SYLLABUS

Class - B.Com - III Year

Subject – Auditing

UNIT – I	Introduction: Meaning and Objectives of Auditing. Types of Audit, Internal Audit. Audit Process: Audit Programme, Audit and book, working papers and evidence, Preparation before commencing of Audit.
UNIT – II	Internal Check System: Routine Checking, Internal Check and Test Checking. Internal Control and Audit Procedure.
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UNIT-I

INTRODUCTION

Meaning of Auditing - According to AAS-1 An audit is an independent examination of financial information, of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to, expressing an opinion thereon.

The person conducting audit is know as the auditor, he makes a report to the person appointing him after due examination of the accounting records and the accounting statement in the form of an opinion on the financial statements. The opinion that he is called upon to express is whether the financial statement reflects a true and fair view.

A complete and comprehensive definition : "Auditing is a critical examination of the books of accounts of an organization, which is conducted by an independent individual skillfully on the basis of vouchers and other information, with an object to reporting that the profit and loss account prepared for a certain period expresses the true and fair profit or loss of the organization and the balance sheet of the organization, prepared on a certain date, depicts a true and fair picture of the financial position of the organization on the particular day".

Definition:

R.B. Bose : "Audit may be said to be the verification of the accuracy and correctness of the books of accounts by an independent person qualified for the job and not in any way connected with the preparation of such accounts.

Advantages of an Audit:

(a) Safeguards the financial interest of persons who is not under management of the entity, i.e., partners or shareholders.
(b) Acts as a moral check on the employees from committing frauds and errors.
(c) Helpful in setting liability for taxes, negotiating loans and determining the purchase consideration for a business.
(d) Useful for setting trade disputes whether it is a matter of performance bonus or increment or it is claim for the damages due to fire or other accident.
(e) Discover the areas of wastages and losses occurring due to the absence or inadequacy of internal checks or internal control measures.
(f) Audit report generally state the fact that whether proper books of account and related records have been properly kept so as to make the deficiencies or inadequacies good in this respect.
(g) As an appraisal function, audit reviews the existence effectiveness and continuity of various controls in the organizations and reports weaknesses, inadequacies, etc., in them.
(h) Audited accounts are of great help in the settlement of accounts at the time of admission or dissolution or death or retirement of partner.

The objectives of audit:

1. Examination of the Truth and Fairness of Final Accounts :
2. Discovery of Errors :
3. Detection of Fraud :
4. Prevention of Frauds and Errors :

5. Advice to Management :
6. Ascertaining true Financial Position of Business :
7. Objectives determined by International Auditing Practices Committee :

Types of Audit:

(1) On the basis of need of audit

a. External Need b. Internal Need

(2) On the basis of period of audit

(a) Continuous Audit (b) Interim Audit (c) Final/Annual Audit

1. **On the basis of Need:**

a. The auditor appointed to satisfy the internal or managerial needs of the organization is known as INTERNAL AUDITOR. According to AAS-7 The internal audit function constitutes a separate component of internal control established with the objective of determining whether other internal controls are well designed and properly operated.
b. The auditor appointed to satisfy the External Needs of the organization is known as EXTERNAL AUDITOR.
c. If external need is a statutory need the same external auditor is known as STATUTORY AUDITOR. For example :

2. On the basis of Period of Audit:

A. Continuous audit - A continuous audit is one where the auditor or his staff is constantly engaged in checking the accounts during the whole period or where the auditor or his staff attends at regular or irregular intervals during the period.

The following features of continuous audit come to light on analysis of the above definition.

(a) It is carried throughout the year.
(b) It is conducted at regular or irregular intervals depending on auditors professional judgment.
(c) The accounts are taken for scrutiny as and when prepared.
(d) Final accounts i.e. trial balance, profit and loss account and balance sheet are audited at the end of the year.

