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S.Y.B.Com. (Sem IV)

Auditing

PREFACE

WHY DOES A BOOK HAVE A PREFACE???

You might have read hundreds of books since your childhood. Have you ever read the preface? Some of you may say yes, but most of you might have never read the preface of the book. We too started reading preface after we started making books ourselves. A preface is basically a door to enter the book. It tells you what has been covered in the book, how you should use the book or sometimes it may also tell you how to not use a book. Most importantly, it allows the publisher to communicate with you, the reader. It gives the reader a chance to know about the motive or intention of a publisher behind publishing any book. Reading a book is more fun when you know why the maker had made it in first place.

OUR FACT FILE:

Two friends started this company around 2013. We are now a team of more than 40 people who work, rack our brains, write content, edit it, get it printed, market the books & deliver them so that they reach you. Over the years we have sold lakhs of books but that's just a number!! What really gives us satisfaction is the fact, that we could make a difference in the lives of so many students. Frankly, that is what we work for.

WHY WE PUBLISH BOOKS:

We started writing books with an aim that a student reading our book should enjoy, understand, grasp and remember the content. Over a period of time, with us, our aims also evolved. Of course, our basic aims remain the same but we realize that for a student scoring good marks & staying ahead in the competitive race is equally important. Now, we try to make books more relevant, more exam oriented and more to the point.

WHAT IS DIFFERENT ABOUT OUR BOOKS?

Some of our books are actually handwritten. It gives the reader a very personalized feel. However, that's just one aspect of our books. We feel that our greatest strength lies in asking 'why' & 'how' at every step. We are curious and we want our readers to be like that too. We want you to keep asking questions, researching about them, gaining more knowledge not just from this book but even from outside it.

HOW TO USE THE BOOK:

Now, comes the little boring part! Rather, the technical part. This book is based on the syllabus issued by the esteemed University of Mumbai. We have created various questions based on the syllabus. Read each and every question carefully. We have included smart codes and recaps to help you

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remember the content better. All the content that is given in the box is only for your understanding and should not be written in your tests/exams.

WE WANT TO TELL YOU SOMETHING MORE

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Revised Syllabus of Courses of B.Com. Programme at Semester III

w.e.f. Academic Year 2017-18

Financial Accounting and Auditing VI - Auditing

Modules at a Glance

Sr. No.	Modules	No. of Lectures
1	Introduction to Auditing	10
2	Audit Planning, Procedures & Documentation	10
3	Auditing Techniques and Internal Audit Introduction	15
4	Auditing Techniques: Vouching & Verification	10
Total		45

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CHAPTER 1 - INTRODUCTION TO AUDITING

Audit in general terms refers to "auditing the financial statements." Auditing is a very wide term and various aspects of audit have been discussed through the book.

Q.1. What are financial statements?

Ans: 1. Financial statements are systematic record of the financial activities of a business.

2. Financial statement consists of:
   i. Balance sheet
   ii. Statement of profit and loss.
   iii. Cash flow statement
   iv. Notes to Accounts
   v. Supplementary schedules based on such statements.

3. The balance sheet gives the position of assets and liabilities of an entity as on a particular date and the statement of profit and loss reflects the financial performance of the entity for a particular period of time.

4. These statements are prepared in accordance with the various guidelines and accounting standards issued by the ICAI.

5. It satisfies the information requirements of different users.

6. It is the responsibility of the management to prepare the financial statement and not that of the auditor.

Q.2. Who are the users of financial statements? What information do they need from financial statements?

Ans: Financial statements are systematic record of the financial activities of a business. The following are the users of financial statements:

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USER	Type of information needed
Shareholders	The shareholders need to know the following: i. Total profit earned by the entity by using the shareholders funds. ii. Whether the funds were used properly only for purposes of business. iii. Whether the business will be profitable and sustainable for a long period of time.
Employees	Employees need to know the following: i. Whether the company is profitable and stable from a long term perspective. ii. The expenditure incurred and investment made by the entity for employees and their benefits.
Lenders	The lenders i.e. banks and financial institutions of the entity understand the following from the financial statements: i. Whether the company is profitable so that it can repay the interest as well as the principal amount to the lenders. ii. Whether the funds which are lent for business purposes are used only for the purpose of business.
Creditors	Creditors are entities who provide goods and services to other entities on credit basis. Creditors need to know whether their outstanding will be paid in time.
customers /	Customers and the society need to know if

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Society	the supply of goods will be constant over a period of time as they depend on the entity for their needs for goods.
Government	The government needs to know the following : i. Whether the company is declaring correct profits and paying proper taxes on the same. ii. The government also gets to know how the industry is performing and can accordingly keep a track of the economy's progress.
Prospective investors	Whether investing in the company is viable or not ?

Q.3. What is auditing ? What are the objects of auditing ?
Ans: Auditing refers to examination of accounting and financial records to ascertain and give opinion whether such records show true and fair view or not.

Auditing has been defined as follows :

1. Prof. L.R. DICKSEE
"Auditing is an examination of accounting records under-taken with a view to establish whether they correctly and completely reflect the transaction to which they relate."

2. INTERNATIONAL AUDITING GUIDELINES
"Auditing is an independent examination of financial information of any entity with a view to expressing an opinion thereon."

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3. AUDITING STANDARD SA 200 ISSUED BY ICAI

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

[For your knowledge :- In India, only practising chartered accountants are allowed to audit accounts of the company. Institute of Chartered Accountant of India (ICAI) is the governing body which regulates the working of CA's]

The following are the objects of auditing :

1. PRIMARY OR BASIC OBJECTS :

The primary object of audit is to enable the auditor to express an opinion whether

i. Balance sheet gives true and fair view of the financial position of the entity and
ii. Profit and loss statement gives true and fair view of the financial result of the entity.
iii. All material items are disclosed
iv. Final accounts comply with the requirement of law.

