accounts currently in use.

(iv) The names of the principal officers, as well as their duties and responsibilities.

(v) Specifics of the accounting and financial system used, as well as the internal

(vi) check-in procedure in the business.

(vii) Information about the company's accounting and financial policies.

(viii) A duplicate of the audit programme.

(ix) Business-related technical terms.

(x) Any notes or queries that may be required during a subsequent audit.

B. Special Issues to be Documented in the Audit Note Book

(i) Routine queries that have not been resolved, such as missing receipts and vouchers, etc.

(ii) Mistakes and errors discovered in detail

(iii) The issues raised during an audit that must be brought to the auditor's attention, such as the company's failure to comply with the provisions of the Companies Act or the Memorandum of Association, as well as other legal requirements.

(iv) Extracted from minute books and contracts, as well as other correspondence with various government agencies, financial institutions, debtors and creditors, and so on.

(v)The points that will be included in the audit report.

(vi) Points that require additional explanation and clarification, such as a change in the basis of valuation of finished goods or the computation of depreciation, etc.

(vii) Dates of audit commencement and completion

3.9.3 Importance of Audit Notebook

a. Assistance in Audit Report: The audit notebook assists the auditor in preparing an audit report. For each concern, a separate audit notebook is kept.

b. Moral Check on employee: The audit notebook is used to assess audit clerks' integrity and honesty. Auditing can be used to examine moral and ethical values.

c. Check on the work of an audit staff: An auditor can appreciate someone who completes his work on time. He may be held liable for any outstanding work after the period has expired.

d. Record for the future: The audit notebook aids in the retention of information. The auditor can read the book on a daily basis.

e. Guidelines for the audit staff: Since the audit notebook is helpful for future reference, it will be able to provide information to the audit staff in the future.

f. Better understanding of the accounts in future: A new auditor will benefit from the audit notebook. They can see the flaw in the past.

g. Defence in the court: The audit notebook aids an auditor's defence in court. People can go to court to determine liability for duty negligence. The audit notebook is written proof of an auditor's work.

3.10 SUMMARY

This chapter deals with Audit Planning procedures and documentation. Any important task to be completed successfully needs proper planning. Similarly Audit of a firm needs proper pre planning before it is actually performed. All the information of the client's business is first collected. His accounting system is studied. A list of books of accounts maintained along with the names of the persons responsible to maintain each book is obtained, Accountant of the client is then asked to close the books of accounts and prepare a Trial Balance and Trading and Profit and Loss Account and Balance sheet. Auditor then studies the internal control system prevalent in the organisation and decides to what extent he can rely on the same. If the system is satisfactory, he may adopt test checking. In such cases he need not waste much time on routine checking of each and every item.

Auditor collects information about the client's business from various sources – internal as well as external. He discusses relevant issues with the client. If necessary, he visits the client's premises and his factory. Accounting policies adopted by the client are noted down.

Auditor decides the number of persons to be spared for the particular Audit assignment taking into account the volume of work involved. The task is divided amongst different assistants taking into account their past experience, qualifications, degree of efficiency and likes and dislikes. Time schedule is to be prepared. Dates of commencement and completion are decided. These dates are decided in consultation with the client taking in to account his convenience. Thus, an Audit programme is developed.

Audit programme has number of advantages. It ensures that each and every book of account and register is checked. Auditor can see the progress of the work completed every day. Audit Assistants can follow the instructions given in the programme and complete the work in time, work is done systematically. Possible problems are properly dealt with Co-ordination between the work done by different assistants can be easily done.

There are also some disadvantages for Audit Programme. Work becomes rigid inflexible and mechanical. It may kill the initiative of the efficient and enterprising assistants. However, by imaginative supervision, the disadvantages may be overcome. There is no alternative to planning and programming specially for the efficient, systematic and timely completion of audit of large concerns.

Audit Working Papers :

There are two files of working papers – 1) Permanent file 2) Current file. Permanent file consists of documents like Memorandum of Association, Articles of Association, Partnership Deed, Trust Deed etc. Current files contain Bank Reconciliation statement prepared, contingent liabilities, Adjustment entries passed etc.

Working papers are very useful to the Auditor while preparing his final report. They can also be used as evidence in the court of Law if subsequently any case is filed against the auditor for negligence in his duties. They are the evidence of the work done by the Auditor and his subordinates. They are carefully prepared and preserved for a reasonable period of time.

There is a controversy amongst the experts about their ownership. However, courts have held that they belong to the Auditor and not the client. However, the Auditor should not misuse the secret information contained in them about the business of the client. He may at his discretion give copies of the same to the client.

3.11 QUESTIONS

1. Explain the importance of Audit Working papers.
2. What are the contents of Working Papers?
3. What are the contents of Audit Programme?
4. Write a short note on :
   a) Audit Note Book
   b) Audit Planning
5. Explain current file. Give examples of its contents.
6. Elaborate the factors considered by an auditor while preparing an Audit plan.
7. What do you mean by an Audit Programme? What are its contents?
8. Discuss the importance of Audit Note Book.
9. Explain "Permanent Audit File. Give examples of its contents.
10. Explain Audit Working Papers and Auditor's lien on them.
11. Objective type questions:

A. Select most appropriate option and rewrite the following sentences.

a) Audit Programme should be –
i) Oral
ii) Rigid
iii) Flexible
iv) Oral and Flexible

b) Working papers are the property of the –
i) Client
ii) Auditor
iii) Client and Auditor
iv) Equity Share holder

c) Audit programme must be prepared –
i) Before commencement of an audit.
ii) During the conduct of an Audit.
iii) After completion of an audit.
iv) After submission of an audit report.

B. Write True of False.

a) Audit plan should be primarily based on knowledge of client's business.
b) Permanent Audit file includes Trust Deed.
c) Audit working papers constitute the link between the auditor's report and client's records.

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4

AUDITING TECHNIQUES

Unit Structure :

4.0OBJECTIVES

After studying this unit, the students will be able to:

- Understand the concept routine checking.
- Know in detail about Test checking
- Learn about Audit sampling.
- Know in detail about internal control system and its utility.
- Understand the difference between Internal Checks, Internal Control, and Test Checks

4.1 INTRODUCTION

Routine checking involves checking of such common records and books which is carried on by the auditor as a matter of routine. Routine checking includes checking the casting carry forwards and other calculations in the books of original entry. Posting from these books to relevant accounts are verified. Balancing and carry forward of different ledger accounts are also verified. While doing this routine checking the auditor uses different types of ticks and different coloured pencils so that they may not be copied easily by the staff of the client. Information about these ticks is kept secret e.g., normally we use blue or black colour pen but to keep their separate identify auditors use a green colour pen. The auditor uses special ticks for each class of transaction checked. Like posting, casting, carry forward, bank statement and vouching. As far as possible the same tick should not be used for the same transaction in all the firms to maintain secrecy of these ticks. While auditing each section, work should be completed up to a certain point otherwise the chances of mistakes increase.