Advantages of Continuous Audit:

(i) Exhaustive and intensive.
(ii) Greater possibility of exposure of errors and frauds.
(iii) Early detection of errors & Frauds.
(iv) Moral impact on employees.
(v) Quick preparation of final accounts.
(vi) Early planning for future.
(vii) Proper advice of auditor
(viii) Early rectifications of errors.

(ix) Facility for interim accounts.

Disadvantages of Continuous Audit:

(i) Possibility of change in audited accounts.
(ii) Snags in routine work.
(iii) Adverse moral impact
(iv) More expensive
(v) Dislocation of sequence of work.
(vi) Mechanization of work
(vii) Sloth in work.

B. Annual Audit : Annual audit is one which is carried out only at the end of an accounting period, spicer and pegler have defined it as. An audit which is not commenced until after end of the financial period and is then carried on until completed. Annual audit is also called periodical, final or completed audit.

Characteristics: The main Characteristics of annual audit are as follows :

(a) It is done at the close of the financial year books of account have been closed and final accounts drawn by the management of the entity.
(b) The audit work is completed at a stretch i.e. in a single continuous session.
(c) Generally this type of audit suitable to small organizations.

C. Interim Audit : An audit conducted between two annual audits is called interim audit. More commonly it is known in case of banks as half yearly review. Interim audit helps management to take timely and appropriate decisions for example declaration of interim dividend or valuation of shares to decide swap ratio in case of a merger. Interim audit is gaining statutory status now a days various regulating authorities like SEBI and RBI requires periodic audited financial statements in between the to annual audited financial statements. However, it is generally carried out by professionally qualified auditors.

Limitations of Audit

1. Auditing does not guarantee 100% correctness.
2. All frauds are not necessarily disclosed by audit.
3. The auditor expresses only his opinion.
4. Auditing is not a credential of the perfect honesty of employees.
5. Auditing does not certify the commercial prudence of transactions.
6. Auditing does not pay attentions to trivial.
7. Auditing is not supported by practical independence.

❖ **Audit Process:**

The steps in audit process is :

1. Appointment of auditor
2. Determination of Objective and Scope of audit

3. Obtaining Knowledge of Clients business
4. Evaluating accounting system, Internal control and Audit risk.
5. Audit Planning and programming, Determining the nature timing and extent of audit procedure and co-ordination of work.
6. Collection of audit evidence
7. Drawing conclusions and making report.

❖ **Preparation of Audit Programme:**

Audit programme is a description, memorandum or outline of the work to be done in an audit and often of the time allotted and personnel assignments, prepared by a Principal as a definition of audit scope, or by an auditor for the guidance and control of assistants. It is the auditors plan of action, specifying the procedures to be followed.

Objects of audit programme :

a. To obtain informations regarding the accounting system, policies and control techniques of the client.
b. To ascertain the extent to which internal control techniques can be banked upon.
c. To lay down the nature, time and extent of audit techniques to be adopted.
d. To co-ordinate the total work.

Characteristics of good audit programme

i. Explicit and clarity of expression.
ii. Segmentation of work in the light of different aspects of accounting.
iii. Logical flow of accounting documents
iv. Elasticity
v. Review of work
vi. According to scope of audit
vii. Based on evidences
viii. Record of movements and accomplishments.

Advantages of audit programme :	Disadvantages :
i. Division of work as per ability	i. Mechanisation of work
ii. Determination of responsibilities	ii. No motivation for free decision
iii. Progress of work	iii. Want of constructive thinking
iv. Change of employees won't affect work	iv. Want of moral influence
v. Uniformity in work	v. Planned frauds are undisclosed
vi. Protection in court of law	vi. Disabilities remain concealed
vii. Complete examination	vii. Plea against auditor

viii. Time saver

ix Facility of review

x. Pursuance of audit principles

- **Audit working papers:**

Audit working papers are personal written materials which an Auditor prepares with regard to all audits and contains techniques adopted by the auditors, his decisions and conclusions and relevant information regarding financial statements.