2. SECONDARY OR INCIDENTAL OBJECTS :

Secondary object of an audit is detection and prevention of errors and frauds. The auditor has to check books of accounts, documents, vouchers, etc. to ensure that the accounts are free from errors and frauds so as to give a true and fair picture. If the auditor comes across errors or frauds in the accounts, then he has to take proper action. He has to ensure that the management has set proper internal controls to avoid errors and frauds.

NOTE : The auditor is not required to give an opinion about

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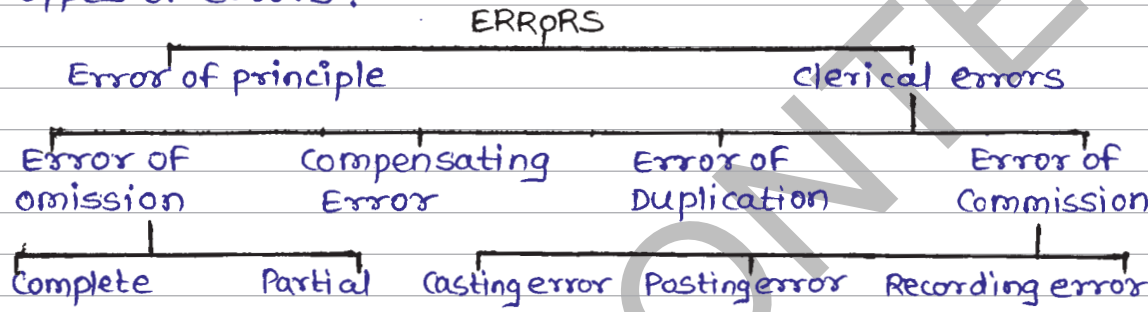
future prospects of entity and its efficiency.

Q.4. What are the different types of errors?
Ans: Error is an unintentional mistake which results in misstatement of books of accounts. The following are the types of errors :



ERROR OF PRINCIPLE : (Apr'16)
Error of principle occurs when any of the generally accepted accounting principles are violated. Such error does not affect the trial balance.

Examples :
i) Treating revenue expense as capital expenditure and vice-versa.
(Eg: Motor vehicle expenses debited to Motor Vehicle A/c)
ii) Over or under charging of depreciation.
iii) Ignoring pre-paid or outstanding expenses.
iv) Over estimating or under estimating amount of provision for bad debts.
v) Ignoring income received in advance or income accrued.
vi) Over valuation of an asset or liability.

CLERICAL ERRORS :
Clerical errors are human errors which are committed in the process of recording financial transaction. Following are the types of clerical errors :

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1) ERROR OF OMISSION:

Error committed by not recording transaction in the books of accounts is called error of omission. Such omission may be complete or partial.

ERROR OF OMISSION

- Complete omission
- Partial omission

COMPLETE OMISSION	PARTIAL OMISSION
When a transaction is not recorded at all in the books of accounts then it is a case of complete omission. Such omission does not affect trial balance. Eg: Sales transaction not recorded at all.	When a transaction is recorded only partially then it is a partial omission, such errors affect the trial balance. Eg: Goods sold to customers recorded only in sales book and omitted to be recorded in party's ledger.

Error of omission can be detected through:

a. Vouching and verification
b. Ledger scrutiny
c. Balance confirmation.

Strong internal controls are required to prevent or reduce errors of complete omission.

NOTE: In current times with use of advanced accounting packages, partial omission does not take place because double entry system gets followed automatically.

2) ERROR OF COMMISSION:

The errors which are committed while posting a transaction are called errors of commission.

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ERROR OF COMMISSION

Casting Error | Posting Error | Recording Error

Casting or Totalling Errors	Posting Errors	Recording Errors
Casting errors are committed while taking the totals or carrying forward balances in day book or ledger account Eg. Total of sales book calculated as RS. 1000 instead of RS. 900.	Posting errors may occur by way of a) Posting wrong amount Eg. Posting RS. 1000 instead of RS. 100. b) Posting to the wrong side of the account. Eg. Posting on Dr. Side instead of Cr. Side c) Posting to the wrong account. Eg. Posting to Mr. A's account instead of Mr. B's account.	Recording errors are errors which are neither casting errors nor posting errors. They are basic errors in passing accounting entries. Eg. Recording a sale transaction as a purchase transaction.
Such errors affect the trial balance.	a) and b) will affect the trial balance. While c) will not affect trial balance.	Such errors do not affect the trial balance.

Errors of commission can be detected through:
a. Ledger scrutiny
b. Balance confirmation from parties
c. Ratio analysis
d. Comparison to previous years figures.

NOTE: In current times, due to use of advanced accounting packages, it is not possible for a casting error to take place as the totalling or casting is done automatically in the system.

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3) COMPENSATING ERRORS :

When two or more errors are committed in such a way that the effect of one error is cancelled or nullified by the other, then such errors are called compensating errors. In short, one error cancels the effect of another error. They do not affect the trial balance.

Examples :

a. If one sales bill of Rs.50,000 is not recorded and simultaneously one purchases bill of Rs.50,000 is also not recorded then they are called as compensatory error. It does not have any impact on the trial balance as the omission of sales bill has been compensated by the omission of the purchase bill.

b. If one purchase bill of Rs. 2 lacs is posted in the account of Reliance Industries Limited instead of Reliable Industries Limited and sales bill of Rs.2 lacs is posted in Reliable Industries Limited instead of Reliance Industries Limited, then it is called as a compensating error. There is no effect on the trial balance as posting error of one bill is compensated by posting error of another.

Compensating errors can be detected through :

a. Ledger scrutiny
b. Balance confirmation from parties
c. Vouching.