All important balances and totals and note worthy points should be noted down in the Audit Note Book. Vouching work should be done by two audit assistants together. The Auditor should not accept any figures written in pencil because they can be easily changed after auditing. He should insist on writing the figures in ink only.

4.2TEST CHECKING

4.2.1 Difference between Test Checking and Routine Checking :

Test Checking	Routine Checking
Meaning	
Here only parts of the transactions are checked to form an opinion.	Detailed checking of all transactions at all stages.
Objectives	
To obtain reasonable level of satisfaction about all transactions by verifying only a few representative transactions	To verify arithmetical accuracy, accuracy of posting to ledgers, correctly balance the ledger A/cs
Advantages	
Volume of work is reduced, time is saved	Errors and frauds are easily detected and trial balance can be easily prepared
Disadvantages	
Some errors and frauds may go undetected as all the transactions are not checked. There is doubt and risk in the auditor's opinion.	Highly mechanical process and monotonous activity. If may lead to boredom, compensating errors and errors of principle will not be detected

4.2.2 MEANING

The main objective of audit is to formulate an overall opinion on the accounts and financial statements of a unit. This enables the auditor, to finally submit his report to the party concerned. He has to express his opinion on the quality of the accounts maintained and whether they give a true and fair views of the profits earned and valuation of assets and liabilities.

In a large organisation there are thousands or even lakhs of transactions to be verified. It is practically impossible for any auditor to physically verify each and every transaction. In such concerns if there is an effective internal check and internal control system the auditor can adopt test check system. He need not check each and every entry thoroughly. He can check in depth few items selected at random and if he finds that there are no errors in them, he can pressure that other entries are also correct and proceed further.

Thus, **test checking can be defined** as "in depth checking of only few selected items and form an opinion about the quality of the accounts".

If the items selected are correct, he can presume that other entries are also correct. For the success of test checking system, representative number of entries of each class is selected for checking. Test checking is an accepted substitute of detailed checking. In many cases, hundred percent checking of entries is neither possible nor necessary. It will also involve lot of unnecessary expenditure. Test checking is based on the theory of probability. If the sample is truly representative of the population, the test checking will give reliable results.

4.2.3 Features of Test Checking

Test checking consists of selecting and checking a proportion of transactions selected by the Auditor. The salient features of Test Checking are –

1. **Scientific:** It is a mathematical truth that a scientifically selected sample would reveal the features and characteristics of the population. The statistical theory of sampling is based on a scientific law. Hence, it can be relied upon to a greater extent than any arbitrary technique which lacks basis and acceptability.

2. **Estimation Process:** Test Checking and Sampling can never bring complete reliability; it cannot give accurate results. It is a process of estimation. What error is tolerable for a particular matter under examination is a matter of the individual's judgment in that particular

3. **Coverage of material items :** Entries involving large amounts or relating to material accounts are seen exhaustively and other entries are picked up for verification from the remainder according to a certain plan. Sometimes entries are checked for a few specified months exhaustively and the rest go unchecked.

4. **Full Coverage over a time period :** Test Check is normally planned in such a way that the audit programmes for 3 to 5 years cover all types of transactions in case of a medium or large sized Company. Thus, if in one year the months of January, June and December are checked; April, July and September may be checked in the second year and so on.

5. **Surprise Element :** The staff and management of the Auditee Company should not be able to anticipate the pattern of test checking, otherwise they will predict the areas and periods to be covered in any one year and will be careful regarding the same.

6. **Flexibility :** If test checking becomes routine, predictable and mechanical, it loses its value. Hence, the Auditor should keep changing the methods of test checking at reasonably frequent intervals.

7. **Judgment Based :** The extent of test checking would primarily depend on the Auditor's judgment of a particular situation. This judgment in turn depends on the previous experience of the Auditor, current developments and the efficacy of Internal Control System.

Anyway, the auditor has to verify the financial statements with the help of available evidence. He has to pay special attention to:

1) The method of presentation,

2) Information disclosed

3) Arithmetical accuracy,

4) Following principles of accounting

5) Complying the provisions of the laws applicable to that business.

There should be no errors and frauds in the books of accounts. The auditor should know why errors and frauds occur and how they are committed. It is his prime duty to detect them.

4.2.4 Factors to be considered while adopting Test Checking:

The numbers of transactions in any large concern are large. There will be number of purchases and sales. Salary may have to be paid to thousands of workers. There may even be overseas transactions. Bank loans, letters of credit, overdrafts, bills discounted etc. may have to be verified. There is the problem of volume and variety. So, selection of the items for test checking should be carefully done.

It should be remembered that by adopting test checking the auditor only reduces his physical labour. However, in no way it reduces his liability. Subsequently if any error or fraud is detected in the accounting entries which were not checked by the auditor due to adoption of test checking, he will still be held personally liable for negligence in his duties. So, he must be doubly careful in selecting the items for test check. They should be fairly representative items and he should be fully satisfied that they are in order. If he comes across anything fishy, he must give up test checking and check all the entries.

While selecting items for test check auditor should consider the following points:

1. He should classify the transactions under appropriate heads.

2. He should thoroughly study the system in the concern from authorisation, documentation, recording and evidencing the same. The system should be found perfectly O.K.

3. The auditor should carefully study the internal check system followed by the concern. As we have seen earlier, internal check system means a system where the work of one is automatically checked by the other as a matter of routine. Financial data provided by the system should be reliable. If and only if the auditor is fully satisfied by the internal check system, he should adopt test check. Not otherwise.

4. There should be absolutely no bias in selecting items for test check.

5. Test check should not be adopted in the audit of such concerns where there are only few transactions of large amount. E.g., A company may have only 20 export or import transactions and each transaction may be in crores of rupees. In such cases, 100% transactions should be checked.

6. The number of transactions to be selected for test check is decided by the degree of reliance on the internal check system.

7. It the auditor comes across any material errors; they should be properly and thoroughly investigated.

4.2.5 When test check can be used.

Test check can be used only under the following circumstances :

a) When the number of transactions to be audited is very large.

b) The auditor has limited time at his disposal.

c) There are number of identical transactions.

d) There is efficient system of internal control.

e) Audit history of the organisation in the past will also decide the size of the sample. The areas requiring audit depend on the previous history.

4.2.6 Precautions to be taken:

Test checking means examination of few selected transactions from the beginning to the end through various stages. The auditor has to take following precautions while adopting this system:

1. For the success of the system of test checking, samples of transactions selected should be fairly representative. It is a mathematical truth that scientifically selected sample would reveal the features and characteristics of the population.