Some papers included in Audit Working Papers;-

1. The agreement regarding the appointment if the auditor or letter of appointment
2. Technical Features of the audited business.
3. Audit Programme
4. Certificates of officials in regard to such important matters as bad debts, valuation of stock, unpaid expenses, accrued income etc
5. Certificate issued by the banks in regard to the bank balance of the client certain date, safe custody of documents etc.
6. Correspondence between the auditor and the debtors, creditors, etc. the client.
7. Rough trial balance.
8. Important extracts from the minute books
9. Particulars of investment.
10. Draft final accounts.
11. A copy of the auditors book.

Objects of keeping Audit-Working Papers;-

1. Certification of the correctness of record and report
2. Use as references, during discussion with the employer.
3. Defensive position of the auditor in case of legal dispute and court proceedings.
4. Guide for Subsequent examinations.
5. To co-ordinate and organize the work of audit clerks.

Ownership of Audit-Working Papers :-

These are the property of the auditor, whether prepared by him or presented to him by the owner of the business and therefore must be kept in safe custody.

Filing of Audit-Working Papers is a necessity. The auditor keeps these papers for his defense, reference, future guidance and as a proof of his. According to section 209 of the Indian Companies Act 1956, the books of accounts of a company must be kept safe up to 8 years after the relevant year.

❖ Audit Note Book;-

An important component of Audit-Working papers is audit note- book basically maintained by the audit clerk in which he notes down the important points and enquires which he has to refer to officials clients or to discuss with his senior or the auditor himself.

Contents of audit note book:

1. Technical details about the business.
2. Queries for which explanations and information have to be demanded.
3. Missing vouchers and invoices whose duplicates have to be obtained.
4. Fraud and errors found in the books during the course of audit.
5. Details to be included in audit report.
6. Notes regarding system of maintaining accounts.
7. Information to be needed in future.
8. Names of officials who certify bad debts, depreciation, etc.
9. Record of all important correspondence.
10. Total of important ledger accounts.
11. Progress of audit work.
12. Record of suggestions made by the audit staff.

Advantages:-

1. Defense in court of law.

2. Yard-stick of the efficiency and diligence and skill of the auditor,

3. Guide for future.

4. Future references,

5. Permanent certificate of audit.

UNIT-2

INTERNAL CHECK SYSTEM

ROUTINE CHECKING:

Regular checking of all the daily transactions is known as Routine Checking. Routine checking incorporates the following tasks:

- Checking of record in primary books, costing, transfer etc.
- Checking transfer of transactions from original books of accounts to ledger account.
- Checking debit and credit side of various accounts.
- Checking transfer of balances of various accounts to other pages or accounts or statements.

Various signs are used while conducting routine check. Such signs provides the proof of routine checking of transactions.

Signs which are used in audit should be small and clear. Generally red or pink color is used while conducting routine check. But green color is used while conducting final audit.

Advantages Of Routine Checking:

Following benefits can be obtained from the routine checking:

1. All the original entries will be checked; so all the errors and frauds can be detected easily.
2. All the entries and posting will be tested.
3. Routine checking helps to conduct final audit because all the balancing and totals have already been checked.
4. Separate and specific staffs are not needed because it is a regular process.

Disadvantages Of Routine Checking:

Followings are the limitations of routine checking:

1. Routine checking is a mechanical test, so the staff who performs this work does not have inspiration. So, there are chances of leaving errors and frauds.
2. Routine checking can only detect small errors and frauds but not the planned frauds.
3. Routine checking is not needed where self balancing system is applied.
4. Routine checking cannot detect principle and compensating errors.

- **INTERNAL CHECK:**

Internal check means that check imposed in such a way on a day to day transaction that work of one person is checked by another person automatically in this way the chances of frauds and errors minimizes.

Objects of Internal Check:

i. Prevention of Fraud
ii. Prevention of Error
iii. Swift discovery of fraud and error
iv. Fixing the responsibility
v. Correct accounting of business transactions
vi. Fast preparation of Final Accounts
vii. Facility of Audit work.