4) ERROR OF DUPLICATION :

Such errors arise when an entry is recorded twice in the books of accounts. Such errors do not affect the trial balance because both the debit and credit effect are passed correctly.

Examples :

a. Reimbursement of expenses of the company driver, Mr.

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Ramu – Rs. 626 booked twice.

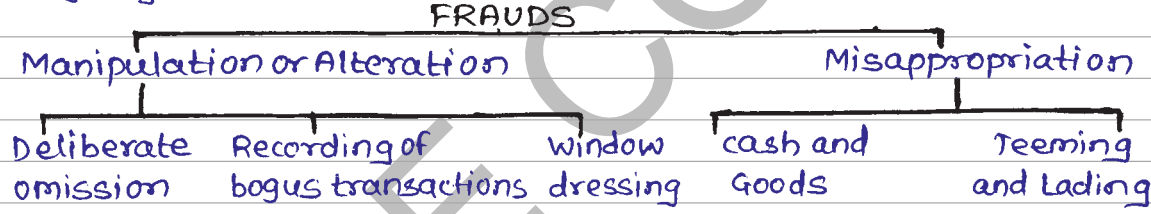
b. Debit note issued by a client for faulty material supplied booked twice.

Errors of duplication can be detected through:

a. Ledger scrutiny
b. Balance confirmation from parties
c. Vouching

Q 5. What is a fraud? What are the types of frauds?

Ans: Fraud means intentional or deliberate misrepresentation of financial information by management or any employee or any third party with an objective to cheat others or make illegal gains.



1) MANIPULATION OR ALTERATION OF ACCOUNTING RECORDS:

i. DELIBERATE OMISSION:

A transaction may not be recorded at all in the books of accounts.

Eg: A cash sale of Rs. 20,000 done by a marketing executive of the company was not informed by him to his superior. He sold the goods and kept the cash with himself. This is example of a fraud done by an employee.

ii. RECORDING OF BOGUS TRANSACTION:

Dummy or bogus transactions may be recorded in order to manipulate the financial position and profit & loss of the company.

Eg: The management may record dummy expenses to show

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lower profit and thereby pay lower taxes to the government.

iii. WINDOW DRESSING:

Window dressing refers to presentation of accounts in a way that it shows a better financial position than the actual position. It is done generally by companies which are listed in stock exchanges or who have applied for a loan from banks. It is done by overvaluation of the assets or undervaluation of liabilities.

2) MISAPPROPRIATION

i. MISAPPROPRIATION OF CASH :

Following are the ways of misappropriation of cash:

- By not recording cash received
- By entering lesser amount in the books.
- By recording excess or dummy cash payments.
- Actual theft of cash.

ii. MISAPPROPRIATION OF GOODS :

Following are the ways of misappropriation of goods:

- By not recording goods received
- Recording only part of goods received
- By recording excess or dummy sales
- Actual theft of goods from warehouse.

iii. TEAMING AND LADING : (Apr'16)

Cash received from a customer Mr. Rahul may be used by an employee for his own personal purpose. To hide the same, he may record cash received later on from Mr. Rohan as cash received from Mr. Rahul and record cash received later on from Mr. Kamlesh as cash received from Mr. Rohan and so on. This fraud done by employees is called teaming and lading. This process goes on till the fraud is discovered.

Q.6. What are the circumstances that indicate errors and frauds ?

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Ans: Error is an unintentional mistake which results in misstatement of books of accounts. Fraud means intentional or deliberate misrepresentation of financial information by management or any employee or any third party with an objective to cheat others or make illegal gains.
The following circumstances indicate errors and frauds:

1. There is a high attrition in accounts department.
2. There have been sudden exits at the top management level.
3. Credit sales are recorded but there is lack of proper documentation and money has not been received for a long period of time.
4. When certain vouchers, invoices, documents are missing.
5. When balance confirmation is not sent by parties even after a request sent by the auditor.
6. When certain transactions are done or entries are passed for which the management is not able to give a satisfactory explanation.
7. There are many transactions with related parties.
8. There is a drastic change in accounting ratios as compared to previous year.
9. When accounts staff does not readily give any explanation to queries of the auditor and consults higher authorities prior to providing any explanation.
10. There is payment or receipt of money from unknown persons who are neither customers nor vendors.

Q.7. What is the responsibility of the auditor with respect to errors and frauds?

Ans: Error is an unintentional mistake which results in misstatement of books of accounts. Fraud means intentional or deliberate misrepresentation of financial information by management or any employee or any third party with an

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objective to cheat others or make illegal gains.
'Standards on auditing (SA) 240' issued by ICAI lays down the responsibilities of an auditor regarding errors and frauds in the financial statements, which are summarised as follows:

(Smart Code : PACCA)

1) PRIMARY RESPONSIBILITY OF MANAGEMENT

Management is primarily responsible for prevention and detection of errors and frauds by implementing a good internal control system.

2) AUDITOR'S RESPONSIBILITY

Detection of errors and frauds is a secondary objective of an audit. However, the auditor should take steps to detect errors & frauds and ensure that the accounts are free from major errors and frauds. For the accounts to be true and fair, it is important that they are free from major errors and frauds.

3) CARO

Under Companies Auditor Report Order (CARO) 2003, the auditor is required to report whether any fraud is noticed and if so, then the auditor has to report:

i. the nature of the fraud
ii. the amount involved

4) CONFIRMATION OF ERROR AND FRAUD

When any error is confirmed, auditor should ensure that management has rectified the same. Further, when any fraud is confirmed, auditor should report the same to an appropriate person.

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5) AUDITOR NOT TO BE HELD RESPONSIBLE:

The auditor cannot be held responsible for undetected errors and frauds if he had taken reasonable steps to detect them.