2. There should be some surprise element. Client's staff should not be able to anticipate the pattern of test checking. Otherwise, they will predict the areas and periods to be covered for audit and will be careful only about those transactions and neglect the others.

3. There should be flexibility. Auditor should change his method of selecting transactions for test check from year to year. In selecting

appropriate transactions for test check, the auditor should use his past experience and discretion current developments and changes made in the internal check system, should also be taken in to account.

4.2.7 Merits of Test Check

1. Effectively reduce Work Load: It is a partial record check from the books of accounts. Because it is difficult to check all financial transactions included in the books of accounts, it only examines specific financial transactions. As a result, work load is reduced and auditing tasks can be completed more quickly.

2. Time and labour savings: Checking a large volume of transactions takes more time and energy. Only selected transactions are examined during test checking, which saves time and labour.

3. Cost Effective: Performing a test check reduces the amount of work, time, and energy required. It means that audit tasks can be finished in less time and with less effort. As a result, the cost of auditing is reduced.

4. Suitable For Large Firms: Because it is difficult to test each and every transaction, it is best suited for large corporations with a high volume of financial transactions.

5. Accuracy and Reliability: Sample transactions are carefully and intelligently chosen with special care. As a result, it ensures the accuracy and dependability of record checking.

4.2.8 Demerits Or Disadvantages Of Test Check

1. Error Probability: In test checking, financial transactions are examined at random. As a result, there is a high likelihood of undetected frauds and errors in the books of accounts.

2. Unsuitable For Small Businesses: Test check is unsuitable for small businesses with few financial transactions.

3. Internal Check And Internal Control: If the organisation lacks a strict internal check and internal control system, it is impossible to conduct an internal check because it may report false data.

4. Doubtful And Suspicious: The audit report is prepared on the basis of a few sample transactions that have been reviewed internally. As a result, auditors are always skeptical and suspicious.

4.3 AUDIT SAMPLING

4.3.1 Meaning:

"Audit sampling" means the application of audit procedures to less than 100% of the items within an account balance about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population.

It is important to recognise that certain testing procedures do not come within the definition of sampling. Tests performed on 100% of the items within a population do not involve 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 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 might imply 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.

4.3.2 Purpose of Audit Sampling

Audit sampling must be used regardless of whether the audit is internal, external, or government in order for auditors to complete their audits without wasting resources checking every single item. The following are the audit sampling objectives:

a. Collect sufficient evidence to form an audit opinion.
b. Reduce the number of resources used
c. Provide auditors with the basis for forming a conclusive audit opinion
d. Detect potential errors or fraud.
e. Ensure that audit completely in accordance with auditing standards.
f. utilised as a research tool

4.3.3 Methods of selecting Sample Size:

SA 530 deals with Audit sampling. (S.A. standards on auditing issued by the institute of chartered accountants of India). There are two methods of selecting the size of the sample and individual items. They are:

1) Judgmental sampling

2) Statistical sampling

Whichever method is adopted it should be particularly noted that the sample selected must be representative. It should be closely similar to the whole population. It should be large enough to provide statistically meaningful results. Sample should be selected in such a manner that it is representative of the whole population. Each item in the population should have an equal chance of being included in the sample.

1) Judgmental Sampling Method :

Here size and composition of the sample are decided on the basis of his past experience and knowledge by the auditor. It is decided at his discretion. The method is simple. So, it was adopted for several years. Auditor may decide the number of pages or personal accounts in the purchase or sales ledger to be checked. E.g., January, April, July and October months may be selected for verification in one year and February, May, August and November months maybe selected next year. However usually a large number of items at the close of the year are selected for detailed checking.

Some people criticize this method. They say that the method is neither objective nor scientific. Risk of personal bias cannot be completely eliminated. Statistical techniques are not used. Selection of items is entirely left to the discretion of the auditor. But mostly, experienced auditor will succeed in selecting right representative items.

2) Statistical Sampling:

The auditor should select sample items in such a way that the sample can be expected to be representative of the population. This happens only when all the items in the population have an equal opportunity of being selected.

This is a scientific method of selection of samples. Hence definitely better than the earlier discussed judgment sampling method which entirely depends upon the discretion of the auditor. Statistical sampling methods use mathematical laws of probability in determining the sample size in different circumstances. This method is widely used especially where the population consists of large number of similar transactions. It is also used for debtors' confirmation, payroll checking, vouching of invoices and petty cash vouchers. Readymade statistical tables are available. So, the auditor need not have knowledge of statistics and mathematics to use this method.

Methods of Selection of sample in Statistical Sampling are:

1) Random Sampling

2) Internal sampling or systematic sampling

1. **Random Sampling :**

There are two types of random sampling.

i. Simple random sampling:

Under simple random system each purchase or sales invoice has an equal chance of being selected. Selection may be done with the help of computers or by picking up numbers randomly from a drum. This method is simple and easy to use. This method can be used where the items are of fairly similar nature. There is no wide difference between two items.

ii. Stratified sampling:

Under stratified sampling the whole population is divided in to some groups and items are selected from each group. E.g., debtors may be divided in to (a) Above Rs. 1,00,000, (b) Rs. 75,000 to 1,00,000, (c) Rs. 25,000 to 75,000 and (d) Below Rs. 25,000 etc. Then certain percentage of items are selected from each group. The percentage of items selected from each group need not be the same. In the above example e.g., more items may be selected from the 1st group and very few items from the last group.

2. Interval sampling or systematic sampling :

Here again there are two methods.

i. **Block sampling**: Block selection means say first 100 items of sales of August, then first 100 sales of December etc. may be selected.

ii. **Cluster sampling**: means dividing the items in to groups called clusters e.g., 500 to 540. 2015 to 2055 etc. These figures are again selected at random.

a. Advantages of statistical sampling in auditing :

It has following advantages.

1) Sample size will not increase in proportion to the size of the area involved.

2) Selection is more objective as there is absolutely no personal element involved.

3) The size of the sample is minimum.

4) Calculated risk is taken.

However, the system should not be universally applied. Sometimes other methods may be more convenient or useful e.g., when exact accuracy is required or there may be legal compulsions.

Factors determining Sample size :

The following factors determine the size of the sample –

1) Sampling Risk
2) Tolerable Error
3) Expected Error
4) Efficiency of internal control

1. Sampling Risk:

Auditor in auditing only the sample entries and arriving at his final conclusion no doubt takes risk. Because, if subsequently errors or frauds are noticed in those entries which he has not audited, he will still be held responsible. Sampling risk means if he audited 100% entries, he may arrive at a different conclusion than the one he arrived by auditing only sample of transactions.

The auditor is faced with sampling risk in both tests of control and substantive procedure. In test of control, it may be risk of under reliance or over reliance. In risk of substantive procedures. There may be risk of incorrect rejection, or incorrect acceptance.