Essential features of Ideal Internal Check System:

1.	Regarding Employees	i. Qualification and Training ii. Honesty and Integrity iii. Security iv. Monitoring v. Fixing Responsibilities vi. Allocation of Work vii. Authorization viii. Compulsory Leave
2.	Regarding Accounting	i. Sound System of Accounting ii. Procedure Manual iii. Forms
3.	Other Features	i. Utilization of Machinery ii. Control over mailing iii. Flexibility.

Advantages of Internal Check:

i. Cautious Employees
ii. Honest Employees
iii. Moral Impact on Work Environment
iv. Elimination of Errors
v. Minimum Frauds
vi. Early discovery of errors and frauds.
vii. No cumulative effect on business
viii. Fast preparation of final accounts
ix. Facility to Auditor
x. Responsibility Fixing
xi. Substitution of Audit
xii. Relief for businessman.

Disadvantages of Internal Check:

i. Expensive
ii. Repetition
iii. Negligence of Owner
iv. Adverse effect on Employees
v. Negligence of Auditor
vi. Frauds through Collusion.

Internal Check Systems in different Business Transactions:

i. Purchase of Services, Assets and Goods
ii. Sale of goods.
iii. Cash Receipts
iv. Cash Payments
v. Internal Transactions

- **TEST CHECKING**:

Test checking is a substitute for detailed checking. It involves only a partial checking. The auditor normally does not check completely all the records made into the books of accounts but, through a process of sampling, selects a few items and if they are found correct, he presumes that the remaining entries would also be correct likewise.
Thus, the whole system of test checking implies selecting and checking only a few selected transactions so as to enable the auditor to form his final judgment as to the whole set of transactions.

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

The use of test checking is, however, dependent upon the system of internal check in operation. If this system is satisfactory, test checking can be of immense help to the auditor.Where there is an efficient system of internal check and the business maintains a separate staff for internal audit, test checking can be a very reliable device to carry on the work of audit.

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

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

Advantages:

i. Time Saving
ii. Correct Results
iii. Utilization of Saved Energy

iv. Suitable for large size enterprise.
v. Adds to the significance of Internal Check.

Disadvantages:

i. Undisclosed errors and frauds.
ii. Incredibility and unauthenticity.
iii. Enhancement of Auditor's Liability
iv. Negligent Employees
v. Continuance of vicious circle.

INTERNAL CONTROL

Meaning of Internal Control :

Internal control comprises all the measures whereby every aspect of business is controlled. A businessman wants to control the internal functions of the business in such a way to maximize profits and reduce to a minimal level the possibilities of errors, frauds, and embezzlement. For such a situation, the businessman controls each and every aspect of the business in a planned manner. Such a measure at the organisational level is called internal control. It helps to control all sorts of business activities, financial as well as administrative. The following definition by W.W. Bigg explains internal control in clear terms. "Internal control is best regarded as indicating the whole system of controls, financial or otherwise established for the conduct of business including internal check, internal audit and other forms of control.

Internal control can be defined as control of enterprise over its business. Every policy, standard procedure, system, rules, plans, introduced with the sole objective of establishing the control is known as internal control. Internal control is all pervasive and not confined to accounting system only. Internal control system is defined as-

All the policies and procedures (Internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable,

- The orderly and efficient conduct of its business, including adherence to management policies,
- The safeguarding of assets,
- The prevention and detection of fraud and error,
- The accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.

Objects of Internal Control :

1. Correct accounting of Transactions
2. Prevention of Error and Fraud
3. Fixing responsibilities
4. Safety of assets
5. Efficiency and improvement in performance
6. Provide aid in management planning
7. To encourage and measure how far policy of business is being implemented

Internal Audit

Internal auditing is the independent appraisal activity within an organisation for the review of the accounting, financial and other operations as a basis for productive and constructive service to management. It is conducted by regular employees of a business concern.