Q.8. What are the inherent limitations of audit?
Ans: Auditing refers to examination of accounting and financial records to ascertain and give opinion whether such records show true and fair view or not.
The following are the limitation of audit:

(Smart Code: MITATION)

1. MAY BE MISLED BY WORK OF OTHERS
The auditor cannot have all the knowledge in all the fields. Therefore he has to depend on reports or work done by others such as lawyers, engineers, internal auditors which might be misleading.

2. IT MAY NOT BE POSSIBLE TO CHECK IN DETAIL
Due to time constraints and large volumes of business, it is not possible for the auditor to check each and every transaction. He may check some areas of the audit on sample basis.

3. THE ACCOUNTS STAFF MAY NOT BE CO-OPERATIVE
The accounts staff may consider the auditor to be an enemy who comes to point out their mistakes. Therefore, they may not co-operate with him. On the other hand, they may also be relaxed and complacent in their work knowing that the auditor will rectify all that has been done wrongly.

4. AUDIT EVIDENCE IS NOT CONCLUSIVE
Audit evidence which is collected by the auditor during the audit aids him in giving an opinion. It is persuasive in nature. It is not conclusive. Audit evidence gives reasonable assurance and not complete assurance,

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5. TRANSACTIONS NOT RECORDED CANNOT BE AUDITED

The books of accounts and other documents presented to the auditor is the only matter which the auditor has to depend and work on. His opinion shall be based on financial statements prepared on the basis of data provided to him. If there are transactions which are not recorded at all, it won't come under the audit scanner.

6. INDEPENDENCE ISSUE ALWAYS EXISTS

The auditor gets fees from his clients for auditing their books of accounts. Auditors who have a major portion of their income from few clients might not issue a negative or qualified audit report. The auditor might fear that he might be replaced by some other auditor.

7. OPINION IS SUBJECTIVE

There are many guidelines and case laws which aid the auditor in giving an opinion. However, eventually, he has to use his own skill and judgement in giving an opinion on the financial statements. Thus, there is an element of subjectivity involved. In simple words, the opinion of different auditors may be different.

8. NOT ALL FRAUDS CAN BE DETECTED

A fraud which has been planned deeply by the management in order to deceive the users of financial statements may be very difficult to detect even for an auditor with good experience.

Q.9 What are principles of audit laid down in SA-200 by the ICAI?

Ans: SA-200 issued by ICAI lays down the basic principles which governs audit. They are explained as follows:

(Smart Code : PRINCIPLE)

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1) PRINCIPLE OF INTEGRITY, OBJECTIVITY AND INDEPENDENCE

- Integrity implies that auditor should be honest & sincere in his professional work.
- Objectivity implies that auditor must be fair and should not be bias in his approach.
- Independence implies that auditor should be free from any interest which may lead to an improper opinion. (Eg. An auditor may not be able to give a proper opinion in a company where the owner or any accounts officer is a relative of the auditor).

2) REPORTING AND CONCLUSIONS

The auditor should review and assess the conclusions drawn from the audit evidences. Based on the conclusion drawn the auditor's report should contain an opinion on financial statements which may be unqualified or qualified or adverse.

3) INTERNAL CONTROL AND ACCOUNTING SYSTEM

The auditor should study and evaluate the internal control system. He should understand the accounting system adopted by the management to perform the audit more effectively.

4) NEED FOR DOCUMENTATION

The auditor should document matters relating to audit to prove that the audit was carried out in accordance with the basic principles governing audit.

5) CONFIDENTIALITY

The auditor should maintain confidentiality of information acquired during his work. He should not disclose any such information to a third party without specific permission of client.

6) INDIVIDUALS WITH SKILL AND COMPETENCE

The audit should be performed with due professional care by individuals having adequate training, experience, skill and competence.

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7) PLANNING

The auditor should plan his work to conduct audit in effective and timely manner. An auditor may prepare an audit program for this purpose. The auditor may also revise the audit program whenever required in the interest of the audit.

8) LAWYERS, AUDIT STAFF AND WORK DONE BY OTHER AUDITORS

The auditor can delegate work to assistants or use work performed by other auditors and experts. However, he should satisfy himself that work done by others is reliable, by carrying out necessary audit procedures.

9) EVIDENCE

The auditor should obtain sufficient and appropriate evidence through vouching of transactions, verification of assets and liabilities and other audit procedures. The opinion of the auditor should be based on the audit evidence collected during the audit.

Q.10. Explain the basic auditing concept of "going concern" & **[NOT IN SYLLABUS]**

Ans: 1. Going Concern is a fundamental accounting assumption (AS-1). Going concern refers to the intention and ability of an entity to exist in the foreseeable future i.e. a period of one year.

2. The entire accounting of the entity is done assuming that the entity will continue in the foreseeable future.

3. If the assumption is not true, then the value of assets and liabilities has to be changed accordingly.

4. The following factors indicate that an entity is not a going concern:

Negative working capital

a. Negative cash flow

b. Closure of manufacturing plant

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c. Staff cutting in large numbers
d. Inability to pay creditors
e. Adverse key financial ratios
f. Loss of key management personnel.
g. Loss of major customer
h. Decreasing production trend
i. Major liability in legal suit
j. Change in government policies
k. Failure to pay tax to the government

5. SA 570 deals with the basic auditing concept of Going Concern. It lays the auditor's duty with regards to the going concern assumption of an entity.

6. Generally, no specific disclosure of the going concern assumption is required in the financial statements. However, when the assumption is not followed or when there is a suspicion in the mind of the auditor, he should collect enough evidence before giving an opinion on the same. The auditor can collect evidence from the following:
   a. Discussing the company's future plans with the management.
   b. Discussing with the management the cash flow statement, future profit projections, funding plans etc.
   c. Discussing with the legal team regarding pending cases.
   d. Verify agreements relating to long term loans and check if there has been any restructuring of the same.
   e. Review events after the balance sheet date and verify if any event has taken place which affects the assumption of going concern.
   f. Obtain a Letter of Representation from the management regarding the going concern assumption and related matters.