2. Tolerable Error :

Sample size is affected by the level of sampling risk the Auditor is willing to accept from the results of the sample. If he is prepared to take higher risk, he will select a smaller sample and if he is not and prepared to take much risk, he will select a larger sample. Tolerable error is the maximum errors in the population that the auditor is willing to accept.

3. Expected Error :

If the auditor expects error in the population, the size of the sample is large and if no errors are expected, the size of the sample will be comparatively small. Auditor should decide expected error taking into account his past experience and changes done in the procedures etc.

4. Efficiency of internal control :

If the internal control system is found to be satisfactory, the Auditor may select a smaller sample. On the other hand, if he finds that it is not effective, he may select a larger sample.

4.3.4 Evaluation of Sample Results :

The auditor shall evaluate:

(a) The results of the sample: An unexpectedly high sample deviation rate in control tests may result in an increase in the assessed risk of material misstatement, unless additional audit evidence substantiating the initial assessment is obtained. In the case of details tests, an unexpectedly high misstatement amount in a sample may lead the auditor to believe that a class of transactions or account balance is materially misstated in the absence of additional audit evidence that no material misstatement exists.

(b) Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested:

If the auditor concludes that audit sampling has not provided a reasonable basis for conclusions about the population that has been tested, the auditor may request management to investigate identified misstatements and the potential for further misstatements and make any necessary adjustments, or may modify the nature, timing, and scope of those additional audit procedures to best achieve the required assurance. E.g.: In the case of control tests, for example, the auditor may increase the sample size, test an alternative control, or modify related substantive procedures.

4.3.5 Auditor's Liability in conducting Audit based on Sample

While auditing the selected sample entries, the auditor should take maximum care in analysing the evidence produced before him in support of the entry. Auditor should select the sample in a scientific manner. He must use statistical rules of sampling. He should exercise his best judgment so that he may not be held responsible subsequently for the opinion he has expressed. As far as possible the auditor should use test check method only after selecting the samples scientifically. He must be extra careful in using test check method because by adopting test check method, he only reduces his physical labour. His liability for errors and frauds extends to the entries in the whole population. He cannot escape from his liability saying that he had not audited that particular transaction.

Check Your Progress

1. Define the following terms:

   a. Routine Checking

   b. Test checking

   c. Judgment Sampling

   d. Stratified Sampling

   e. Block sampling

   f. Cluster sampling

2. Enlist the factors determining the Sampling size.

4.4 INTERNAL CONTROL

4.4.1 MEANING AND DEFINITION

Internal control is a broad term with wide coverage. It covers the control of the whole management system. It may be financial as well as non financial. It involves number of checks and controls in order to ensure that the business is carried on efficiently. Only with the help of control, efficient and effective management of business becomes possible. Internal control system helps the business to achieve its goals effectively. Effective internal control system is important from the point of view of the management as well as auditor. It helps the auditor in devising a proper audit procedure for the audit of a particular unit.

4.4.2 Definitions of internal control:

W.W. Bigg defines it as "internal control is best regarded as indicating the whole system of controls, financial and otherwise, established by the management in the conduct of the business including internal check, internal audit and other form of control." This definition explains internal control from the auditor's point of view.

According to American Institute of Certified Public Accountants, "Internal control comprises of the plan of organisation and all the co-ordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data to promote operational efficiency and to encourage adherence to prescribed managerial policies." In this definition both accounting and administrative control are emphasized.

Internal control includes financial and administrative controls. It is established by the management to run the business smoothly. Internal control system is very important from the point of view of the auditor. It will help him to select the right method of working.

4.4.3 Purposes of Internal Control:

Internal control system is beneficial or useful to both the client and the auditor.

1. Usefulness to the client :

a. Reliable data is provided. On the basis of such data the management takes its day-to-day decisions e.g., Fixation of selling price, quantity of goods to be produced etc.

b. Assets and records are safeguarded. If there is no proper system of control, the physical assets may be stolen, misused or accidentally destroyed. Same is the case of other important documents in the business. Confidential records may be properly maintained. Now a days lot of such documents are fed to the computers. If proper care is not taken magnetic tapes can be destroyed.

c. Internal control system promotes operational efficiency. Business resources are properly used. Business policies are strictly followed.

2. From the Auditor's point of view :

The business will have competent and trust worthy personnel. This will reduce the chances of errors and frauds and the job of the auditor becomes safe and simple. There is scientific division of duties amongst different members of the staff. Every transaction is authorised by the competent authority. Duties and responsibilities of each member of the staff are clearly stated. The internal audit is part of the whole system of internal control.

4.4.4 Review of Internal Control

An internal control review ensures that your company's internal control environment is effective. Internal controls protect the company from financial loss, aid in the maintenance of accurate financial reporting, and allow your organisations to operate more efficiently and securely. An internal control review typically determines whether your internal controls are operating effectively or working as intended (design testing). Internal control evaluation entails:

- Identifying the internal control objectives of your organisation
- Evaluating the relevant policies and procedures, as well as their documentation standards
- Internal controls are being discussed with management and staff.
- Observing the environment under control
- Comparing control documentation to your expectations and observed design

- Evaluating whether the control achieves its intended goals, also known as "walkthrough testing."

4.4.5 Advantages of Internal Conrols

1. Detection of Errors and Frauds: Because the work of one employee in a process is checked by another without the former's knowledge, any fraud committed is exposed unless there is collusion among fraudsters.

2. Time Saving: The auditor can test or sample check the transactions to ensure reliability and accuracy, allowing him to finish his audit work on time.

3. Errors and Fraud: Each employee is only assigned a limited amount of work, and the knowledge that his work is being independently checked by another keeps him alert at all times. In such a situation, the chances of committing an error or committing fraud are reduced.

4. Operational Efficiency: It promotes accountability, error-free work performance, and accuracy reliability and authenticity of entries and eradicate inefficiency, fraud, theft, etc. which help the management to assess the performance of employees leading to enhance the operational efficiency of organization as a whole.

4.4.6 Inherent limitations of Internal Control:

Standard auditing practice SA–6 issued by the Institute of Chartered Accountant of India mentions certain inherent limitations of internal control. They are :

1) The control system involves expenditure of time and money. If attempts are made by the management to economise in this expenditure, effectiveness of the control system is adversely affected.

2) Internal control system lays greater emphasis on routine transactions. So, unusual and irregular transactions are likely to be neglected.

3) The possibility of human error cannot be ruled out. This may affect the effectiveness of the control system.

4) Persons implementing the system may abuse the authority given to them.

5) Whenever there are changes in the circumstances, the system also needs to be changed. If such changes are not done in the systems from time to time, the system may lose its effectiveness.