Objects of Internal Audit:

1. To assure the effect of internal check.
2. To see that transactions are authorised
3. To discover frauds.
4. To prevent frauds.
5. To discover errors and prevent them.
6. To facilitate statutory audit
7. To check the safety and proper accounting of assets.
8. Improvement in procedures.
9. To check commitment to Planning
10. To Review.

Difference between Internal Check and Internal Audit

1. **Nature of job-** Internal check is a system of recording transactions whereas internal audit is a system of checking the records.
2. **Time of examination –** The transactions are so recorded by internal check that the checking work continues with the recording. The checking of internal audit commences when recording or accounting work is over.
3. **Disclosure of fraud –** Internal check is a device wherein fraud is discovered in the course of the work. Internal audit discloses frauds when the work ends.
4. **Test of Effectiveness –** Internal check assures whether the accounting system is reliable and effective or not. Internal audit assures whether both the accounting system and internal check the reliable and effective or not.
5. **Operative function and Advisory function –** Internal check is an operative function whereas internal is an advisory function.
6. **Checking and Review-** The checking function continues with the accounting function in internal check system. But internal audit only reviews the accounting function.
7. **Persons involved –** In internal check, same persons are involved in both accounting and checking. But the persons acting as internal auditors are separate individuals. They have nothing to do with accounting function.

Limitations of Internal Audit:

1. Limited ability
2. Lack of Independence
3. Use of Employees in Miscellaneous Jobs
4. Fraternity
5. Prejudices

Internal check system in different business transaction:

The business transactions can be divided into following categories from internal-check point of view:

(i) Purchase of services, assets and goods.
(ii) Sale of goods.
(iii) Cash-Receipts.
(iv) Cash-Payments
(v) Internal transactions.

Purchase of Service, Assets and Goods

With regard to services, there is a Personnel Department in big companies which performs the job of purchasing the services. For purchase of services of high categories and permanent assets, the Board of Director or top management is generally authorised.

The function of purchase can be dividend into following segments:

1. **Estimation of requirements –** Usually it is the duty of the store-keeper to send indent to the purchase department for purchasing goods, by filling up Purchase Requisition Form, mentioning the quantity of goods, quality, code number and estimated cost while a copy of the Form is kept in the Stores. The Purchase Department can place orders for the supply of goods on the basis of these Requisition forms.

2. **Placing order for Supply of goods –** After making an estimate the Purchase Department begins the activity of purchasing goods. First of all, inquiries are made from different suppliers regarding goods and information is collected in respect of price, terms of purchases and other matters. After the decision of top officer with regard to the supplier order for goods are prepared. The purchase department maintains an order book for this purchase containing order forms which bear serial numbers.

3. **Receipt of Goods-** On the arrival of goods, it must be recorded in the Goods Inward Book, provided such a book is maintained at the gate, and thereafter, the goods must be sent to the Material Stores directly, together with 'packing note' sent by the vendor. The goods has got to be weighed, counted or measured. The Store-keeper must have no authority to receive until he has received a copy of the 'Order' for Goods.

4. **Checking the Invoice and making payment-** The Receipt clerk of the enterprise sends the invoice to the Purchase Department, where the stamp of number and date of receipt has got to be put on it.

Purchases Returns and Internal Check :

As goods received are sometimes not in agreement with the order for goods or they get broken in transit, then it becomes imperative to return such goods. In this case, the internal check system shall take the following form:

1. **Intimation by Stores for Purchases Return-** If the goods received is not in accordance with the order, the Store- keeper must mention the fact in the remarks column of Goods Received Note. The intimation of goods to be returned must be sent by the Store-keeper to Purchase and Accounts Departments. It is also his duty to segregate such goods so that it may be returned soon after necessary action.

2. **Action by Purchase Department to Return Goods –** It is the Purchase Department which passes the invoice of in-coming goods. Obviously, the invoice has to be in agreement with goods Received Note sent by the Store-keeper. The Purchase Department is required to send an Advice Note annexed to the invoice, which must bear a clear advice that the purchase, return goods has got to be kept in mind, while passing the invoice.