7. The auditor has to issue a report after taking into

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considering the various evidences that have been collected by him. The auditor may give the following opinion in different circumstances:

a. When the going concern assumption is appropriate - Unqualified report.
b. When the going concern assumption is not appropriate but the management provides an explanation which mitigates the unfavourable factors - Unqualified report. However, the auditor needs to provide adequate disclosure in notes to accounts and invite attention of the shareholders to these notes.
c. When the auditor has doubts regarding the going concern assumption and the explanation provided by the management is not satisfactory - Qualified report.
d. If the assumption of going concern is not appropriate - Adverse report.

Q.11. Explain the "materiality" concept ?

Ans: 1) SA-320 deals with the concept of materiality.
2) Material means important from the perspective of the audit. The auditor should consider materiality when conducting an audit.
3) Any information may be considered material if its misstatement could influence the decision of the users of the financial statements.
4) Explaining further, an information may be considered material if it either individually or in the aggregate are relatively important for the true and fair presentation of the financial statements.
5) Materiality is subject to the professional judgement of the auditor while conducting an audit.
Eg: The auditor of Infosys might decide that only vouchers

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above Rs. 10,000 need to be vouched. On the other hand, the auditor of a small private limited company might decide that vouchers above Rs. 500 need to be vouched.

6) The basic factor on which materiality depends is the size and nature of the item. Therefore, it is not necessary that only financial information is material. Even non-financial information which may have an impact on the decision of the users can be material. The disclosure of non-financial items can be done in the notes to accounts.

7) As mentioned earlier, materiality is subject to professional judgement. However, materiality is even influenced by the laws. The law may require compulsory disclosure of the certain items. Schedule VI of the Companies Act requires compulsory disclosure of the following items separately:

a. Any debit or credit in the P&L Account on account of a transaction of exceptional nature or a non-recurring transaction.

b. Any expenditure which exceeds Rs 1,00,000 or 1% of the turnover of the company whichever is higher. (i.e. if turnover is Rs 2 crores, then 1% of turnover is Rs. 2 lacs and then any item of expenditure exceeding Rs. 2 lacs would be material and disclosed separately)

c. If an item was material in the previous year, then its corresponding figure in the current year also has to be disclosed separately

The term 'disclosed separately' means that the item of expenditure cannot be clubbed with any other item or under miscellaneous expenditure.

8) As per Accounting Standard 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", the following shall be material:

a. Extraordinary items

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b. Prior-period items
c. Changes in accounting policies which has a material effect

9) Materiality of items has to be considered by the auditor while presenting the financial statements for a true and fair view.

Q. 12. Explain the concept of "true and fair view"?
Ans: Auditing refers to examination of accounting and financial records to ascertain and give opinion whether such records show true and fair view or not. There are various users of financial statements and they can rely on it to make a decision only if the auditor reports that the accounts are true and fair.

The accounts are said to be true and fair only if:
1. The profit or loss shown in the Statement of Profit and Loss is true and fair.
2. The value of assets & liabilities shown in the Balance Sheet is true and fair.

There is no specific definition of "true and fair" under any law. However, the accounts are true and fair if:
1. CONFORM TO ACCOUNTING PRINCIPLES
The books of accounts are maintained as per normally accepted accounting principles.
2. MATERIAL FACTS ARE DISCLOSED
As per the concept of materiality, items that are material as per the professional judgement of the auditor and as per the Companies Act have been disclosed separately.
3. ACCOUNTS ARE PREPARED AS PER REQUIREMENTS OF THE LAW
The final accounts are prepared in the format prescribed under Schedule VI to the Companies Act, 1956 and all the

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items required to be disclosed have been properly disclosed.

4. GUIDELINES OF ICAI ARE FOLLOWED

The Institute of Chartered Accountants of India keeps issuing various guidance notes from time to time. The accounts comply with the guidelines issued by the ICAI

5. NO WINDOW DRESSING OR SECRET RESERVES

The accounts show the actual financial position as it is i.e. the profits and net worth are neither understated nor overstated. The accounts show actual position only when:

a. Final accounts agree (match) with the books of accounts

b. ASSETS

All assets are valued properly. There is proper provision for depreciation. There is proper provision for bad and doubtful debts. Intangible assets are written off properly. Revenue expenditure is not treated as capital expenditure.

c. LIABILITIES

Liabilities are not understated. All contingent liabilities are disclosed in notes to accounts and not treated as actual liabilities. Provision is made for all known losses and liabilities.

d. PROFIT AND LOSS A/C

Transactions are recorded on accrual basis. Any advance received is not recorded as income. Expected income is not recorded as income. All known and accrued expenses till the date of balance sheet are booked.

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NOTES

Q.13. What are the various types of audit ?

Ans : Auditing refers to examination of accounting and financial records to ascertain and give opinion whether such records show true and fair view or not.

The following are the types of audit :

1. Statutory Audits
2. Non-Statutory Audits or Voluntary Audits.

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1. STATUTORY AUDITS

As the name suggests, statutory audits are audits which are compulsory under a statute i.e. law. The audit is governed by the provisions of the respective law. The auditor has to follow the provisions of the law while conducting the audit.

Sr.No.	Form of Organization	Act
1.	Company	Companies Act, 1956.
2.	Banks	Banking Companies Regulation Act, 1949
3.	Insurance Companies	Insurance Act, 1938
4.	co-operative societies	Co-operative Societies Act relevant to the particular state Eg.: Maharashtra Co-operative Societies Act, 1960
5.	Public Charitable Trusts	Act under which the trust is registered.
6.	Statutory Corporations eg. LIC, GIC, ICAI, RBI etc.	Special Act of Parliament.
7.	Electricity Companies	Electricity Supply Act, 1948
8.	Persons liable to pay tax	Tax Audit under Income Tax Act, 1961.