6) Management may manipulate the system.

4.4.7 Scope of internal control :

Internal control is a broad term having wide coverage. It may normally cover the following areas :

1) **Financial control**: It includes proper system of accounting and proper supervision.

2) **Cash control** : There is proper control over receipts, payments and balance kept in hand misappropriation of cash in any way by anybody is not permitted.

3) **Trading transactions** : There will be proper control over purchase as well as sales transactions. Suitable procedures are laid down and handling of goods is effectively controlled and properly accounted for.

4) **Employee's remuneration** : Pay sheets are properly prepared. A detailed record of work done by each worker is kept and used while preparing pay sheets. Salaries and wages must be paid to the concerned workers regularly in time. There should be no scope for payment to dummy workers.

5) **Capital Expenditure** : Capital expenditure involves heavy amount. So, it should be authorised by proper authority and wisely spent. Amount should be used properly.

6) **Others** : Control is also in existence on maintaining proper relationship with the staff, inventory in the factory and investment of funds.

4.4.8 Internal Control and Auditor:

The management of any business unit is duty bound to introduce a good system of internal control. Existence of an efficient system of internal control in the unit is very useful to the auditor. It helps him to reduce his workload to a large extent. So, if he finds any defect in the existing internal control system the auditor can suggest suitable changes in the same as he is an expert in the field. However, it should be remembered that though he may suggest changes, his suggestions are not binding on the client. He can only help and guide the client.

4.4.9 AUDITORS DUTIES

Following are the duties of an Auditor considering the internal control system:

1. Auditor will carefully study the existing system of internal control and then decide to what extent he can rely on the same. Then he can decide the audit procedure to be adopted for auditing this particular unit.

2. The auditor has to decide to what extent he can adopt test check. The auditor is expected to critically review the existing system before the commencement of his work. Where there is a good internal check system; the work of the auditor, automatically becomes simple. However, it should be distinctly remembered that adopting test check will in no way reduce his liability. He should perform all his normal duties as usual. If he performs his duties carelessly or negligently, he will be held liable subsequently if any errors or frauds are detected.

3. **Necessity for Evaluation:** The Auditor is interested in ascertaining that transactions are executed in accordance with the Management's authorisation, all transactions are recorded properly and assets are adequately safeguarded. Therefore, the examination and evaluation of the Internal Control System is an indispensable part of the overall audit Programme.

4. If the Auditor reviews the Internal Control System of the client, he will be in a position to bring to the Management's notice, the weaknesses in the system and suggest measures for improvement. During the course of his audit, he may also ascertain how far the weaknesses have been removed.

4.5 INTERNAL CHECK

4.5.1 Meaning and Definition

Internal check is an important part of internal control. The whole accounting system is so arranged that the work done by one is invariably checked by another as a matter of routine. No additional expenditure is incurred for this procedure. Different methods of internal check are devised for different types of concerns taking in to account the special needs of each concern.

It can be defined as **"an arrangement of the duties of the members of the staff in such a manner that the work done by one person is automatically and independently checked by the other."**

Each employee here works independently but it does not involve duplicating the work of other. Frauds, errors or irregularities are thus prevented. Under these circumstances if frauds are to be committed, a collusion among different members of the staff is necessary which is normally not easy.

Definition :

Spicer and Peglar "Internal check is an arrangement of staff duties where by no one person is allowed to carry through and record every aspect of transactions, so that without collusion between two or more persons, fraud is prevented and at the same time, the possibilities of errors are reduced to the minimum."

F.R.M. Paula "Internal check means practically a continuous internal audit carried on by the staff itself, by means of which the work of each individual is independently checked by other members of the staff."

Ronald A Irish – "Internal check refers to the organisation of office duties in such a way as to prevent or disclose both errors and frauds."

Many other authors have defined the term in almost similar words but the common idea is that here the system is internally organised in such a way that the work of one employee is automatically checked by the other and the possibility of error or fraud is reduced to the minimum.

4.5.2 Features of internal check system:

1) The work is divided amongst different assistants.

2) Work is divided amongst different persons, taking in to account the qualifications and ability of each member of the staff.

3) Only one person does not perform any task from the beginning to the end.

4) The work done by one is independently and automatically checked by the other. E.g., in the case of cash sales, the salesman will not receive cash and deliver the goods to the customer. Price of the item is received by the cashier. Gate keeper or goods clerk will deliver the goods and the accountant will make entry in the cash book and so on.

4.5.3 Objectives of Internal Check System:

1. Internal check system is introduced to bring moral pressure on the staff.

2. Reliable and adequate information is made available from the books of accounts.

3. Valuable assets of the business can be saved and frauds and errors are avoided.

4. Available work in the accounts department is suitably distributed amongst the members of the staff.

5. If any error or fraud is subsequently found the responsibility for the same can be easily fixed on the person concerned.

6. Staff becomes more alert and efficient.

7. The firm can get all the advantages of division of labour.

4.5.4 Principles of a Good System of Internal Check :

1. Here the responsibilities of each member of the staff are clearly stated.

2. The available work load is equitably distributed so that no one is over burdened with work and there is no dissatisfaction amongst the staff on this issue.

3. People having custody of assets should not have access to books of accounts.

4. Duties allotted to the staff should be changed from time to time.

   Whenever a different person takes charge of the table, the mistakes if any committed by the earlier occupant of the table are easily detected. If the same man remains at the same table for a long time, this is not possible. Work done by one should be automatically checked by another.

5. The management should not rely too much on any one person. Frauds are normally committed only when there is over reliance in any person in the organisation.

6. Cheque books important files etc. should be maintained safe under lock and key.

7. The management should carryout supervision from time to time to ensure that the rules prescribed for internal check are being followed meticulously by one and all.

8. Deviations from the rules should be permitted only by the top authorities and only when it is absolutely necessary.

9. The system of internal check once introduced should be reviewed from time to time taking into account any changes that have occurred in the business in the interim period.

12.5.5 Advantages of Internal Check System :

The advantages of the system can be enjoyed by the business, auditor and also by the owner of the business. Let us study them one by one.

1. Advantages for the Business :

The business enjoys number of advantages of internal check system. Some of them are :

i) **Proper division of work :-**

Available workload is suitably divided amongst the different members of the staff. Division of work is done taking into account the qualifications, experience, likes and dislikes etc. of each member of the staff.

ii) **Detection of errors and frauds** :-

Errors and frauds are easily detected and taking up of prompt suitable remedial action becomes possible at an early date.

iii) **Increased efficiency of the staff and economy** :-

As each one is given the work he likes and capable of doing, there is increase in the efficiency of the staff and their efficiency will bring down the administrative expenditure.

iv) **Moral Check** :-

There is a moral check on the staff because the work done by every member is routinely and automatically checked by another. Members of the staff will not be easily tempted to commit frauds.