3. **Action by Accounts Department-** The Accounts Department must check the said Advice-Note with the invoice and Goods-Received-Note received from Store-keeper. After a complete inquiry the Accounts Department must prepare a Debit Note and record it in the Purchase-Return Book.

4. **Return of Goods –** As soon as a Debit Note is received by the Purchase Department, action must be initiated to return the goods accordingly. The purchase Department must issue instructions to the Stores Clerk to pack the returnable goods and the same must be recorded in Goods Outward Book kept at the gate. The purchase Department, thereafter, must return the goods together with Packing note, Debit-note and other dispatch documents to the vendor and the Credit-note received from him must be sent to Accounts Departments, keeping back the particular with it.

Credit Sales and Internal Check

1. **Receiving Sales order and preparing copies thereof –** Order for goods is received first of al by the Sales Department. As soon as an order is required, all the particulars thereof, should be recorded in the 'Order Received Book', i.e., the date of order, quantity of goods, name of customer, date of receipt etc.

2. **Dispatch of goods-** As soon as the Dispatch Section receives a copy of the order, the in-change officer of the section issues instructions for collecting, packing and dispatching goods and the copy is sent to Stores Section for necessary action.

3. **Dispatch of Invoice-** The Invoice clerk prepares invoice in accordance with the copy of the order received from Dispatch section, which is to be signed by a responsible officer after checking it. Invoice is prepared in three copies.

4. **Accounting of Sales and Receiving Payments-** The transaction is recorded in the Sales Book in accordance with the copy of invoice in Accounts Department. This accounting should never be in the hands of the employees of Sales Department or the cashier who keeps the accounts of payments received from the customers.

Sales Returns and Internal Check

1. Receipt of intimation as well as Sales-Return from Customer,
2. Preparation of Credit-Note and its dispatch,
3. Accounting on the basis of Credit-note.

Cash Transactions and Internal Check

1. **Cash Receipts –** The internal check system in respect of cash-receipts should be so effective that accounting is done as soon as cash is received and that the due amount is actually received. Cash-received can be of three types: (a) Cash receipts by mail, (b) On window, and (c) Cash Sales.
   - **(a) Cash receipts by mail –** A responsible employee must be authorised to open the mail containing Cash, cheque, Bills of exchange, and Draft etc. This work should never be assigned to the cashier. All such mails should be duly recorded in Mail-Receipt Register and then handed over to the cashier. All documents must be crossed and the word 'Not Negotiable' put in between the lines.
   - **(b) Cash-receipt on window-** The cash-receipt clerk must issue cash-receipt-foil duly singed by authorised person forthwith to the depositor and keep counterfoil with him. After business hours the cashier must hand over all the counterfoils and the total amount of cash received to the employee who has the charge of Cash-book. He shall cash entries and put serial number of receipt against each entry. Now, a third person shall post the entries in the ledger. The other things to be noted in this context are the same as detailed heretofore regarding Cash-receipts by mail.
   - **(c) Cash-Sales-** Cash-sales can be done by any of the following manners:
     - (i) Sales at the counter
     - (ii) Sales by Travelling agents
     - (iii) Postal sales.
2. **Cash Payments:**

Frauds are common regarding payment for purchases of goods, sundry expenses, labour-charge etc.

Therefore, satisfactory evidence of each payment must be obtained. To make effective check on such payments, the system should be divided into the following divisions:

(i) Passing the payments for purchases

(ii) Preparing cheques for payment

(iii) Examining the cheques,

(iv) Accounting of the payments.

Wages and Internal Check:

The procedure of internal check for wages can be classified in four segments:

(i) Purchase of the services of labour ;

(ii) Accounting of each labourer on time and function basis;

(iii) Computing the wages of labour for a definite period;

(iv) Making payment of wages

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