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2. NON-STATUTORY AUDITS

Non-Statutory audits are audits that are not compulsory i.e. organizations may get such audits conducted voluntarily. The following are examples of certain non-statutory audits:

i. Systems Audit
ii. Operations Audit
iii. Management Audit
iv. Environmental Audit
v. Internal Audit.

Q.14. What is a continuous audit? What are the merits and demerits?

Ans: **MEANING:**

i) Continuous audit refers to an audit in which auditor conducts auditing process at regular intervals through out the year and not just after the end of the year. Eg. Say for FY 2012-13, auditor conducts audit from April 2012 itself at regular interval throughout the FY 2012-13.

ii) It does not mean that audit is conducted throughout the 365 days, but implies that audit is conducted once in month or two at regular intervals.

iii) Continuous audit is required when the volume of transactions is very large or when accounts are required quickly after the end of the year.

SAMPLE CONTENT

iv) Generally listed companies or a company with a very high turnover may opt for continuous audit.

ADVANTAGES:

(SMART CODE : DUA And Medicines For Every Patient)

i) **DISCOVERY OF ERRORS AND FRAUDS IN TIMELY MANNER**
It helps the auditor to prevent error and fraud and even if there is any error or fraud, it can be detected in a timely manner.

ii) **UP-TO DATE ACCOUNTS :**
Continuous audit helps to keep accounts up to date. The up to date final accounts are useful to banks and investors for taking decisions regarding loans and investments.

iii) **AUDIT STAFF :**
The audit staff can be kept busy throughout the year and work load get evenly distributed.

iv) **AUDIT WORK QUALITY IS GOOD :**
The auditor has ample time to do a thorough checking of all the transactions. Hence, the quality of audit work improves.

SAMPLE CONTENT

v) MORAL CHECK ON EMPLOYEES :
Since the auditors visit regularly throughout the year, it acts as a moral check on employees and the chances of frauds are reduced. Employees know that they are being watched.

vi) FAMILIAR WITH BUSINESS :
Regular visits enable the auditor to get familiar with all aspects of client's business. This also helps the management to discuss various issues with the auditor and take his advice when required.

vii) EARLY DIVIDENDS :
It helps the company to pay final dividend on timely basis and further facilitates payment of interim dividend.

viii) PREPARATION OF FINAL ACCOUNTS AND AUDIT REPORT IS QUICK :
Since audit is done on a continuous basis, the final accounts and the audit report can be prepared quickly.

DISADVANTAGES :

(SMART CODE : Burger At MAC D)

i. BACK DATED ENTRIES
Figures in the books of accounts which are already audited

SAMPLE CONTENT

by the audit staff may be changed and this would be very difficult to detect. However, now advanced accounting packages allow a certain period to be locked so that no changes are made therein.

ii) **ACCOUNTS STAFF BECOMES TOO DEPENDENT ON AUDITOR :**
The account staff may become dependent on the auditor. They may require the help of auditor even on small rountine matters.

iii) **MONOTONOUS & TEDIOUS :**
Continuous audit may make the work tediaus and monotonous for the audit staff. The quality of work suffers.

iv) **ABSENCE OF LINK :**
Since the audit is done at intervals, the auditor may miss the link between two visits. The audit staff may overlook some unsolved queries raised in previous visit.

v) **COSTLY :**
Since the auditor spends more time on audit work, the audit fees will be high and hence it is expensive for the company.

vi) **DISTURBANCE IN ACCOUNTING WORK :**
Continuous audit may disrupt the routine accounting work of the client. The employees have to attend to the auditor for explanation whenever a query is raised.

SAMPLE CONTENT

PRECAUTIONS TO NEGATE DISADVANTAGES:

i) **SUITABLE TO LARGE COMPANY:**
Since continuous audit is expensive, only a large organisation should opt for it.

ii) **CO-ORDINATION WITH CLIENT:**
The audit programme should be co-ordinated with the client to avoid disruption in routine accounts work.

iii) **CLARIFY SCOPE OF AUDIT:**
The auditor should make clear to the client the scope and nature of audit so that he can keep his distance from routine matters.

iv) **ROTATION OF AUDIT STAFF:**
The audit staff must be frequently rotated to prevent the audit from being monotonous and tedious.

v) **NO ALTERNATIONS IN AUDIT WORK:**
Once the entries are checked by the auditor, no alternations should be allowed to be made. The auditor should put secret ticks against figures to detect alteration of figures.

vi) **AUDIT PLANNING & AUDIT NOTES:**
Audit should be well planned. All queries should be noted

SAMPLE CONTENT

in the audit note book by the auditor and they should be cleared before taking up fresh work.

Q.15. What is a Final Audit? What are its advantages and disadvantages?

Ans : Final audit is the most common type of audit. In general parlance, audit is referred to final audit only.

MEANING :

Annual audit refers to an audit which generally starts after the end of accounting or financial year. In India, a financial or accounting year is 1st April to 31st March. Eg. For FY 2012-13, auditor conducts audit only after the end of FY i.e. from April 2013.

ADVANTAGES :

NOTE : Advantages of final audit are opposite of the disadvantages of continuous audit.

i) **LESS EXPENSIVE :**

In an annual audit, the audit team visits the client's place only once i.e. after the end of the financial year. Therefore, the auditor may charges relatively lesser fees. Also, expenses on conveyance and refreshment of the audit team reduce accordingly.