2. Advantages for the Auditor :

Internal check system is very useful to the auditor. It reduces his workload to a large extent. Advantages to him can be enumerated as follows :

i) Quick preparation of final accounts :

where there is an efficient system of internal check, the books of accounts are regularly written. So, the auditor can readily prepare annual statements like profit and loss account and balance sheet and start his work.

ii) Convenience :

Where there is an efficient system of internal check, the Auditor can adopt test check and complete his work within a short time. He need not undertake detailed checking of routine transactions.

3. Advantages to the Owner :

i) The owner can rely on the accuracy of the books of accounts.

ii) Increase in profits. As there is increase in the efficiency of the staff, there is economy in the cost of administration and this will lead to increase in total profits.

4.5.6 Disadvantages of Internal Check System :

Just like there are advantages, there are also some disadvantages of internal check system. They can be enumerated as follows :

1) Costly :

Introduction of this system requires a large number of staff. Naturally the cost of administration will increase. So, the system can not be introduced in a smaller business unit.

2) Quality Sacrificed for promptness :

Here the quality of work may decline. Members of the staff may devote more time to complete the work in time but may not devote enough time towards the quality of the work.

3) Carelessness amongst high officials :

Higher officer may not strictly supervise the staff presuming that the work is being done properly.

4) Risky for the auditor :

Relying too much on the system is sometimes likely to be proved risky for the auditor. If there is any laxity in the implementation of the system, errors and frauds can not be ruled out.

In short, the system should be carefully and continuously implemented. Auditor should use his tact and judgement while studying the system and relying on it.

4.5.7 Auditor and Internal Check :

Scope of the Auditor's work is largely decided by the internal check system prevalent in the organisation. After studying the system, the auditor decides to what extent he can adopt test checking. Where there is an efficient system of internal check, the auditor need not check all the transactions in detail. The time thus saved an be utilized for more important matters. However, the auditor should always keep in mind that though his physical labour is saved, his responsibility is not at all reduced. He will be held responsible if any errors or frauds are found subsequently even in those transactions which he has not audited as he has not selected those transactions in the sample selected for test checking. He cannot argue that he did not audit 100% transactions as there was an efficient system of internal check. Thus, though a good system of internal check is helpful to the auditor, in no way it relieves him of his contractual responsibilities. So, the auditor should take enough care before deciding the extent to which, he should depend upon the internal check system prevalent in the organisation.

4.6 INTERNAL CHECK SYSTEM FOR BUSINESS TRACTIONS

4.6.1 Internal Check System for Sales and Debtors :

Sales may be for cash as well as on credit. A businessman has to use both the types of sales to increase his turnover and profit. However, here we are considering only the internal check system for credit sales.

Example of Internal check System for cash sales of the goods

The salesman will only complete the transaction of sale by showing the goods to the consumer. He will neither receive cash nor deliver the goods. He prepares 3-4 copies of the invoice and sends the goods to the packing department. Packer packs the goods according to the invoice and forwards them with a copy of the invoice to the cashier. Cashier receives cash from the customer and sends a copy of the invoice to the accounts departments for making entry. He also sends the goods to the delivery department, which again verifies the goods with the copy of the invoice with the customer and then hands them over to him. Thus, the work of selling the goods is divided amongst so many members of the staff.

1. **To start with, different forms used in this connection** like invoices; delivery challans etc. should be standardised. They should be serially numbered and kept in the custody of any responsible officer. If any of them are missing, efforts should be made to trace them and causes for their loss should be investigated. If not found even after all efforts, duplicate may be obtained and this fact may be mentioned by the auditor in his final report.

2. **Credit control**: No businessman can insist on cash sales only. To increase his sales and to meet the needs of the customers, he has to sell on credit. However, many a times, the recovery of the amount from the customers becomes difficult. Its an unpleasant task. So, to avoid bad debts, though sales should be done on credit basis also, all care should be taken before extending credit to a new customer. Decision regarding grant of credit, extent and period of credit, should be decided by a responsible officer only. Before accepting an order for credit sale, a suitable enquiry should be conducted about the credit worthiness of the customer. Enquiries may be done about his credit worthiness with his other suppliers and also with his bankers. However, this should be done only after obtaining the permission of the prospective customer. It should always be remembered that selling on credit is easy but the job of recovering credit is difficult and unpleasant.

3. **Different functions related with the sales should be allotted to different persons** e.g., preparing invoice, dispatching the goods, recording the sales in the sales book maintaining customers' Ledger Accounts or Debtors Ledger, preparing their list at the end of the year etc.

4. **Delivery challans should be tallied with the orders received**. These challans should be serially numbered and kept in a separate file by a person who should not have any access to the stock.

5. **Customers should be asked to acknowledge** in writing the receipt of the goods. These acknowledgements should also be serially arranged and kept in a separate file.

6. **Along with the goods, invoice for the same should be sent**. Quantity mentioned in the invoice should be the same as the one mentioned in the order of the customer

7. **If there is any transfer of goods from the Head Office to Branch** or from one department to another it should be distinctly recorded.

8. **Invoices should be prepared with proper care**. There should be strict rules regarding the discount to be allowed if any.

9. **When the price of the goods is received from the customer,** an official receipt should be sent to him and entry for the same should be promptly done in the Cash book.

10. **If there are any sales returns**, they should be properly recorded in the books and the causes for the return should be investigated. If the return of the goods is found to be in order, a credit note should be sent to the customer.

11. **Debtors' balances should be tallied** with the balances in the control accounts if a self balancing system is in vogue.

12. **Reminders should be regularly sent to the customers** whose accounts are overdue. All possible efforts should be done to recover the dues as early as possible, without displeasing the customer.

4.6.2 Internal Control System for Purchases and Creditors :

There are different stages in purchasing and there should be proper control system of control at each stage. Purchases are also of two kinds' viz. cash purchases and credit purchases.

1. **Different departments which need different items for consumption or production send their requisitions** in a prescribed form to the purchase department. This department then prepares purchase order in duplicate and sends the original copy to the supplier. Duplicate copy is retained in the purchase department for future reference. In some concerns the order is prepared in triplicate and one copy is sent to the stores department to keep space ready for the receipt of the goods.

2. **Orders are always sent only to the selected or approved supplier**. Supplier is selected after inviting quotations or tenders. Prices of different suppliers and the quality of the goods are studied by experts and then 2-3 suppliers whose rates are reasonable and quality is satisfactory are selected as approved suppliers. Orders are sent only to these approved suppliers, 2-3 suppliers are selected instead of only one who is the best amongst the lot, because sometimes if the goods are not available due to any reason like strike etc. services of the alternative suppliers may be utilized to avoid inconvenience.

3. **Verification** – On receipt of the goods, the stores department verifies their quality, quantity and price with the copy of the order sent and the invoice received with the goods, and then send the invoice to the accounts department for making necessary entry in the books of accounts and making payment as per the terms agreed upon. Stores department then stores the goods in the respective shelves or bins. If the goods are not found to be of appropriate quality or as per the order placed, they should be immediately returned along with a debit note.

4. **Copies of the personal accounts of the suppliers should be sent to them** at regular intervals for the confirmation of the balance.

5. **When the invoice is received from the stores department with a satisfactory remark,** the accounts department sends a cheque to the supplier. As referred to above a list of approved suppliers is prepared by every concern. However, if any supplier, fails to supply the goods as per order in time his name should be dropped from the list. In other words, this list is revised from time to time on the basis of the experience.

4.6.3 Internal check system for Salaries and Wages :

Most common entry in the books of accounts of any concern after purchases and sales is that of payment of wages or salaries. Payment of wages or salaries in a large concern involves number of functions.

1. **A record is kept of Number of days or hours worked** by each employee. There is a punch card system and the card is punched when the employee enters the office or factory and when he leaves.

2. **On the basis of the above, pay sheets are prepared and wages or salaries payable are calculated**. From the gross amount of salary there are different deductions to be made for items like Provident Fund, Employees State Insurance, Income Tax, Profession Tax, deductions for housing or other loans or advances etc. After considering these different deductions net amount payable to the employee is arrived at. However, these days, the pay sheets are prepared by the computer and directly sent to the bank. The bank will then credit the net amount payable to each employee, to his bank account.

3. When pay-sheets were manually prepared one person used to make calculations. Second person used to prepare pay-sheets taking into account leave taken, hours worked etc. These salary sheets were then test checked by some higher authority. If a particular worker is absent on the date of payment, his packet was kept in the safe custody and handed over to him personally when he returns to work. Actual payments were done by persons different from those who prepared the paysheets.

4. Many a times bogus or ghost workers were shown and their salary was misappropriated. So, the Head of the Department should take proper care to avoid such misuse of funds.

Previously there was a procedure of obtaining signature of each employee on a revenue stamp. But such procedure is no more prevalent as the amount of salary or wages is directly credited to their bank accounts. So, no other proof of payment is necessary.

Under the law wages are to be paid before 10^{th} of every month. So, care should be taken to see that the whole procedure is completed in time.

Any way it should be remembered that there is no one standard internal check system applicable to all types of units. Each unit has to evolve its own system to suit its own needs.

4.7 DISTINGUISH

4.7.1 Test Check v/s Internal Check

Test Check		Internal Check	
1)	It means checking only selected few items instead of checking all transactions.	1)	It means division of work in such a way that work done by one is automatically checked by another.
2)	It is used by the Auditor	2)	It is instituted by the management
3)	Errors and frauds are detected by checking only few items.	3)	It helps to prevent errors and frauds.
4)	Management has no control over it.	4)	Management has full control over it.

4.7.2 Internal Check v/s Internal Control

INTERNAL CHECK	INTERNAL CONTROL
1) Internal check means the arrangement of work different employees in such a manner that work of any person is automatically checked by another person is doing his duty.	1) Internal control is the whole system of controls, financial and otherwise, established by the management in order to carry on the business of the company in an orderly manner, safeguard its assets and secure as far as possible the accuracy and reliability of its records.
2) It on going continuous process	2) Internal control is a wider term which includes internal check, internal audit, etc.
3) It is applicable to both, small & large organizations.	3) Generally, it is more applicable to large organizations where there are many departments.
4) Relatively it is cheaper.	4) Relatively setting up of internal control system is costly and time consuming.

CHECK YOUR PROGRESS:

1. Enlist the advantages and disadvantages of Internal check system.

2. “Internal control is a broad term having wide coverage”, Explain.

3. Define the terms Internal Control and Internal Check.

4. Explain the examples of Internal Check System.

4.8 SUMMARY

Test check means the auditor selects at random some transactions and checks them in detail. If he finds that there is nothing objectionable in these items, he will conclude that other transactions are also recorded properly.

Next technique of auditing dealt with in this chapter is sampling. There are two methods of selecting samples viz judgemental sampling and statistical sampling. In judgemental sampling, the auditor relies more on his past experience and selects items at his discretion.

Size of the sample is decided by taking in to account sampling risk, tolerable error, expected error and the efficiency of the internal control system.

It should always be remembered that by adopting test check of sample item, the auditor only reduces his physical labour. His liability for mistakes in auditing extends to the whole population of the transactions and not only restricted to the items he has actually checked.

The third important technique discussed in this chapter is that of internal control. Internal control means dividing the work amongst different members of the staff in such a way that the work done by one is routinely and automatically checked by the other.

4.9 QUESTIONS

1. What is test checking? What are the advantages and disadvantages of test checking?

2. What precautions are to be taken by the auditor while adopting test checking?

3. What do you mean by internal check?

4. What are the duties of an auditor in respect of internal check?

5. What are the principal aims of audit by Test – checking?

6. Write short notes on :

   a) Objectives of Internal control

   b) Test Checking

   c) Technique of audit

7. What is internal control? How is the auditor concerned about it?

8. Explain the terms Internal control, Test check and internal check.

9. What is internal control? Suggest internal control system for credit purchases.

10. What are the various techniques of auditing?

11. Select the appropriate option and rewrite the following statements :

i. Internal check is meant for ------------------.

   a) Prevention of fraud

   b) Increase in the profits

   c) Detection of fraud

   d) Helping audit in depth

ii. ----------------- deals with audit sampling.

   a) SA 530

   b) SA 400

   c) SA 610

   d) SA 510

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5

AUDITING TECHNIQUES

Unit Structure :

5.0 OBJECTIVES

After studying this unit, the students will be able to:

- Understand the concept of Internal Audit.
- Understand the Principles of Establishing Internal Audit
- Understand the concept and create ability to distinguish between Internal Audit Vs External Audit, Internal Checks Vs Internal Audit

5.1 INTERNAL AUDIT

MEANING AND DEFINITION

The normal concept about audit is checking the books of accounts by an outside expert to detect and prevent errors and frauds. In other words, the auditor is an outsider and an independent expert. However, some concerns get their accounts audited by its own staff and then presents the same to the outside expert. This is internal audit. Internal audit is the review of its records by its specially appointed staff.

Definition :

Watter B. Meigs defines Internal Audit as "Internal Audit consists of continuous critical review of financial and operating activities by a staff of auditors functioning as full-time salaried employees."