SAMPLE CONTENT

ii) NO DISTURBANCE IN ROUTINE ACCOUNTING WORK :
Since the audit team is not present at the client's place round the year, the routine work of the accounts and finance department does not get affected.

iii) NO CHANGE OR ALTERATION OF FIGURES :
The auditor visits the client place for audit only after the financial year is complete and all entries relating to the financial year have been passed. Therefore, generally, no back dated entries are passed in the books for the previous financial year.

iv) PROPER LINK :
Unlike a continuous audit, the final audit is conducted at a stretch. There are no breaks between the audit. Hence, there is no question of absence of link.

v) NO MONOTONY IN WORK
The final audit is conducted at a stretch and a considerably fast speed within a limited time frame. Therefore, the audit staff may conduct audits of many different companies in a year. As a result, monotony does not set in.

vi) ACCOUNTS STAFF MAY NOT DEPENDENT ON THE AUDITORS :
The auditors are not present at the client's office round the year and hence the accounts staff uses their own knowledge in various accounting matters. They do not

SAMPLE CONTENT

depend on the auditor for help on routine matters. However, they may take advice of the auditor regarding complicated transactions.

DISADVANTAGES:

NOTE: Disadvantages of final audit are opposite of the advantages of continuous audit.

i) **DELAY IN FINAL ACCOUNTS:**

The final audit begins after the end of the financial year. During such audit, transactions that have taken place throughout the year are required to be audited which becomes very time consuming. As a result, there is a delay in preparation of audited final accounts.

ii) **DELAY IN DISCOVERING OR ERRORS AND FRAUDS:**

Since the final audit begins only after the end of the financial year, there is a huge time gap between accounting and auditing. As a result, any errors or frauds which have taken place during the year are discovered only after the end of the year. Till then, the damage might be already done.

iii) **NOT A THOROUGH AUDIT:**

A final audit is to be completed within a limited time span. Therefore, the auditor might use the audit procedure of sampling wherein only a part of the transactions are

SAMPLE CONTENT

audited. As a result, some transactions may get ignored. Hence, a final audit cannot be said to be a complete or a thorough audit.

iv) **NO MORAL CHECK ON EMPLOYEES:**
The final audit is conducted only after the end of the year. Therefore, since the auditor is not present on a consistent basis, there is no moral check on the employees.

v) **NO FAMILIARITY WITH CLIENT BUSINESS:**
The auditor is not present in the client's office continuously and hence he might not be very familiar with the client's business. Discussion with management and other officers after the end of the financial year may not be sufficient to gain knowledge.

vi) **PRESSURE ON AUDIT STAFF DURING PEAK PERIOD:**
The work pressure for the audit staff is uneven in case of final audits. They may be busy at the end of the financial year when final audits take place and may be relatively less busy during other times.

vii) **NOT SUITABLE FOR LARGE ORGANIZATIONS:**
Large organizations might not find final audit suitable because of the sheer large volume of transactions. Moreover, large organizations might require accounts to be submit audited accounts to banks on a regular basis.

SAMPLE CONTENT

State accounts are useless for banks and investors.

Q.16. What is an interim audit? What are its advantages and disadvantages?

Ans:

MEANING:

Interim audit is an audit of interim financial statements. which are prepared between two annual financial statements. Hence interim audit is conducted between two annual / final audits. Generally, in India, it is conducted for the period from 1st April to 30th September (i.e. 6 months).

CIRCUMSTANCES:

Interim audit is conducted under following circumstances:

i) **QUARTERLY RESULTS:**

Public limited companies listed on stock exchange are required to declare quarterly result. It is advisable that such company declare quarterly results based on interim audit.

ii) **INTERIM DIVIDENDS:**

Interim audit is advisable when a company wants to declare interim dividends. The audit ensures that the declaration of interim dividends is justified.

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iii) **SALE OF BUSINESS** :
In case of a sale of business, interim audit is necessary to fix the sale price of the entire business.

iv) **CHANGES IN FIRM** :
It becomes necessary to conduct interim audit in case of admission, retirement or death of a partner in a partnership firm.

ADVANTAGES :
NOTE : Advantages of interim audit are similar to advantages of continuous audit.

i) **HELPS TO PUBLISH QUARTERLY RESULTS** :
Companies listed on stock exchanges are required to publish quarterly results. These quarterly results are required to be audited and hence interim audit helps to comply with that provision.

ii) **DISCOVERY OF ERRORS AND FRAUDS**
Interim audit helps faster detection and prevention of errors and frauds.

iii) **UP-TO DATE ACCOUNTS**
The up to date accounts are useful to banks and investors for taking decisions regarding loans and investments.

SAMPLE CONTENT

iv) INTERIM DIVIDENDS

Interim audit helps in declaration of interim dividend. This helps the company to develop good investor relations

v) MORAL CHECK ON EMPLOYEES

Since the interim audit is done between the two annual audits, it acts as a moral check on employees and the chances of frauds are reduced.

vi) AUDIT STAFF

The audit staff can be utilised in a better manner as work gets evenly distributed. Also, at the end of the financial year, only the transactions for the second half of the year need to be checked. Hence, the volume of work reduces.

vii) PREPARATION OF FINAL ACCOUNTS AND AUDIT REPORT IS QUICK

Since interim audit is carried out, the final accounts and the audit report can be prepared quickly at the end of the year.

viii) Quality OF AUDIT WORK IMPROVES

Due to interim audit, the auditor gets enough time at the time of final audit which helps him to check at material items in proper manner.

SAMPLE CONTENT

DISADVANTAGES :

NOTE : Disadvantages of interim audit are similar to disadvantages of continuous audit.

i) **BACK DATED ENTRIES**

Figures in the books of accounts which are already audited by the audit staff may be changed and this would be very difficult to detect. However, now advanced accounting packages allow a certain period to be locked so that no changes are made therein.

ii) **ABSENCE OF LINK :**

Since there is a gap of six months between two audits, the auditor may miss the link between two visits, The audit staff may overlook some unsolved queries raised in previous visit.

iii) **COSTLY :**

Since the auditor spends more time on audit work, the audit fees will be high and hence it is expensive for the company.

iv) **DISTURBANCE IN ACCOUNTING WORK :**

Interim audit may disrupt the routine accounting work of the client. The employees have to attend to the auditor for explanation whenever a query is raised.