Internal Auditor comments on the effectiveness of the internal check system and suggests improvements in the same if necessary. Assets of the firm should be properly accounted for and adequately safeguarded. Acquisition and disposal of assets should be done only with the permission of the proper authority. Internal Auditor will ensure that the accounting policies laid down by the management are being meticulously followed :

5.2 BASIC PRINCIPLES OF ESTABLISHING INTERNAL AUDIT

The basic principles of establishing internal audit in a business concern are-

1. **Independence:** the internal audit department should have an independent status in the organization. It may be required to report directly to the board of directors.
2. **Objectives:** the objectives of the internal audit function should be made very clear and unambiguous. The objectives should be properly communicated so that internal audit is not viewed as "over-the-shoulder check" by other departments.
3. **Clarity in Scope:** the scope of internal audit department must be specified in a comprehensive manner. The department must at all times, have authority to investigate every phase of organizational activity from the financial angle, under any circumstances.
4. **Definition of Duties:** The internal audit Department's duty is to review operations as part of the internal control system. It should not be involved in performance of executive actions.
5. **Internal Audit Department:** The size and qualification of staff of the internal audit department should be equal with the size of the business. The cost of internal audit department should not exceed the benefits expected to be derived from it.
6. **Reporting:** The Programme of internal audit should be time-bound. There should be provisions for periodic reporting on various operational and other aspects.
7. **Follow Up and Review:** There should be sufficient scope for the follow up actions on the various points raised in internal audit report. Top management should take active part in ensuring compliance with actions points raised in the report.
8. **Relationship with statutory auditor:** The copy of the internal audit report should be made available to the statutory Auditor, who can deal with the same in the manner as he deems fit.

5.3 OBJECTIVES OF THE INTERNAL AUDIT

1. To verify the accuracy and authenticity of the financial accounting and statistical records presented to the management.
2. To ascertain that the organization is following the standard accounting practices or not.

3. To establish that there is a proper authority for every acquisition, retirement and disposal of assets.

4. To confirm that liabilities have been incurred only for the legitimate activities of the organization.

5. To analyse and improve the system of internal check; in particular to see (a) that it is working;(b) that it is sound; and (c) that it is economical.

6. To facilitate the prevention and detection of frauds.

7. To examine the protection afforded to assets and the uses to which they are put.

8. To make special investigation for management.

9. To provide a channel whereby new ideas can be brought to the attention of management.

10. To review the operation of the overall internal control system and to bring material departures and non-compliances to the notice of the appropriate level of management; the review also generally aims at locating unnecessary and weak controls for making the entire control system effective and economical.

5.4 EVALUATION OF INTERNAL AUDIT BY STATUTORY AUDITOR

Both of them apply similar techniques for examining the books of accounts. However Internal Auditor is a representative of the management. He is a regular employee of the concern. He reports to the managements. Statutory auditor in the case of the company is appointed by the share holders and reports to them about the truth and fairness about the account statements. Scope of work and functions of the internal auditor are decided by the management. In the case of statutory auditor, they are decided by law.

If an auditor finds that internal audit is adequate and satisfactory or effective, he may apply audit procedure to a limited extent. Thus, presence of internal auditor reduces the physical labour of the auditor. However, it in no way reduces his responsibility. He cannot say that he did not verify a particular item because it was already verified by the internal auditor. The ultimate responsibility for reporting on financial statements is that of the statutory auditor only. Internal auditor will verify the reliability and integrity of the information. He will confirm that the management's policies are being strictly followed and the accounts are maintained taking in to account the different laws applicable to the business. Resources are used economically and the assets are being properly safeguarded.

Finally, it is the past experience and discretion of the outside auditor which decides to what extent he can rely on the work done by the internal auditor. Internal auditor, being a regular employee, cannot act effectively as an independent auditor

5.5 USEFULNESS OF INTERNAL AUDIT

1] More Effective Management: Internal auditing facilitates effective organisational management. The internal auditor will be able to identify any weaknesses in the organization's operations or internal controls.

2] Continuous Review: The internal audit process provides the organisation with a unique opportunity to conduct a performance review during the current fiscal year. They don't have to wait until the end of the year to evaluate the company's performance; they can change course and correct their errors right away.

3] Employee Performance Improves: The company's employees remain alert and active, and they avoid engaging in any fraudulent activities for fear of their mistakes being discovered by the internal auditor, resulting in improved employee performance.

4] Ensures Optimal Resource Use: Another advantage of the internal control process is that it can be used as a tool to promote resource optimization. It will aid in identifying areas where resources are being underutilised or wasted. These can then be corrected. It will aid in the management of the company's costs and expenses.

5] Labor Division: Internal auditing promotes labour division. It is critical to monitor and observe the activities of all departments and their employees. The division of labour will aid in this endeavour.

5.6 INTERNAL CHECK VS INTERNAL AUDIT

Both internal check and internal audit are parts of the whole system of internal control. Both are complementary to each other and go together. Still there is lot of difference between the two.

Internal Check		Internal Audit	
1)	It is arrangement of duties in such a way that the work done by one is automatically checked by the other	1)	It is independent appraisal of the records
2)	Object is to prevent errors and frauds	2)	Object is to detect errors and frauds
3)	No additional staff is necessary	3)	Additional staff is to be appointed
4)	It starts before the transaction	4)	It starts after the recording of the transaction

5.7 INTERNAL AUDIT V/S EXTERNAL AUDIT

Internal Audit		External Audit	
1)	It is arrangement of duties in such a way that the work done by one is automatically checked by the other	1)	It is independent check of the books of accounts done by an qualified person.
2)	The role of internal audit is determined by management	2)	The role of external audit is determined by Companies Act.
3)	Internal auditor reports to the management of the company.	3)	External auditor reports to the shareholders of the company.
4)	The internal audit cannot be expected to have same degree of independence as external auditor	4)	External auditor are independent of the management and it is one of the basic condition of the appointment.
5)	They are appointed by the Management of the company.	5)	They are appointed by the Shareholders of the company.

5.8 SUMMARY

In big concerns in addition to audit of accounts by an independent outside Auditors, they have their own Audit staff. Before presenting the books of accounts to the external auditor, they are audited by the internal auditor. The purpose behind this additional system of audit is to detect and prevent errors and frauds at an early date. Suitable penal action can be taken at an early date against the guilty persons and the concern may be saved from the further such loss in the future.

5.9 QUESTIONS

1. How internal check is different from internal audit?

2. Write short notes on :

   a) Internal audit

   b) Principles of Internal audit

3. Explain the terms “Internal control” an “Internal Audit”.

4. Distinguish between Internal Audit Vs External Audit

5. Distinguish between Internal Checks Vs Internal Audit

6. Select the appropriate option and rewrite the following statements :

a. Internal auditor's appointment is made by --------------------

   a) Institute of internal auditors of India.

   b) Members at the Annual General meeting.

   c) The management

   d) The statutory auditor

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