SAMPLE CONTENT

Q.17. What is a balance sheet audit ?

Ans :

MEANING:

Balance sheet audit is an audit in which all the balance sheet items are verified and only those items in P&L account are verified which are directly related to assets and liabilities such as depreciation, bad debts, etc.

CIRCUMSTANCES :

Balance sheet audit is suitable under the following circumstances :

i. Where the volume of transactions is very large.
ii. Where the system of internal control is very strong and effective.
iii. Where qualified accountants are employed and accounts are computerized.

PROCEDURE :

Balance sheet audit is conducted as follows:

1. **INITIAL REVIEW :**

The auditor should review effectiveness of internal control system. Based on the evaluation of internal controls the auditor should plan his audit programme.

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2. ACTUAL PROCESS :

After review of internal control auditor conducts the following :

i. Physical verification of major items of assets and liabilities.
ii. Checking valuation of assets & liabilities.
iii. Inspection of ownership documents of major assets.
iv. Vouching major transactions on sample basis.
v. Verify account of depreciation charged, bad debts, etc.
vi. Confirmation from debtors and creditors.
vii. Verifying whether presentation & disclosure of assets & liabilities is according to the accounting policies and requirements of law.

3. FINAL CHECK :

i. Compare each item of profit & loss account and balance sheet of current year with that of previous year and find out any material difference.
ii. Check major ratios & examine cause of variation.
iii. Check all non-recurring transactions.
iv. Check the statements of sources & application of funds.
v. Apart from the verification of the books of accounts, the auditor should also check the minutes book, have discussions with the legal department regarding pending cases and ascertain if any matter may have any impact on the books of accounts.

SAMPLE CONTENT

Q.18. What is concurrent audit?

Ans:

MEANING:

Concurrent audit is an audit of transactions concurrently as the transactions takes place. It is an audit which is prevalent in large banks, mutual funds, insurance companies etc. Statutory bodies which regulate the working of these institutions have laid down the guidelines for the concurrent audit.

Eg.: SEBI issues guidelines regarding concurrent audit of mutual funds, the IRDA issues guidelines regarding concurrent audit of insurance companies and RBI issues guidelines regarding concurrent audit of banks.

OBJECTIVE:

The objectives of concurrent audit are:

i. To verify the authenticity of the transactions on regular basis.
ii. To ensure timely detection of irregularities and prevention of fraud.
iii. To improve the functioning of the organization.
iv. To identify areas requiring corrective action and urgency.

SCOPE:

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The scope of concurrent audit (with respect to banks) is as follows:

i. To check daily cash transactions with special attention to abnormal receipts and payments if any.
ii. To verify that advances are in accordance with guidelines of RBI.
iii. To rectify the irregularities immediately.
iv. To verify the purchase & sale of investment.

Any errors are reported to the branch manager for rectification. However, the auditor may report to the Controlling Office if there is any major irregularity or errors reported are not rectified within a certain period of time.

The scope of concurrent audit (with respect to mutual funds) is as follows:

i. Verify calculation of NAV on daily basis.
ii. Ensure that the NAV of all the schemes of the mutual fund is uploaded on time.
iii. Verify that investments are done backed by proper research reports.
iv. Verify that purchase and repurchase requests are completed within reasonable period of time.
v. Check that complaints are solved and cleared regularly.

Any errors are reported to the Chairman or Chief Officer of the Asset Management Company. If rectifications are not done, then the matter may be forwarded to SEBI.

SAMPLE CONTENT

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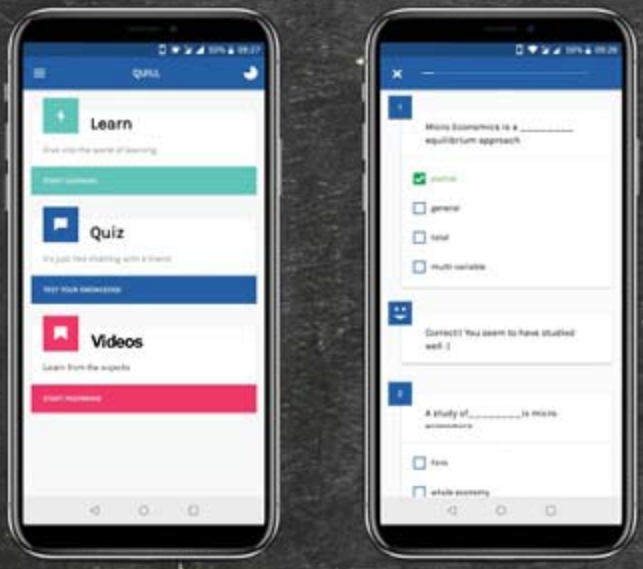

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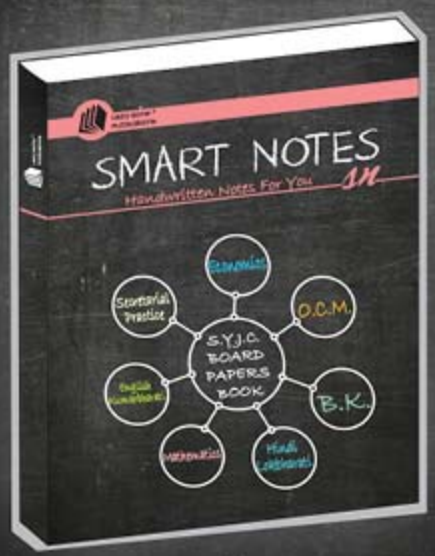

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